

**SBH NEWSLETTER**

# Thoughts on the Current Environment



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***“If something cannot go on forever, it will stop.”***

-Herbert Stein, “Stein’s Law”

The U.S. stock market finally provided some fireworks in the first quarter. Just like the best of the Fourth of July displays, however, when it’s over, all that is left is a bit of smoke and a lot of oohs and ahhs. As the table below indicates, the big daily point moves in the popular averages (such as the Dow Jones Industrial Average or the S&P 500 Index) may make headlines, but they are occurring in the context of an equally large base. The percentage gains or losses, consequently, are much smaller. Indeed, the average daily percentage price change of the S&P 500 Index for the first quarter of 2018 is not too far removed from the comparable figure of the current bull market of the last nine years. Compared to the more recent experience of 2017, it is, of course, a significant increase. Similarly, the number of days with an absolute change of plus or minus 1% to the prior close is up substantially in the first quarter over the recent experience of 2017, which has not been the case in the context of the current bull market.<sup>1</sup>

Time Period	Avg. S&P 500 Index Daily Price Change	Percent of days with price change of +/- 1%
Period from 3/9/09 (Bear Market Bottom) to 3/31/18	0.68%	23.6%
Calendar Year 2017	0.30%	3.2%
First Quarter of 2018	0.89%	37.7%

Sources: FactSet, Bloomberg, SBH

<sup>1</sup> SBH Equity Research Group, drawing on FactSet and Bloomberg data.

This is not to say that the big up days aren't gratifying and that the down days don't make one wonder whether the steep roller coaster drop that many have been predicting—and predicting—and predicting—won't finally come to pass. A day in which the decline in the Dow becomes newsworthy can and should raise serious concerns because such days pose the question: is this the beginning of a return to more normal levels of volatility? We firmly believe that Reversion to the Mean is a powerful force not just in finance but in life, but that when it will arrive “we know not the hour nor the day.”<sup>2</sup>

What we do know is that our investment approach for any of our strategies does not oblige us to have a hard forecast of the markets or of interest rates. We evaluate prospective holdings from their fundamental investment merit and from our valuation work. We pay a good deal of attention to the risks our considered investments entail, as downside protection matters to many of our clients. These clients, whether pension funds, endowment funds or the personal funds of an individual or their family, generally come to us with a pool of capital either fully accumulated or close to completing the accumulation phase. They all anticipate that the distribution phase of their life cycle will come sooner or later. In his most recent Shareholder Letter, Warren Buffett, Chairman of the Board of Berkshire Hathaway, has expressed it this way: “*Investing is an activity in which consumption today is foregone in an attempt to allow greater consumption at a later date. ‘Risk’ is the possibility that this objective won’t be attained.*”<sup>3</sup> At times, Buffett has argued that this means that a price decline is “risk” only if it proves to be a permanent impairment and that declines of a transitory nature—if the underlying merits of the investment have not changed—can be ignored or used as an opportunity to buy more. From the perspective of a long-term investor with no liquidity concerns (such

as Berkshire), this point of view makes a great deal of sense. But from the point of view of an investor who is planning on drawing funds and has developed formal (or informal) spending rules for the portfolio (as, for example, an annual withdrawal rate of 5%), a market decline must be considered “risky.” One cannot know that the decline will be recovered. And that means that without mid-course adjustment, one cannot know whether the risk of Gamblers’ Ruin—that the portfolio will run out of money before luck turns—will prove real. Most clients with portfolios in distribution—from pension funds to retired individuals—budget their draws on an annual basis and cannot or really don't want to make mid-year budget changes. For such reasons, we think about such measures as the Sharpe Ratio, which is a calculation of return earned per degree of volatility incurred, in our analysis of portfolio returns. It is why we are attuned to “upside/downside capture” relationships as well. To be sure, none of these steps provide any guarantee of success, but being forewarned is the first step to being forearmed.

In the 1st Quarter *Thoughts on the Current Environment*, we had made the observation that 2017 might have belonged to Wall Street but 2018 was likely to belong to Main Street. As the employment data, Consumer Confidence Survey data and a host of hard and soft economic indicators suggest, Main Street seems to be jumping. Partly as a result, the U.S. Federal Reserve (Fed) raised short-term interest rates again in March, and the expectation is for three more increases in 2018 and possibly three more in 2019. Perhaps the long running bull market in interest rates, which began back in 1982, is indeed drawing to a close and the yield of 1.37% on the 10-year Treasury note back in June 2016 should prove to be the low for sovereign debt yields going back almost 750 years.<sup>4</sup>

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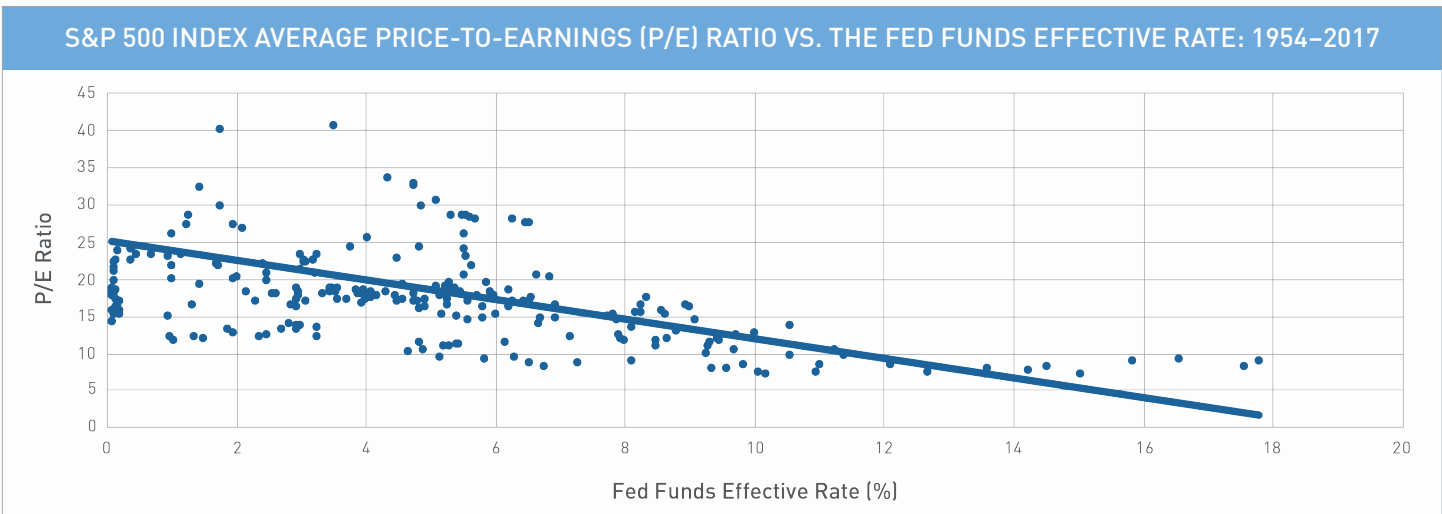
<sup>2</sup> “Therefore keep watch, because you do not know the day or the hour.” Matthew 25:13, New International Version (NIV).

<sup>3</sup> “Shareholder Letter,” Warren Buffett, Berkshire Hathaway Annual Report 2017, pg. 15.

<sup>4</sup> Paul Schmelzing, “Staff Working Paper No. 686: Eight centuries of risk-free rate: bond market reversal from the Venetians to the ‘VaR Shock,’” Bank of England, London, October 2017.

Assuming that interest rates at long last begin to inch higher, the question for stock market participants is to determine what the impact will be on stock prices. Interest rates will have their greatest impact, of course, on price-earnings multiples. The higher price-to-earnings (P/E) multiples are, the lower the capitalization rate (the “cap” rate) an investor is accepting. The “cap rate” is the rate an investor expects to earn on a particular investment and what is “acceptable” is influenced by primarily the general level of interest rates. As interest rates rise, they offer greater competition for an investor’s dollar, which will have the effect of pushing cap rates up, or said another way, P/E multiples down. The chart below shows the average of the S&P 500 Index P/E Ratio to the effective Fed Funds Rate over the period 1954 to 2018. The key take-away is simply this: higher short-term interest rates are associated with lower P/E levels. Corporate earnings, helped by a vibrant economy and further boosted by the tax cuts, may indeed surge in 2018, but those earnings may be valued at lower P/E multiples than they would have been in 2017.

If a market decline of any proportion does ensue, it might cause investors to reassess their views of holding stocks. As a refresher, it is useful to take a step back and recall just why we want to own them. Holding shares in companies is a way to participate in their growth. At bedrock, the reward for holding stocks comes in the form of dividends and, over time, the growth in those dividends. The rules of the game have been turned seemingly upside down since 2009. One of the consequences of the central banks’ great experiment in quantitative easing (QE) and the resultant decline in interest rates for such a prolonged period has been that investors may have forgotten that the great bulk of the return from holding stocks has historically come from just dividends (with no effect for buybacks). Note the figure below, which looks at the source of returns in the S&P 500 Index in which the relationship is essentially the opposite of historical levels.



Source: RBC Capital Markets, SBH, FactSet

Time Period	Percentage Contribution from Price to Average Annual Return	Percentage Contribution from Dividends to Average Annual Return
Bear Market Bottom (3/9/09) to 3/31/18	78.0%	22.0%
50 years to Present —3/31/68 to 3/31/18	21.8%	78.2%

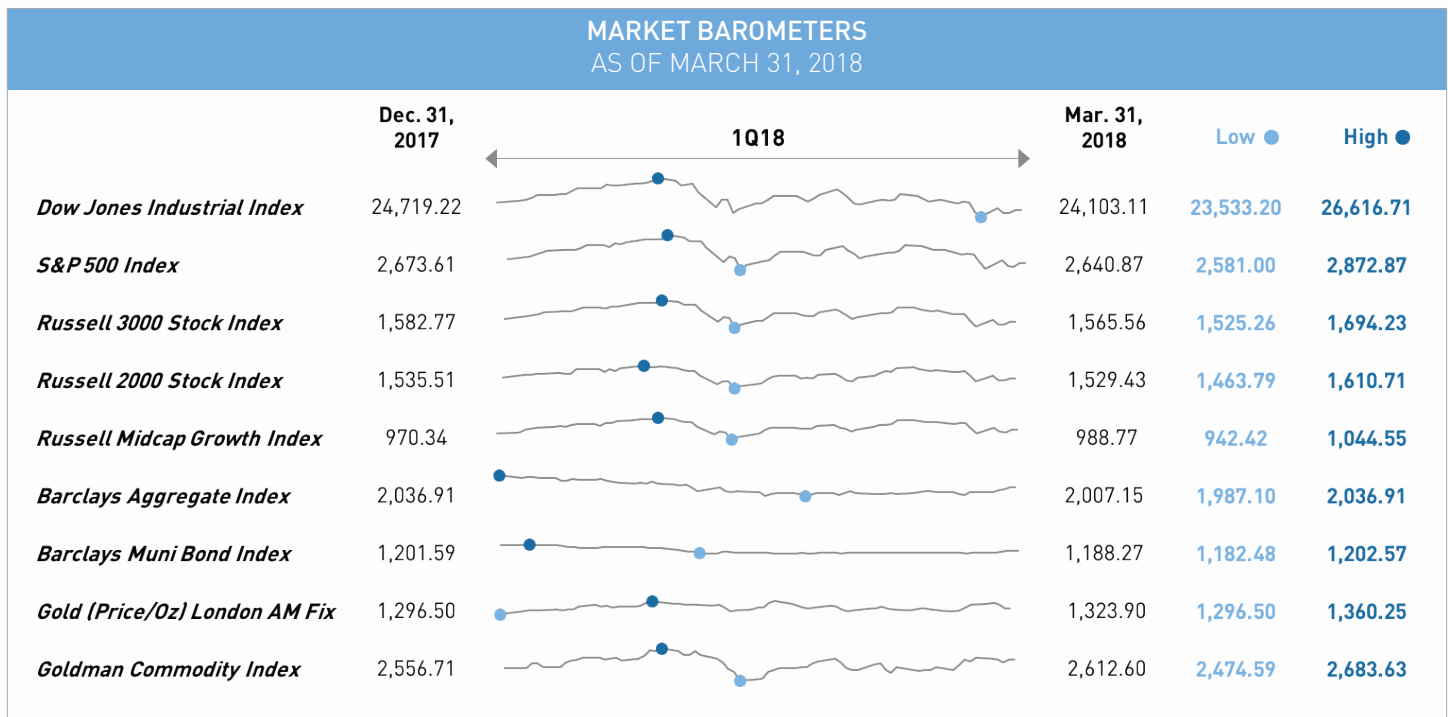
Source: FactSet

This may seem incredulous to investors in the market of recent vintage, for whom the capital gain component—and finding the most efficient ways to secure those gains—has been the paramount concern in recent years. Baskets of stocks, analysis of “factors,” investing to match an index—these are techniques to be used if it is assumed that the underlying market direction is up, that deviation from trend is likely minimal, and that volatility is not a concern.

Contrary to the headlines, the market’s reaction of late has been muted to the perceived heightened stresses—whether economic, political or social—suggestive of almost a drugged state that excessive money inflows have created for the market over the last 10 years in terms of volatility. If (more likely, when) some event shakes the market from that mindset, it will be important to understand why one owns the stocks they do. It will not be because they are included in 12 different exchange-traded funds (ETFs) or have been added to membership in an

index. Rather, it will be because the companies have a valuable franchise, either the consequence of being part of a vibrant part of the economy; or being the most efficient provider of the services or products they sell; or having a unique or patent-protected suite of products or a well-developed infrastructure to create and deliver them. It will be because we think the franchise is sustainable and because management has the talent and the desire to convert that franchise into value for their shareholders. And finally, it will be because we think the price of the shares in the market sufficiently compensates for the errors in forecast that everyone who is not privy to “knowing the time or the day” must acknowledge will be made in generating a forecast.

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Source: Bloomberg

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