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SBH NEWSLETTER

Thoughts on the Current Environment

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"In the short run, the market is a voting machine but in the long run, it is a weighing machine."

-Benjamin Graham

In September, an article appeared in the third quarter edition of the CFA Institute's *Financial Analysts Journal*, which is likely to become seen as a significant paper in the world of investments. The paper, titled "The Long-Run Drivers of Stock Returns: Total Payouts and the Real Economy," was written by Philip Straehl and (more importantly) Roger Ibbotson. Back in 1976, Ibbotson, along with Rex Sinquefeld, authored a paper in *The Journal of Business* entitled, "Stocks, Bonds, Bills, and Inflation: Year-by-Year Historical Returns (1926-1974)," which provided the data needed to translate the theoretical work which became known as Modern Portfolio Theory (MPT). MPT was pioneered by several Nobel prize winners—first by Harry Markowitz and then by Merton Miller & Franco Modigliani in the 1950s as part of an explosive period in the research on rates of return among various classes of financial assets. (I still have my copy of a monograph of this article, published in 1977, in my office, complete with underlinings and highlighting. Like all of us, it is a bit worse for the wear.)

To quote from the summary of Straehl and Ibbotson's recent paper:

> *We provide theoretical and empirical evidence over the period 1871–2014 that total payouts (dividends plus buybacks [of outstanding shares from the public]) are the key drivers of long-run stock returns......total payouts per share...grew in line with economic productivity whereas* **aggregate** *[emphasis in original] total payouts grew in line with GDP.*

[1] Philip U. Straehl and Roger G. Ibbotson, "The Long Run Drivers of Stock Returns: Total Payouts and the Real Economy," *Financial Analysts Journal*, Vol. 73, No. 3 (Third Quarter 2017): 32–52.

[2] Roger G. Ibbotson and Rex A. Sinquefeld, "Stocks, Bonds, Bills, and Inflation: Year-by-Year Historical Returns (1926-1974)," *The Journal of Business*, Vol. 49, No. 1 (Jan. 1976): 11–47.

The significance of this article is crucial in two respects. First, it provides quantitative support that **over the long run, the market is anchored on profits and, by extension, on the actual economy in which the companies that issue shares conduct business**. In other words, fundamental analysis of companies to develop a forecast of their future profits is a worthwhile endeavor. As Benjamin Graham (perhaps now best known as Warren Buffett's early mentor) put it: "in the short run, the market is a voting machine but in the long run, it is a weighing machine." In other words, in the short run, stock prices may be moved by fads, by emotions—either bursts of enthusiasm or of despair—but in the long run, stock prices will respond to the underlying fortunes of their companies. Companies generate cash returns to their shareholders either by paying dividends out of the cash flow created by profits or by using that cash to buy back (and then retire) shares in the open market, thus leaving the remaining shareholders with a larger proportionate stake in the company.

For many years, buybacks were seen in a negative light by most investors. They thought it indicated the company had nothing better to do with the profits it was generating, which could possibly have been signaling few growth opportunities. Many investors then (and still now) prefer that managements retain the profits and re-invest them back into the business on their behalf. Think of Amazon as the current-day poster child of seemingly unlimited opportunities to invest at high rates of return. Think of Berkshire Hathaway as another example of the opportunity to deploy capital strategically in much more effective ways than the average investor[3]. As the global economy has become somewhat more "asset-lite," investors have become more appreciative of managements that are willing to acknowledge there may not be sufficient investment opportunities generating high returns on invested capital to warrant holding cash. Instead, managements are paying more and more back to their owners, the stockholders. Data on understanding the scope and extent of buybacks has been historically somewhat incomplete. Companies were obliged to announce they were authorizing a buyback, but they were not obliged to actually complete them. Straehl and Ibbotson have developed a framework that allows them to estimate buybacks in the years for which the data is not explicitly available, allowing them to build a comprehensive data set covering a very long time period.

The second significant point this article makes, albeit not explicitly, is that **returns from investing in the stock market are a function of investing in stocks, not in indices of stocks**, and that there can be a basis to undertake fundamental analysis to make judgments about which companies have competitive advantages. In the long run, it is postulated, companies that prosper can reasonably be expected to be superior investments. It is important to keep in mind that stock market indices were and are not created to be compilations of the "best stocks." Their function is to represent the behavior of the average or typical stock in the universe they purport to describe. It has to be noted that one of the byproducts of this approach is that the index will also include companies that are either in deteriorating industries or whose shares would be viewed as overpriced. Those attributes (i.e., ones of investment merit) are not the purview of the index. As recently as the 1980s, there were only a handful of recognized stock market indices—the Dow Jones Industrials (and Transportation and Utility) Averages, the Standard & Poor's 500 Index, and, later on, the NASDAQ Index. Times do change. With the proliferation of various exchange-traded funds (ETFs) to provide investors with exposure to sectors of the market, to say nothing of sub-sectors, more and more indices have been created. An article in Bloomberg earlier this year observed that there are now more indices than individual stocks registered for trading in the U.S.[4] Indeed, Wall Street truly does have the ability to take a good idea and drive it to an absurd conclusion.

Whatever the reason, indices (and the vehicles created to replicate them) have done better of late than many managers picking individual stocks based on their own proprietary selection system. Inherently, however, there is no reason this has to be the case. **Again, to be clear, the purpose of an index is to represent the underlying range of securities it covers, not to pick the "best" ones**. A herding instinct can certainly cause money to chase after the index, which causes all the names in the index to be bought. This can create for a period of time a self-fulfilling model, but in the long run, if the findings of Straehl and Ibbotson are valid, opportunities to exploit differences in companies' business success will always remain available, sometimes more profitably than others.

[3] Neither of these descriptions should be construed as recommendations to buy or to hold securities of either company. That, of course, depends on both an investor's objectives (to which holdings like this may not contribute) and on their current valuation, which may (or may not) fully discount the opportunities they present.

[4] Bloomberg, "There Are Now More Indexes Than Stocks," May 12, 2017. https://www.bloomberg.com/news/articles/2017-05-12/there-are-now-more-indexes-than-stocks

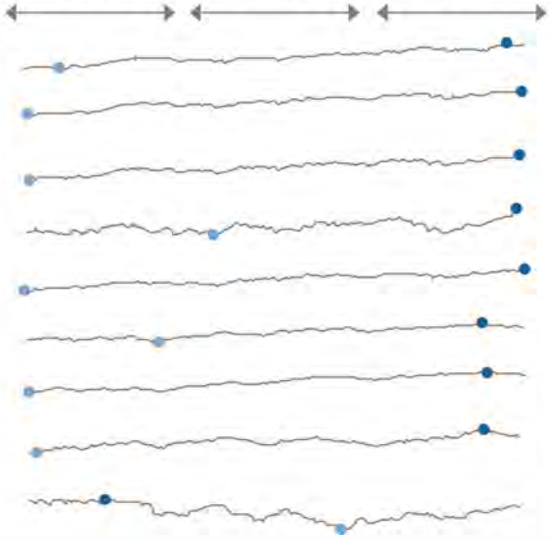
Let us pause for a moment to engage in a brief thought experiment. You and I are going to form a partnership to invest in stocks together. I will provide a list of names that I think are good investments, say 60 of them, and you will whittle the list down by excluding 10 that, for whatever reason, you don't like. The remaining 50 will form our portfolio into which we will invest our funds, which amount to $100 we have pooled together. We have our culled list, and the question now is how much to invest in each name. You and I have sorted down the list from thousands of names. Perhaps we should put $2 into each of the 50 names. Instead, you ask me to tell you which are my favorite five as a starting point. I do so, and you respond that we should emphasize our best ideas, putting $10 into each of those. You ask for the next five favorites, and those get $3 each. By the time we get to the last five, there is only $1.50 left, which means each one gets allocated only $0.30. In effect, we are saying that stocks 1 through 5 are 33x better investments than stocks 45 thru 50. If such an allocation seems somewhat unrealistic in terms of allocation between the largest holding and the smallest, keep in mind that what has just been described is the allocation of the S&P 500 Index as of the end of the third quarter of 2017, not merely an example drawn out of thin air. In other words, not only is the selection criteria of the committee that chooses the stocks in the index not focused on their underlying investment merit (as defined by their ability to produce a return for their shareholders), but the weightings that such an index produce also creates a portfolio that bears a much larger amount of concentration risk than many would consider warranted. **An investor may think they own a broad diversified exposure to the stock market via the S&P 500 Index, but the fact is that the top 50 names account for 50% of the value of the index.**

Despite all this, indexing as an investment theme has flourished. Of course, part of the reason the herding instinct has nevertheless been so effective is that stocks have proven to be the only game in town over the last nine years. The effect of the central banks to drive down interest rates has created a market environment in which one wise market commentator, Jason Trennert, back in 2010, observed should be called "TINA": There Is No Alternative. Indeed, stocks have moved inexorably higher, and for many years in this period, they moved in lockstep. Since the financial crisis, correlations of the returns of individual stocks between and among each other have been very high. In 2016, correlations began to break down, but curiously enough, in 2017, correlations *among* sectors (technology, health care, utilities) have fallen sharply, while correlations *within* sectors have become very high. **As the indices' advances have gone higher and higher, the experience of the underlying economy has not necessarily underwritten such gains, and the average stock is not doing as well as the index.** The advance has become narrower and narrower. The thought experiment we considered is what is going on in the market right now. Think of a storm that has produced flooding, and the amount of dry land is steadily growing smaller. (Unfortunately, this is an all-too-easy metaphor for us to recognize this hurricane season.) It would not take much for a new storm to swamp the small patch of dry land that is left.

What is the likelihood that even a modest storm will develop? We at Segall Bryant & Hamill have been of the opinion that a recession does not seem likely. There are no excesses in the real economy that appear systemically large enough to warrant the need for a recession to resolve. On the other hand, we have been and remain cautious about the ability of profits to grow as expected. Sluggish growth could well lead to a squeeze in profit margins. The economy might chug along, but profits could well enter a recession phase or at least plateau on their own. The U.S. Federal Reserve (Fed) has announced its intention to end quantitative easing (QE) "soon." If QE had beneficial effects when it was implemented, ending QE has to produce some degree of adverse effect. Our view has been that one of the unintended consequences of QE has been to distort pricing in the capital markets by holding interest rates at administered levels rather than allowing rates to move as they would on their own. As a result, there are no natural shelters for investors to consider to protect them from even a modest storm. A stressed system is one in which even a modest risk can have a consequential effect.

MARKET BAROMETERS
AS OF SEPTEMBER 30, 2017

	Dec. 31, 2016	1Q17	2Q17	3Q17	Sept. 30, 2017	Low	High
Dow Jones Industrial Index	19,762.60				22,405.09	19,732.40	22,412.59
S&P 500 Index	2,236.20				2,516.10	2,236.20	2,516.10
Russell 3000 Stock Index	1,331.72				1,495.43	1,331.72	1,495.43
Russell 2000 Stock Index	1,357.13				1,490.86	1,345.24	1,490.86
Russell Midcap Growth Index	782.97				910.87	782.97	910.87
Barclays Aggregate Index	1,967.23				2,029.03	1,957.61	2,044.95
Barclays Muni Bond Index	1,139.51				1,192.65	1,139.51	1,202.28
Gold (Price/Oz) London AM Fix	1,159.10				1,284.30	1,148.65	1,350.90
Goldman Commodity Index	2,417.31				2,326.46	2,053.66	2,428.42



Source: Bloomberg

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