August 2023 Market Commentary

Of Course, That's Your Contention

"Of course, that's your contention. You're a first-year grad student. You just got finished readin' some Marxian historian -- Pete Garrison probably. You're gonna be convinced of that 'til next month when you get to James Lemon, and then you're gonna be talkin' about how the economies of Virginia and Pennsylvania were entrepreneurial and capitalist way back in 1740. That's gonna last until next year -- you're gonna be in here regurgitating Gordon Wood, talkin' about, you know, the Pre-revolutionary utopia and the capital-forming effects of military mobilization." – ***Good Will Hunting*** ***https://www.youtube.com/watch?v=hIdsjNGCGz4***

The bar scene above, from Good Will Hunting, is one of those iconic movie scenes that we all wish could have happened in real life. The pretentious, being put in his place by someone smarter than he is. Unfortunately, real life is much more nuanced, knowledge generally comes from years of hard-earned learning and experience. As Will goes on to say, *"See, the sad thing about a guy like you is in about 50 years you're gonna start doing some thinking on your own and you're gonna come up with the fact that there are two certainties in life. One, don't do that. And two, you dropped a hundred and fifty grand on a ****in' education you coulda got for a dollar fifty in late charges at the Public Library."*

Many investors formative years are very similar to this bar scene. We embark on a journey of discovery but quickly find ourselves adrift in an ocean of investment philosophies. Over time, generally decades, we begin to understand that there are many ways to get to investment heaven, there is no one right way to invest.

We could say, *"Of course, that's your contention. You're a first-year investor. You just got finished reading some deep value historian, Ben Graham probably, you're gonna be convinced of net-nets until next month when you get to Warren Buffett, then you're gonna be talking about how Graham's ideas are antiquated and that you simply have to buy and hold quality, letting time arbitrage do its thing. That's gonna last until next year, you're gonna be in here regurgitating Fisher and Lynch, talkin' about, you know, the importance of placing more emphasis on qualitative analysis in your investment process. Shortly after that, you'll discover*

Druckenmiller, parroting that we should never invest in the present and that buying decisions should be based on what you believe the environment or prospects will be like 18-24 months from today."

What I've learned after some forty years in this business, is that there is no right or wrong way to invest. The best way to invest is to find a strategy/philosophy that works for your personality and follow it religiously. Just like real life, this generally means you're going to make some messy mistakes along the way, but hopefully you'll learn from them and move forward. Some strategies will feel just right for you when things are going well, only to become a nightmare when the markets turn. Unfortunately, only time and a variety of market cycles will help you discover what is right for you.

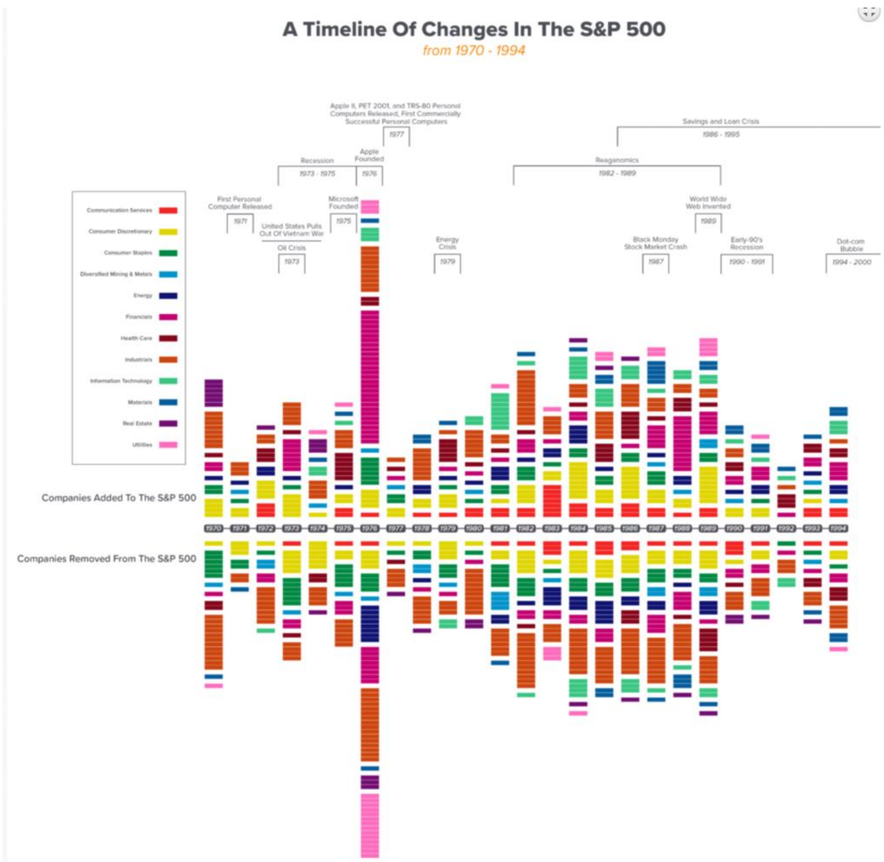
My investment philosophy has certainly evolved over the years. I've tried many, dismissed many, and adopted bits and pieces of many. Mostly I've followed Charles Darwin's advice, ***"It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is most adaptable to change."*** Mostly it's a strategy that I'm comfortable with, that's flexible enough to adapt to changes in the world, one that I understand, and most importantly can stick with when the s*** hits the fan.

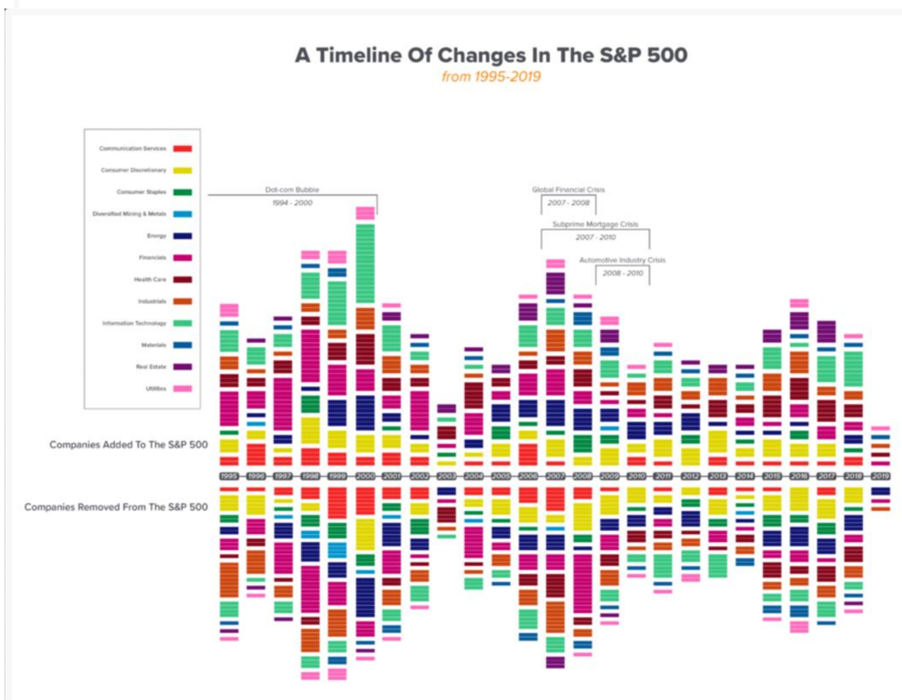
I've also grown to a point where I can separate my personal philosophy from my professional philosophy. Professionally, I'm charged with beating a particular benchmark, like the S&P 500 or the Russell 1000 Value Index, my strategies are focused on that benchmark in both up and down markets. Personally, my goal is to earn a respectable return no matter what the markets throw at me. I want to participate on the upside and protect my assets on the downside. I could care less if I beat a particular benchmark, it's all about being comfortable with my risk/return.

When it comes to trying to beat a benchmark like the S&P 500, it is paramount that you have a deep understanding of your competition. I have been a long-time fan and follower of Morgan Stanley's Michael Mauboussin, who has recently published a piece titled ***"Birth, Death, and Wealth Creation"***
https://www.morganstanley.com/im/publication/insights/articles/article_birthdeathandwealthcreation.pdf?1690283806853

While this may sound like another demographic piece, it is actually about the demographics of corporate America. For this discussion, a company is "born" when its stock starts trading on a public exchange, and "dies" when it stops trading there. Ironically, for the purposes of this paper, Mauboussin quotes two studies done by Hendrik Bessembinder of Arizona State University, and Jay Ritter of University of Florida, both schools that have recently received copious tuition payments from yours truly.

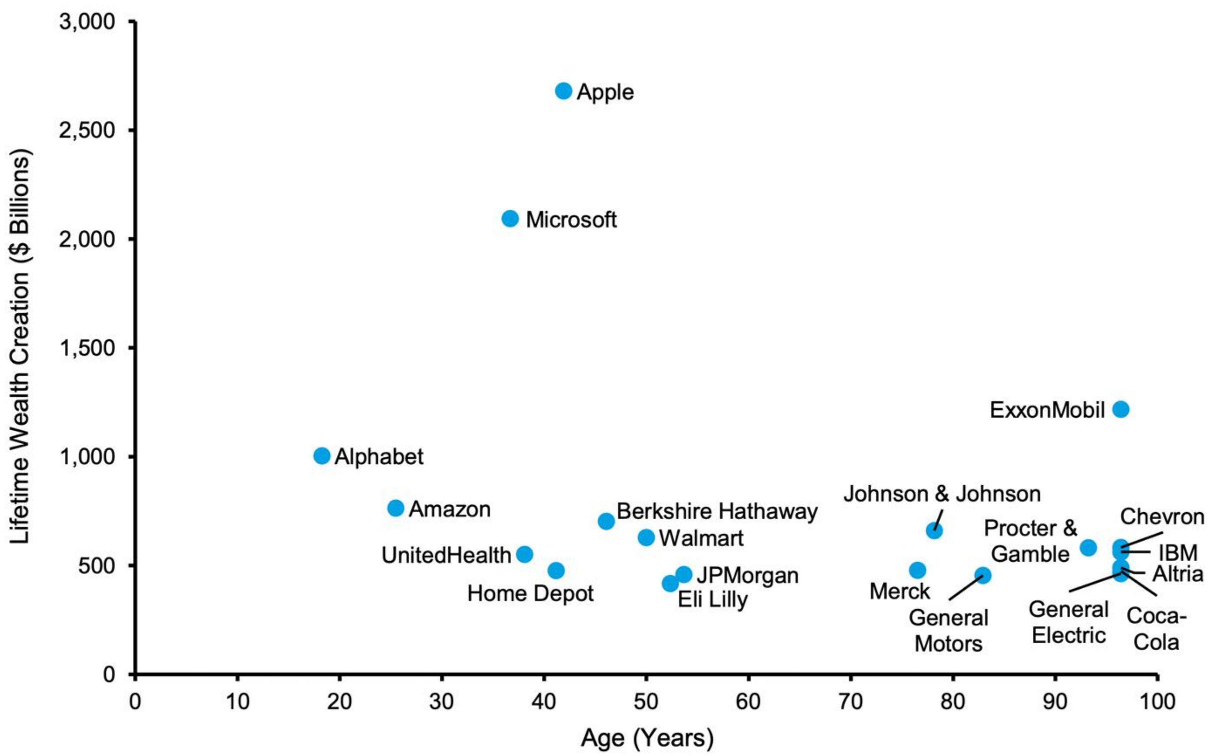
What the paper highlights is just how active a supposedly "passive" index like the S&P 500 is. **Their studies show that about 50% of the companies that are "born" (go public) die in ten years**; 58% by mergers, 39% by cause, and 3% voluntary. Only about 10% of the companies that were in the index when I started investing 40 years ago are still in there today. Below are two graphs that show the number of stocks going into and out of the index by sector from 1970-2019.





After we move past "births & deaths" we get to another equally fascinating part of the paper, "wealth creation". **Bessembinder studied roughly 28,100 public companies listed since 1926, and found that 60% failed to generate life-time returns higher than a one-month Treasury Bill.** Of the $55.1 trillion net wealth created, more than $50 trillion was attributable to just 2% of the sample. This next chart shows the top 20 wealth creators since 1926 who accounted for $15.7 trillion in wealth created or 28% of all wealth created.

Exhibit 16: Age and Total Wealth Created of the 20 Top Wealth Creators, 1926-2022



Source: Hendrik Bessembinder and Counterpoint Global; Presentation based on Carson Kamp, "Do Stocks Outperform Treasury Bills?" W. P. Carey, *Autumn 2018.*

Some conclusions: If your goal is to outperform an equity benchmark like the S&P 500 you have to realize some very important facts.

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- Most major equity benchmarks are reflections of our economy, they are constantly evolving and changing, and therefore their constituents are constantly changing.
- For a lot of companies, wealth is often created before the IPO, and the IPO is often a means of rewarding early investors.
- There are a small handful of company's that generate the majority of returns, and investors should probably focus on those that have a proven ability to generate wealth.
- Just because a company has generated a large amount of wealth doesn't mean it will continue to do so, much of that wealth may have been generated decades ago.

An index like the S&P 500 is an extremely tough competitor, not because it is passive, but because it is very dynamic. Constantly purging losers and rewarding winners. In order to have any hope of outperformance, an active manager must be able to do the same and do it efficiently.

Bidenomics Blather:

So far, one of the biggest surprises of 2023 has been the absence of the most expected recession of all time. Second quarter GDP surprised most economists with a faster-than-expected 2.4% annualized growth rate. Now those same economists have adjusted their full-year 2023 GDP growth up to 1.9%, from their earlier 0.3% expectation. The main reason given for this surprising economic strength is Bidenomics, a term coined by the President's spin doctors, and a term you will be hearing ad nauseum over the next 16 months.

What is Bidenomics? Basically, central government controlled industrial policy, aka directing loads of government spending (your money) toward favored industries like clean energy and semiconductor production, and constituents like unions. The stated goal is to make America a high-tech manufacturing hub that's less reliant on global supply chains while creating solid middle-class jobs.

It's intended to be the antithesis of Reaganomics, the philosophy that reducing business regulations and cutting taxes juices spending, leading to economic growth that lifts the standard of living for all Americans.

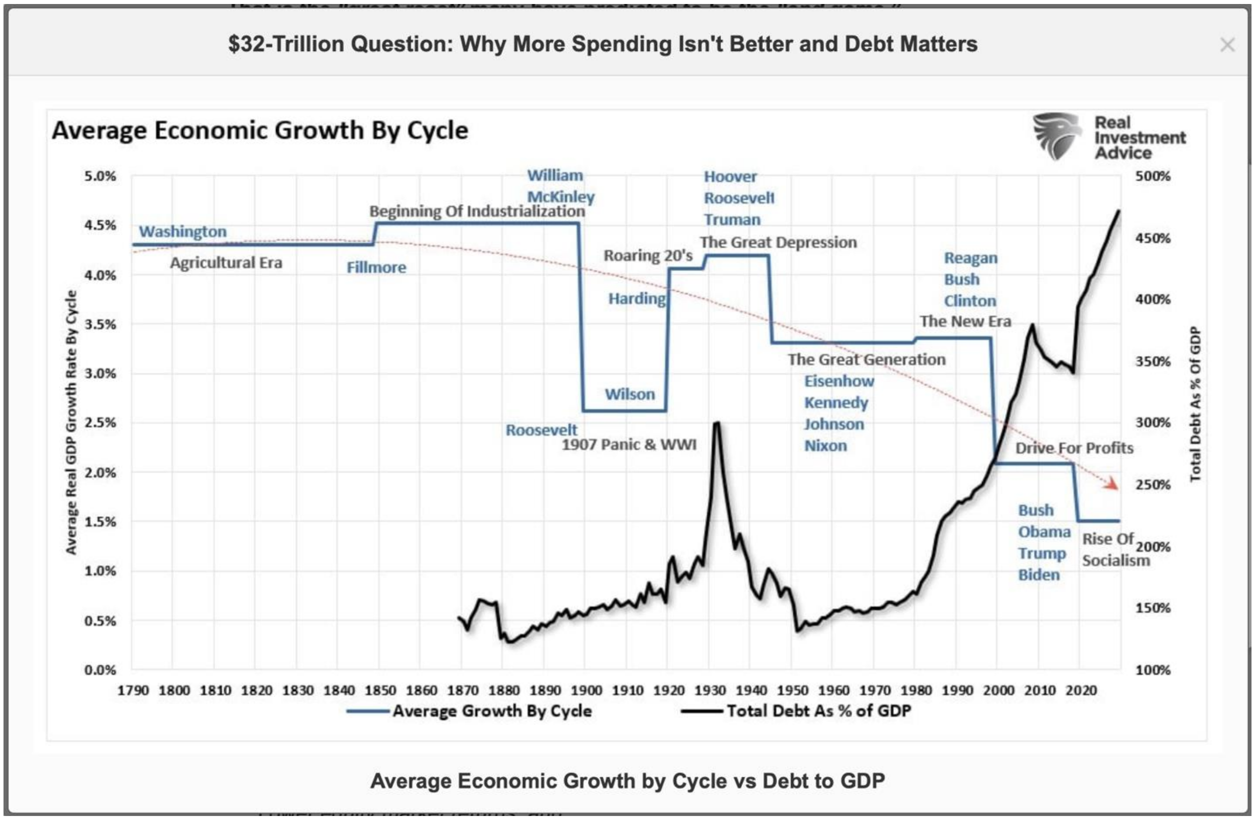
Instead of free market capitalism we have central government planning, no different from Russia or China and their Five-Year Plans, where the government decides where capital should flow and who gets to benefit.

Here is a taste of Bidenomics:

- The Infrastructure Investment and Jobs Act made $550 billion available for road repairs, broadband expansion, and electrical grid upgrades.
- Chipmakers now have more reason to make chips in the US thanks to $52.7 billion in direct subsidies in the CHIPS and Science Act.
- And companies involved in solar, wind, and clean hydrogen technologies can receive tax breaks and funding from the $500 billion Inflation Reduction Act.

Not only is the government choosing where investment should be made, they are also dictating the terms. Manufacturers are strongly encouraged to use union labor, they must have a plan to provide employees with "affordable, high-quality" child care, and be willing to refrain from making stock buybacks and share any "windfall" profits with the government. In other words, the government is telling corporations how to allocate capital.

In hindsight the surprising GDP growth and correspondingly strong stock market shouldn't be all that surprising given the massive increase in debt our government has been willing to undertake. But the simple economic fact that increased levels of debt-to-GDP lead to lower GDP growth has not been refuted. We are not talking about an economic boom here, we are looking at skirting a recession with 1.9% GDP growth, and it only cost us $3 trillion!



Average Economic Growth by Cycle vs Debt to GDP

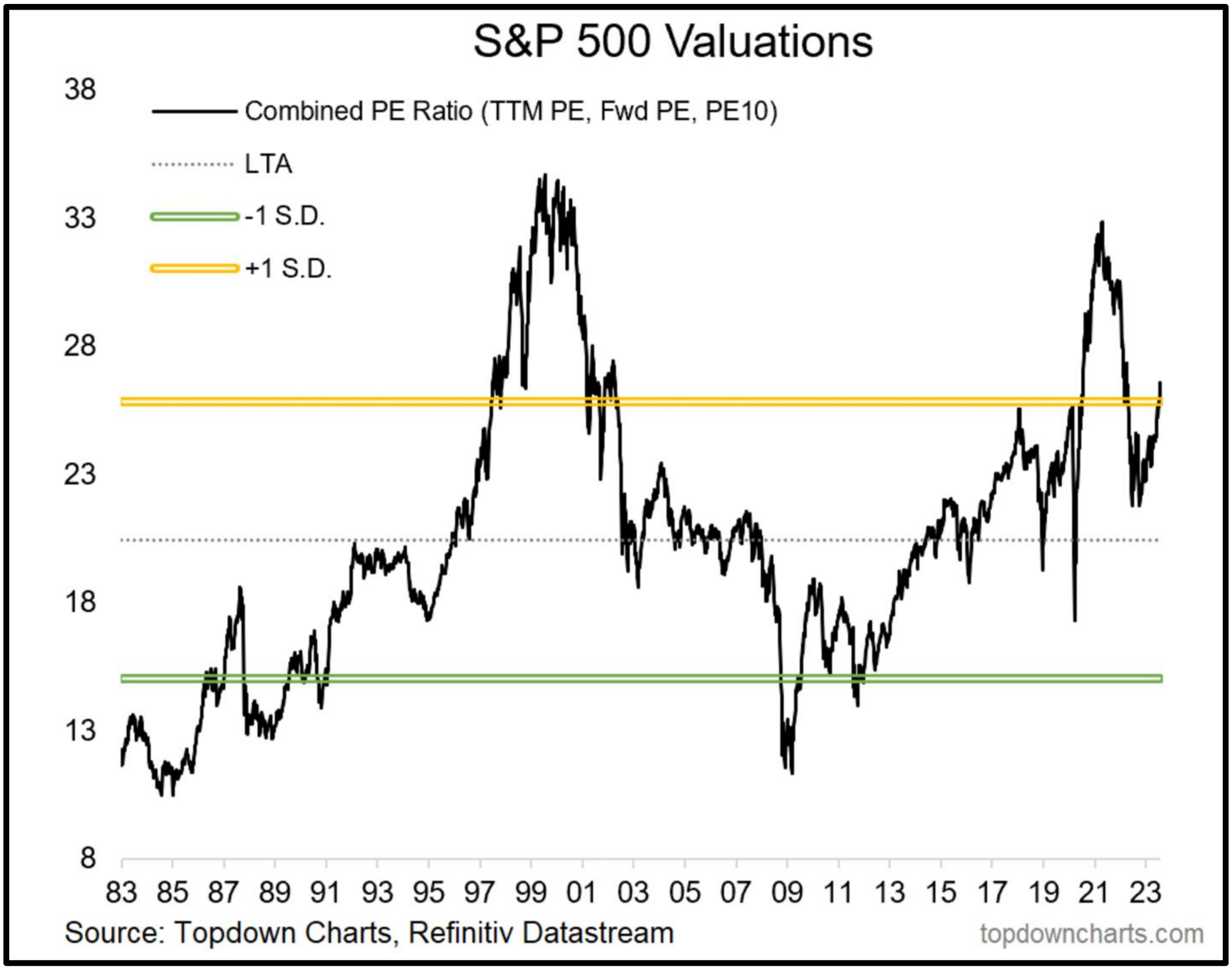
Market Commentary:

The Fed continued raising interest rates in July, and while this is a welcome relief to short-term savers, it is a continued headwind for longer-term fixed income investors. Even with yields greater than 5% the total YTD return for the Aggregate Bond Index is about 2%.

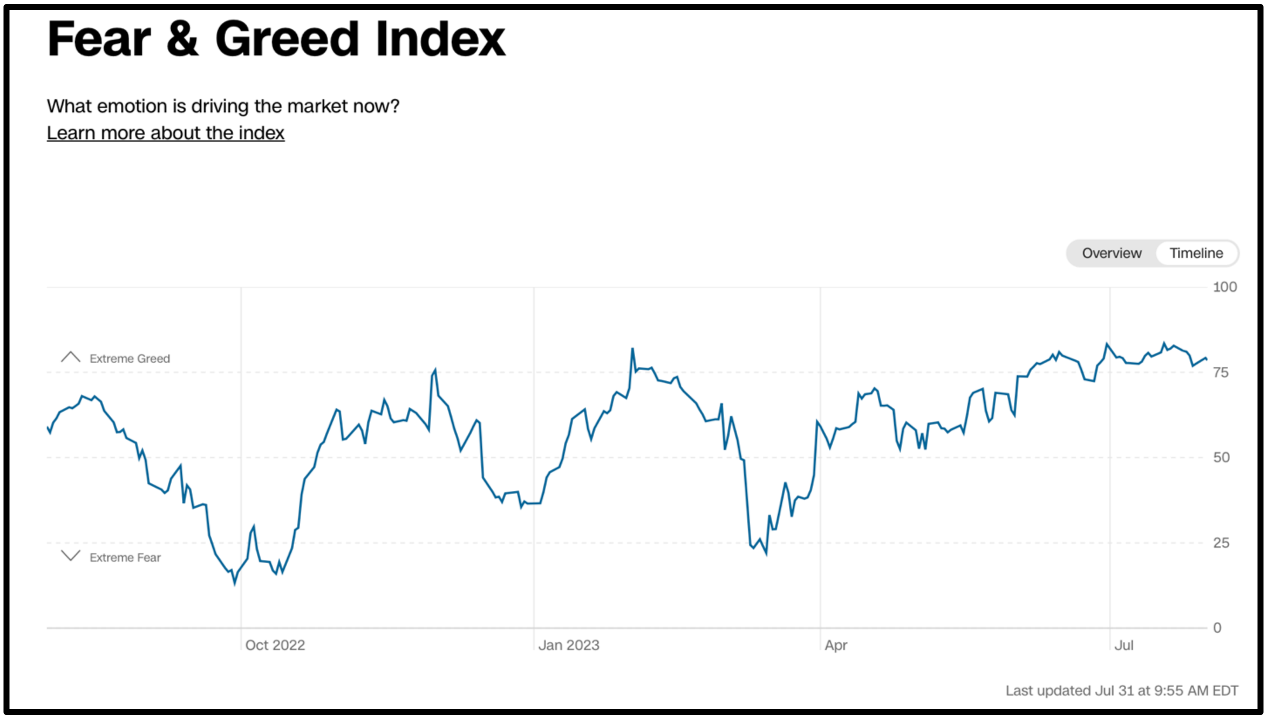
As mentioned earlier, what appears to be at least a reprieve from imminent recession aided by copious government spending, has resulted in a booming stock market rally. The S&P 500 is so far experiencing its 13^{th} best year since 1926 with a nearly 20% YTD total return.

S&P 500: Best Performance through First 143 Trading Days (1928 - 2023)				
Rank	**Year**	**Price Return: First 143 Trading Days**	**Price Return: Day 144 to Year-End**	**Price Return: Full Calendar Year**
1	1933	45.2%	-0.8%	44.1%
2	1975	30.2%	0.5%	30.9%
3	1987	28.3%	-20.2%	2.3%
4	1997	26.7%	3.4%	31.1%
5	1954	22.3%	17.8%	44.1%
6	1995	22.3%	9.7%	34.1%
7	1989	21.7%	4.5%	27.3%
8	1943	21.6%	-1.8%	19.4%
9	1983	21.1%	-3.2%	17.2%
10	1955	21.1%	4.4%	26.4%
11	2019	20.7%	6.8%	28.9%
12	1938	19.6%	4.1%	24.5%
13	2023	19.3%		
14	2013	18.6%	9.3%	29.6%
15	1936	17.9%	9.1%	28.6%

But, as is usually the case with strong rallies, valuations begin to get stretched. The chart below shows that the S&P 500's price-to-earnings ratios are getting back up into lofty areas. This isn't necessarily a sell signal, since markets can stay at lofty levels for years, but it is a good tool for signaling when you might want to be cautious versus aggressive.



Finally, if you believe, as Warren Buffett does, that you should be greedy when the crowd is fearful and fearful when the crowd is greedy, then you should pay attention to the CNN Fear & Greed Index. A year ago, the Fear/Greed index was at a reading of 24, extreme fear. At the beginning of this year the Fear/Greed index was at a fearful reading of 37. Both of those times were ideal times to buy stocks. Today, the reading is at extreme greed, 79. The crowd is greedy, you should at least be wary.



That's all for this month, I hope you are enjoying your summer.

As always, be careful out there.

Chris Wiles, CFA

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