KOVITZ INVESTMENT GROUP
Intrinsic Values®

Market Insights
Winter 2019

The mind is its own place, and in itself can make a heaven of hell, a hell of heaven. – Paradise Lost

It was a tough year for global equity markets. While it might be overly simplistic to say nothing of monumental significance occurred during the year that would easily explain the large swings in equity valuations, there rarely is a direct cause of these sorts of things. Investor psychology, amplified by machine-based algorithmic trading, is a fickle thing, often creating demons or angels out of thin air.

Some investors point to the positive points in the U.S. economy, such as low unemployment, rationalized corporate tax rates, recent GDP growth, and consensus economic forecasts that call for more of the same. Data points such as these certainly carried the day for the first three quarters of 2018. But the focus turned decidedly to various negative concerns in the fourth quarter, including damaging trade wars, a government shutdown over the President's demands for funds to build a wall across the U.S./Mexico border, and the ever-present pockets of geopolitical uncertainty. Regardless of what *should* be happening, if there is such a thing, the reality is that this was the first down year for the market[1] since 2008. Even growth stocks[2], which have enjoyed seemingly unlimited optimism regarding their future prospects for several years, were not immune as they declined 1.5% on the year. Value stocks[3] failed to pick up much ground in the latest quarter and ended the year down 8.3%. The pain was more acute overseas as developed international markets[4] suffered a 13.8% decline and emerging markets[5] ended the year off 14.6%.

Given that the U.S. market[1] peaked as recently as October 3rd and proceeded to shed nearly 20% before bottoming after the worst return on Christmas Eve in at least a century, the speed of the decline may have been more jarring than the modestly negative calendar year return itself would otherwise indicate. No matter how you were spending the Christmas holiday, if you had any contact with other people at all, someone more than likely asked breathlessly, "Did you see what happened to the stock market yesterday?" Fear was in the air and this was indeed an abnormally poor quarter for global equity markets.

So, it's settled then. A recession is inevitable and equity returns will be poor in the immediate future, right? Hardly. Well, maybe, but it is hardly assured. Stock market returns have historically been a poor predictor of both recessions and future stock market returns. The below chart shows the last eleven recessions that have occurred in the U.S. dating back to 1948, the decline in GDP associated with

---

[1] *As represented by the S&P 500*
[2] *As represented by the Russell 1000 Growth Index*
[3] *As represented by the Russell 1000 Value Index*
[4] *As represented by the MSCI EAFE Index*
[5] *As represented by the MSCI Emerging Markets Index*

each, and the returns of the stock market[1] over the 12 and 24 months preceding the recession. As you can see, only two of the eleven recessions have been preceded by a decline in the stock market in the year prior to the recession. If anything, recessions tend to be preceded by periods of strong performance in equity markets, although this is also a poor predictor of, well, anything. There are plenty of years with above-average equity market returns that aren't followed by a recession.

Start of Recession	Peak-to-Trough Real GDP Decline	S&P Return, Prior Year	S&P Return, Prior Two Years
Nov-1948	-6.72%	12.96%	23.67%
Jul-1953	-9.72%	2.30%	29.32%
Aug-1957	-13.69%	0.71%	18.83%
Apr-1960	-5.13%	3.22%	40.70%
Dec-1969	-4.20%	-10.64%	6.27%
Nov-1973	-11.90%	0.02%	21.94%
Jan-1980	-8.46%	18.61%	26.40%
Jul-1981	-10.14%	20.61%	41.48%
Jul-1990	-5.43%	16.45%	40.35%
Mar-2001	-1.70%	-6.94%	2.57%
Dec-2007	-15.00%	7.79%	23.12%
Jan-2019	*???*	*-4.39%*	*16.47%*

Furthermore, even if the economy does slide into a recession, we must be careful to guard against the scars of 2008. Not all recessions are created equal, and that recession was remarkable because of its severity, not simply because of its recency. If history is any guide, a recession – should a recession even occur in the near future – is more likely to be a modest decline in GDP rather than the global financial panic we experienced a decade ago.

However, you certainly wouldn't know that by looking at certain sectors of the stock market where depressed valuations are implying a significant disruption in the economy is imminent. Perhaps these shares are being pushed down by overreaction to legitimate concerns regarding the effect of ongoing trade wars and global instability. Or, perhaps it was just the shine coming off generously valued momentum stocks and, once that started, the machines and algorithms that drive daily market movements drove everything else down in tandem – valuation be damned.

Ultimately, our job is not to guess why the stock or bond market is doing what it's doing – a Sisyphean task to be sure. Our role is to help our clients meet their financial goals – whatever they may be. To accomplish this task, we first create a financial plan with each of our clients. Second, and most important, we all stick to the plan. As you are no doubt aware, the plan never entails ripping up the plan just because the stock market fell – or rose – over some brief period of time. Finally, we create an investment portfolio based on the plan that we feel offers the best odds of helping our clients meet their goals.

For the equity portion of these portfolios, we select companies with sustainable competitive advantages, high returns on capital, sensible levels of debt, and a history of prudent capital allocation trading at prices that imply none of these characteristics are present. Please see the accompanying Equity Commentary for additional thoughts on this segment of your portfolio.

For the fixed income portion, we select bonds which we believe are high-quality and have a low risk of default. We then structure portfolios that we believe will generate satisfactory returns for clients with limited sensitivity to changes in interest rates, especially during a time of rising rates during calendar year 2018, and during the steep sell-off of risk-based assets in the fourth quarter. In other words, our client bond portfolios are generally acting as we intend. Please see the accompanying Fixed Income Commentary for additional discussion on this topic.

Additionally, we sometimes recommend investments in alternative asset classes where we feel there is the potential for increased returns without materially altering the overall risk of the portfolio or where we feel there is the potential to materially mitigate market risk without materially reducing the overall expected return of the portfolio. An example of the latter, our hedged equity strategy, had a notable year.

In brief, the increased volatility through the year and sharp sell-off in the overall equity markets greatly benefitted our hedged equity strategy over the past twelve months. As has become apparent, many hedged equity strategies offered in the marketplace don't actually hedge against a market decline. This was borne out in 2018 when our strategy's hedged equity peers[6] ended the year down more than 9% on average – or more than twice as much as the stock market[7]. If you are an accredited investor, we can provide you a separate hedged equity commentary, which provides a broader discussion, at a later date.

Again, this is our job – set goals with clients, plan to meet those goals, and invest in assets that we believe offer the best risk-adjusted chances of satisfying the plan. As always, this is the same process we follow for ourselves, and our money is invested side-by-side with our clients'.

Best Regards,

Kovitz Investment Group

Kovitz Investment Group

[6] As represented by the HFRX Equity Hedge Index
[7] As represented by the S&P 500

This newsletter has been prepared by Kovitz Investment Group Partners, LLC® (KIG), an investment adviser registered under the Investment Advisers Act of 1940, and is a quarterly newsletter for our clients and other interested persons. Within this newsletter, we express opinions about direction of the market, investment sectors and other trends. The opinions should not be considered predictions of future results. Discussion in this newsletter relating to a particular company is not intended to represent, and should not be interpreted to imply, a past or current specific recommendation to purchase or sell a security, and the companies discussed do not include all the purchases and sales by KIG for clients during the quarter. A list of specific recommendations made by KIG over the past year can be made available upon request. Information contained in this newsletter which is based on outside sources is believed to be reliable, but is not guaranteed or not necessarily complete.

Past performance does not guarantee future returns.