Market Insights
Summer 2018

"Certainly . . . whoop, whoop, whoop, whoop, whoop, whoop . . . nyuk nyuk nyuk."
– Jerome Horwitz, aka Curly

The only certain thing in this world is the persistence of uncertainty. No matter how much you read, how many CEOs, investors, or industry experts you talk to, or how smart you are, you just can't get around the fact that nothing is certain. Only a Stooge like Curly would believe otherwise.

A real-world example of this uncertainty is playing out right now. Who among us would have predicted that the President of the United States would usher through Congress a massive corporate tax cut that would serve as a huge benefit to owners of stock, and then the same President, not six months later, would embark on a path resulting in escalating tariffs between the U.S. and its major trading partners?

As to how the burgeoning global trade war plays out over the coming months or years, we can't be sure. The range of outcomes is wide, but we believe the most likely scenario is that any negative effects will be broad-based, transitory, and will ultimately reverse when the tit-for-tat maneuvering among countries runs its course and winds down. Ultimately, trading partners will recognize that from this starting point, we are heavily intertwined and will ultimately find a way to work together. Yet the future may continue to surprise.

With this in mind, we note the value of an equity security, which is comprised of the present value of the future cash flows of a business into perpetuity, is only minimally affected by even a multi-year negative event (example: the recession of 2008-2009). Additionally, the ability of corporations, in general, to make the scheduled principal and interest payments on their debt will not be materially impaired. Nor, for example, will a protectionist trade policy by itself meaningfully damage the prospects for buying, leasing, improving, and selling industrial real estate in the greater Chicago area.

We spill a lot of ink in these quarterly missives emphasizing our process and the four primary elements we look for before committing client capital to an investment: companies that have sustainable competitive advantages; a sensible amount of financial leverage; management with a history of prudently allocating capital; and shares that trade at a meaningful discount to our estimate of their intrinsic value. What these four elements have in common is not that they are a means for us to express our certainty regarding the future prospects of a business, but that they allow us to account for the inherent uncertainty regarding the future prospects of a business.

The first element listed above serves to increase the probability that a company will continue to grow and maintain its operating margins in a future where unexpected threats will occur regularly. The second and third elements serve to both mitigate the downside in the inevitable occasions where our assessment of the first element proves incorrect, and as evidence that management will refrain from piling on excessive amounts of debt or pursuing value-destroying acquisitions – both acts of hubris that only a management team that thought the future was certain would undertake.

The fourth and most important element – price and its relation to value – is often the most misunderstood. Value is not a specific point. That would imply a level of certainty in our predictions of the future that does not and cannot exist. Value is a range, a distribution of points, each with probabilities assigned to it that acknowledge the many, varied paths the future could take. Price, on the other hand, is a specific point and the only constant in all of investing. Thus, the importance of buying only at a price that allows for the highest possible probability of gain, and the lowest probability of a future path that results in a permanent loss of capital.

We have written a number of times recently about how the overall market's[1] return is being driven by so-called "growth" stocks trading at high valuations. That trend has continued into this quarter as "growth[2]" has now outperformed "value[3]" by nearly 9% in 2018 and by 32% over the last three and a half years. In contrast to previous periods, US-based "growth" has really been the only major market segment working across the globe this year. In addition to the divergence with the rest of the domestic market, both international developed markets and emerging markets have experienced dismal returns of -3% and -7%, respectively, this year.

The misnomer about "growth" versus "value" though is that plenty of so-called "value" stocks, including most of the companies held in our clients' portfolios, have been growing their earnings at roughly the same rate as the overall market throughout this period. The only difference is that market participants have deigned to reward already richly valued companies (primarily in the technology sector) with even higher valuations. These levels require a high degree of certainty that the future path of earnings will closely resemble the recent past just to be called fair, and they provide very little room for error in that assessment. Meanwhile, many of the companies owned by our clients have been cast aside under the guise of a different kind of certainty: that earnings for these companies will not grow, or grow only modestly for the foreseeable future, despite these same companies disproving that theory many times over the past several years.

Ever-patient and ever-disciplined, this divergence continues to appear untenable to us over any meaningfully long period of time, so we will bide our time until a combination of reality and math corrects this imbalance. Others may continue to blithely pay seemingly any price for companies that they must be absolutely certain will grow enough to justify their high valuations, but that is not our way. As always, we will continue to position our client portfolios, side-by-side with our own, in a manner that we believe offers the highest probability of gains while minimizing the probability of a permanent loss of capital. Importantly, despite an environment that is hostile to our style of investing, our equity composite has still generated returns of nearly 300% (after all fees and expenses) since the market bottomed in 2009.

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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*

Across asset classes, our client portfolios are currently positioned as follows:

1. Equities: Our typical client portfolio is close to fully invested in a collection of companies that we believe are priced, in aggregate, at levels that offer a high probability of upside relative to the overall market. Please see the accompanying Core Equity Commentary for additional details.
2. Fixed Income: Client portfolios remain focused on capital preservation. Our bond laddering strategy that balances the impact of rising interest rates between stability of principal and opportunity for reinvestment at higher yields has weathered the current environment well. Additionally, the increase in short-term rates continues to be a great benefit to our clients' substantial holdings in non-agency mortgage-backed securities backed by adjustable-rate loans. Please see the accompanying Fixed Income Commentary for additional discussion of the interest rate environment and how Kovitz is responding to it.
3. Hedged Equity: We are very happy with the performance of Kovitz' hedged equity strategies during the first half of the year as the downside and upside hedges we employed captured gains due to the increased volatility. The strategy remains positioned defensively, much as it has been for the past several years.
4. Industrial R/E and PE: The Kovitz co-sponsored industrial real estate offering focuses on investing in single and multitenant 50-200,000 square foot industrial properties, purchased at substantial discounts to replacement cost. Over four funds, we have purchased, financed, rehabbed, leased, and then sold almost 100 properties. We have developed and taken advantage of deep industry experience and networks to opportunistically purchase properties from motivated sellers in mostly off-market transactions. We strive to sell at low cap rates after stabilizing the properties, and often are able to group properties into attractive portfolios. We recently sold virtually all of the properties in our second and third funds in one large transaction (over 50 properties) in just such a manner, and continue to find attractive opportunities for our fourth fund.

As always, these are general comments that do not apply to all KIG clients. Please discuss your particular situation with your KIG Financial Advisor for more information on these topics.

Best Regards,

Kovitz Investment Group

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