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PERSPECTIVES
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Onward to 2020

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Time stands still for no one. It seems like yesterday when, as a newly minted securities analyst employed by a Midwestern bank in the summer of 1982, I was quickly scribbling down stock quotes with my sharpened pencil. The quotes were relayed to me through the phone by "Bob", the bank's local Dain Bosworth broker. I would call Bob each day at 9am, 11am and 2pm and record the most recent stock prices, on a clipboard with "xerox" paper, for all 50 companies in our Harris Bank-inspired trust department investment portfolios. I would then hand the clipboard over to my boss, the Chief Investment Officer, and we would study the prices together. The digital age was in its infancy. The bank did not yet have a Quotron machine for retrieving quotes, much less any type of desktop computer or Bloomberg terminal as we have today. In retrospect, I was the Quotron!

One particular afternoon, August 12, the numbers were lower than they had been all summer. As the Dow Jones Industrial Average closed at 777, I remember thinking, "Could the Dow possibly be 700 by Labor Day?" Bad news was rampant, as was investor anxiety. There was speculation that if President Reagan were up for election in November of 1982, he would be beaten. August 12 was a Thursday. The Mexican Prime Minister informed the U.S. Federal Reserve that Mexico was going to default on certain short-term debt and that its foreign exchange markets would be closed on Friday. Penn Square Bank in Oklahoma had failed in July. However, little did I (or anyone) know that day would mark the start of a tremendous bull market from that 777 low. Investors wouldn't see Dow 777 again. From that low, an eventful and, in many ways, astounding 37 years later we sit close to Dow 27,000.

The 2010s Are History

Now, the last months of the 2010 decade draw near. 2020 is not only on the horizon, it is practically here, hovering over us. So, what's next? What should we do? How should we think about the coming new decade? We are approaching it with three thoughts in mind. 1) Keep our eyes open and be situationally aware to what markets are communicating. 2) Seek answers to three important questions from our portfolio companies regarding strategy, capital allocation and ownership/succession. 3) Be not afraid. Pack some courage.

A recent Wall Street Journal article about "Mega-Mistakes" explored the notions of massive prediction errors by "experts" and not being fooled by prevailing opinion. Columnist Andy Kessler wrote, "The 2010s were about holding cash, maybe in your mattress, vs owning stocks. Oops---Apple, Amazon and Microsoft would soon flirt with trillion dollar valuations. Tera-Mistake?"

His point is a good one. Investors (companies too) can be so obsessed looking backwards they miss the future. The 2010s decade will not end up being as strong as the decades of the 1950s, 1980s or 1990s (which ranged from 17% to 19%) in terms of compound annual returns for the S&P 500. However, the 2010s results will likely be in the 15% range. As Kessler details, holding cash in a mattress was not a winning strategy this decade. After the Great Recession, a "Fear Bubble" developed among many investors that did not pop but rather has been slowly deflating for over a decade. We believe it will continue to deflate over time.

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Eyes Open

It is important to be clear-eyed about what is transpiring today and what current developments may mean for tomorrow. We are highly cognizant of the fact the current U.S. economic expansion turns 10 years old this month, making it officially the longest on record. However, we should not confuse longevity with strength. While the longest, this recovery is historically weak. Real GDP is up cumulatively 25% from Q2 2009 through Q1 2019, with the best of that coming in the last two years. According to Yardeni Research, which has done excellent work for decades, of the prior six 10-year periods that began with an expansion, this is the second weakest. As Ed Yardeni has stated many times in forecasting a longer than average expansion, "How can we have a bust when we have had no boom?" We think this sentiment makes a lot of sense. Our own fixed income staff has repeatedly noted that the U.S. and the world economies have an abundance of "supply" across many segments of our economy, from virtually all commodity markets to retail brick and mortar stores. This excess supply serves to mitigate capacity constraint induced economic overheating.

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Answered Questions

Critical to identifying successful businesses is understanding the vision of the owners and the leadership team. What is the strategy? What are the choices that are being made? What is the winning aspiration of the business? What kind of markets is the business seeking to serve? How is the business expecting to win in these chosen markets? As we evaluate businesses for investment, we seek logical answers to these questions. Sometimes, the questions remain unanswered. For businesses that fail to answer to our satisfaction, we pass or sell.

In the digital age, differences between companies are becoming increasingly stark and easier to identify. Those that are willing and able to adapt have a decided edge. Over the last 25 years, no better contrast exists than between Sears and Amazon. Sears allocated little capital to investing in its own business or adapting its business model. It made minimal investment in technology or people. Its strategy, if one wants to call it that, was to enrich the personal fortune of its largest shareholder, Eddie Lampert. Conversely, Amazon, headed by Jeff Bezos, has had a clear, well-articulated strategy based on digital disruption of the retail establishment. Bezos migrated his business model away from selling only books and invested heavily in technology and human capital. He made clear his intentions regarding ownership and succession. Consequently, investors and capital flocked his way and away from Lampert. For Amazon and others that can successfully answer these questions, the flocking will continue.

Pack Some Courage

John Templeton, one of the pioneers of the investment management profession, once said, "Bull markets are born on pessimism, (as was certainly the case in August 1982) grown on skepticism, mature on optimism and die on euphoria." We believe neither of the two extremes, pessimism or euphoria, accurately describe the current environmental backdrop for stocks today. The "Fear Bubble" is still deflating. It will likely continue to deflate. Therefore, we are constructive on stocks and believe this is no time to be afraid of them.

We fully acknowledge the existence of investor apprehension. 10,000 Americans are turning 65 every day. Many are retiring from the workplace and many are apprehensive about their financial futures. To have this sense of concern is entirely understandable. However, we have found that optimism almost always pays in investing. The best investors pack some courage for their investment journey and fight the inclination to be fearful, apprehensive and reticent. They then muster the gumption to invest in the innovative ingenuity, creativity and resilience of American business through consistent ownership of quality U.S. common stocks. Onward to 2020 and beyond.