January 2020

"The big money is not in the buying and the selling, but in the waiting."

– Charlie Munger

The total return for the S&P 500 was 31.49% in 2019. That capped a decade of over 13% annualized returns, nearly 50% higher than the long-term average. Stocks bounded higher in 2019 as the Federal Reserve cut interest rates and injected liquidity into the repo market. While we benefited from the rising market, we must maintain a balanced perspective in light of the bull market's ushering of a psychological shift that obscures rational risk assessment. Jay Ritter, finance professor at the University of Florida, noted the return of the willingness to bet on unproven businesses, as about 80% of companies that debuted on US stock exchanges in 2019 did so with negative earnings, matching the peak level during the irrational exuberance of the late 1990s. The Bank of America Global Research Fund Managers Survey in December showed the biggest two-month increase in growth expectations in the survey's history. Fund managers are more bullish now than they were when stocks could be bought more cheaply.

Low interest rates have predictably invited risk-taking and greased the bond market. Corporate debt to GDP is at an all-time high, and BBB-rated bonds – the lowest investment-grade rating – represent 50% of investment grade debt, compared to just 17% in 2001. Increased leverage, together with expanded stock multiples, have amplified returns for stocks and further emboldened investors. It's an incendiary formula that has fed the popularity of owning stocks without discretion; Morningstar reports that the percentage of US assets in passive equity strategies has doubled in the last ten years to 50%.

Clearly, risk management has taken a back seat. As they always do, investors keep dancing as long as the music is playing, no matter how dissonant. With the price-to-sales ratio for the S&P 500 now higher than the peak in early 2000 at the height of the first technology bubble, long-term investors should consider the consequences of pricing companies with weakened balance sheets as though their equity has become safer. Market buyers beware.

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Portfolio Update

We took advantage of market strength to narrow our holdings and better position our portfolios for the long run. We made no new investments in the second half of 2019, as we failed to find any new stocks that satisfy our investment criteria, outlined below. In reassuring ourselves that we're not crazy or lazy, we reference past cycles. Warren Buffett had gone much longer periods when he refrained from making major purchases in the stock market, including between 1985 and 1988, when he chose not to participate in the "manic rampage" that preceded the stock market correction in late 1987. The average price to trailing reported earnings for the S&P 500 during Mr. Buffett's hiatus was 15.5x, which probably felt more expensive considering the multiple had doubled over the prior six years or so. For perspective, the current multiple of price to trailing reported earnings is 24x. Because the S&P 500 index is weighted by market capitalization, the prices of its largest constituents have outsized influence on the overall multiple.

Although it's no fun sitting on our hands for six months, we do not rationalize a lowering of the bar for what we consider a sensible investment. Our lack of new investments should not be mistaken for a lack of intensive research. As always, we continued to expand our research library of shares of competitively entrenched, growing businesses. When the shares of any are offered in the market at fair prices, we will jubilantly load up. In the meantime, we feel very good about our investment portfolio, which is centered on business strength, but away from market euphoria. It's also increasingly tilted toward companies based outside of the United States, either in markets where long-term demographics and economic growth rates are much more favorable than in the US, or in markets where shares are priced considerably cheaper than in the US.

Four Core Tenets

For our clients and ourselves, we prioritize the elimination of unnecessary risks. Avoiding the two extremes referenced above – excessive leverage and frothy prices – greatly increases an investor's odds of success, and lowers the analytical threshold required for success from "exactly right" to "roughly right". In fact, stocks of companies with the worst balance sheets underperformed stocks of companies with the best balance sheets by ten percentage points annually from 1964-2009[1], while the most expensive stocks underperformed the least expensive stocks by six percentage points annually from 1929-1997.[2] Eliminating stocks that fail on these measures marks two of the four core tenets of our investment philosophy.

The third tenet is what Charlie Munger termed "the waiting". Stocks are the ultimate perpetual investment vehicle, directly tied to the fortunes of the companies by which they are issued. One of the great ironies of investing in these perpetual securities is that their owners are increasingly transitory. Ned Davis Research pegs the average holding period for New York Stock Exchange-listed stocks at about eight months, down from eight years in the 1950s. Eight months is not long enough for company fundamentals to have much of an impact on investors' portfolios. According to Grantham Mayo, changes in stock price multiples account for 80% of one-year returns, whereas dividends and dividend growth account for 80% of five-year returns.[3] In other words, short-term trading is akin to gambling, and the destructive effects are evident.

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In a 1987 experiment, Harvard psychologist Paul Andreassen found that people who received frequent news updates on their investments earned lower returns – due to excessive trading – than those who received no news.[4] We suspect it's even more difficult now for investors to avoid distraction when every bit of news is dramatized by a flood of personalities from Twitter to CNBC and everywhere in between. It's no wonder that many investors succumb to their impulses and rely on liquidity and the ease of trading to jump in and out of the market. Perhaps the clearest evidence of this phenomenon is the fact that investor returns in mutual funds have been measured at just 60% of the underlying returns of the funds in which they invest.[5]

Instead of viewing the sell button as a safety valve, we believe investors should approach each investment with the intent of never selling, or at least not selling for a decade. Investors with that mindset will be much more judicious in choosing each investment, and we believe they will be much better off as a result. That brings us to our final core tenet: we want to own durable businesses that are very likely to be larger in ten years' time. Those are the companies that carry the potential of returning multiples on one's original investment, far outweighing the potential for loss, thereby further tipping the odds in the investor's favor.

Looking back through market history, the shares of many obviously strong franchises, purchased when euphoria was not propping up the prices, have been much better investments than simply investing in the market. It is not necessary to discover wonderful businesses in their first inning to realize a great outcome. In fact, investing at that stage is much riskier, and is more aptly described as swinging for the fences. That's not what we do. Rather, we are looking to invest in good businesses in the third or fourth inning of their life cycles, with plenty of growth ahead, but after their market shares have been somewhat solidified. Ultimately, the best strategy, to paraphrase Mr. Munger, is to buy a few great companies at fair prices and sit on your ass. After all, the miracle of compounding is awarded to those who stick with it.

Please reach out to us with any questions or comments.

Sweetbay Capital Management

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Notes

1. James P. O'Shaughnessy, What Works On Wall Street, Supplemental Material, Case Studies & Exhibits, 2015.
2. James Davis, Eugene Fama, Kenneth French, Characteristics, Covariances, and Average Returns: 1929-1997, February 1999.
3. James Montier, A Man from a Different Time, *GMO,* August 2010.
4. Paul Andreassen, On the Social Psychology of the Stock Market, *Harvard University*, April 1987.
5. Quantitative Analysis of Investor Behavior, *Dalbar* (March 2014) and *Lipper*.

Important Disclosures:

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Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be profitable. The New Investments section describes each new security in which we initiated a position during the referenced six-month period. Every security may not have been purchased for each client based on the timing of a particular account opening, or based on assessed needs of a particular account.

Past performance may not be indicative of future results. Therefore, no current or prospective client should assume that the future performance of any specific investment or investment strategy (including the investments and/or investment strategies recommended by the adviser) will be profitable or equal to past performance levels.

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