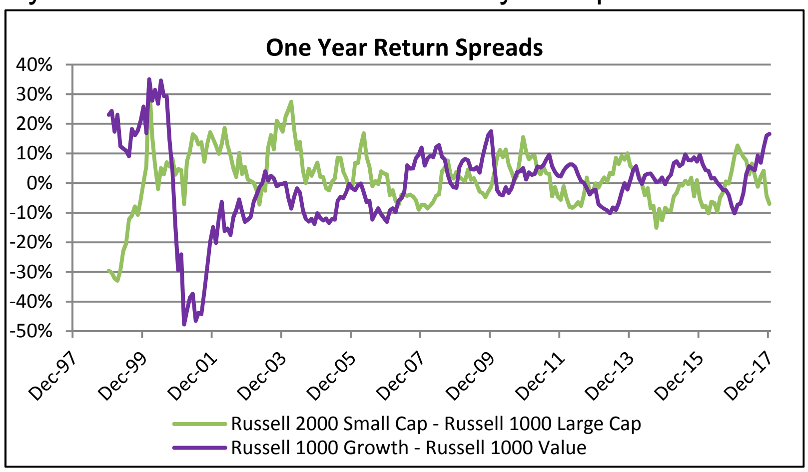
The Long & Short of It
Quarterly Newsletter
Fourth Quarter 2017

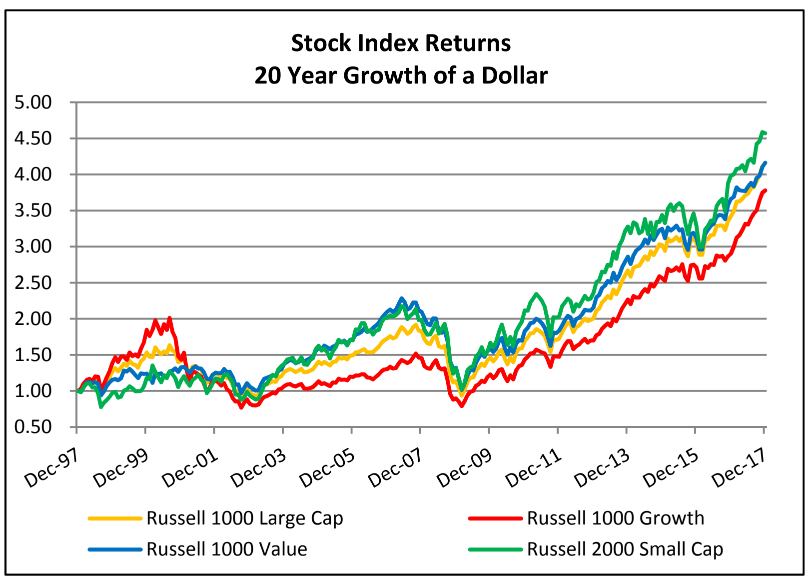
Holiday Cheer

Last October, we wrote: "The holidays are nearly here, a time when tranquility and bull markets thrive." No politician wants to be labeled a "Scrooge" and sure enough, Congress pulled together the votes on tax reform for a very strong finish to a solid year. The FAANG and other large cap growth stocks continued to dominate performance through the broader market showed improved traction. Emotions ran high: those with exposure to FAANG were elated while everyone else was pleased but felt a bit left out.

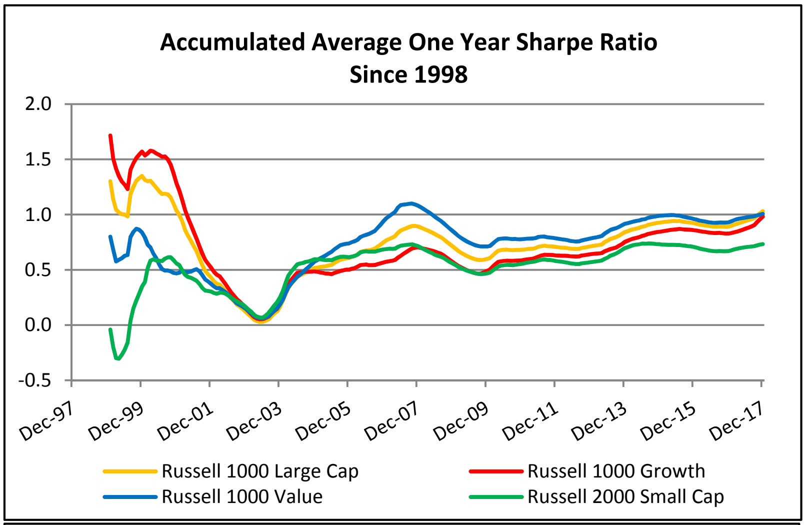
For contrarian investors, these polarizing reactions suggest a sea change afoot. The disparity in performance that drives the disparity in emotions is best illustrated by the spread between large cap growth and large cap value, which since the election has remarkably surged from a 10% lag to a 16% premium (see "One Year Return Spreads" chart). Large cap has also outperformed small cap, though by a smaller margin. Furthermore, the differential between growth-value and large cap-small cap spreads is at the outer bounds of a range in place for the last 12 years.

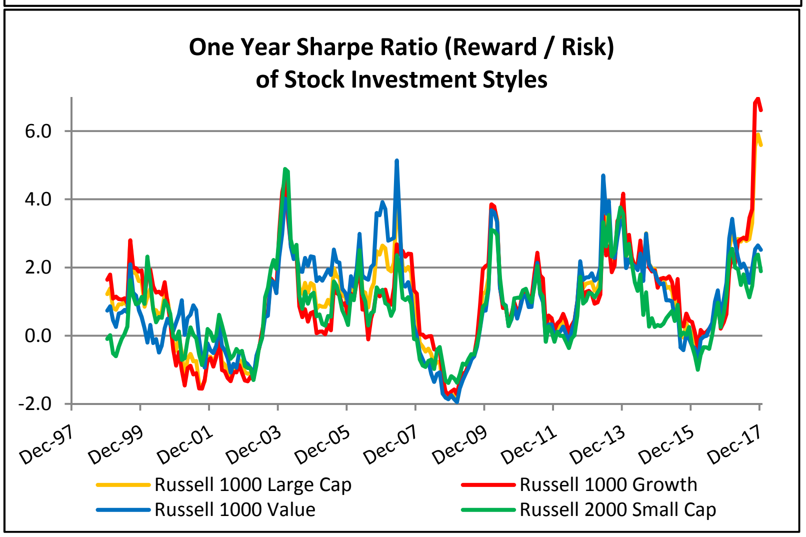


Large cap and growth may be the current winners but historically they have been losers to small cap and value (see "Stock Index Returns" chart). The risk (standard deviation) associated with small cap stocks, however, has averaged 40% greater than for large cap. Within the large cap space, growth has been 13% more volatile than value. Choosing between large cap vs. small cap or value vs. growth comes down to perspective and philosophy. At Robinson Value, we will never consider return without measuring and understanding the risk employed to achieve that return.



One helpful tool is the Sharpe ratio, named after William Sharpe, who won the Nobel Prize for quantifying risk. The Sharpe ratio is an investment's return in excess of the return from a "risk free" investment (i.e. short term US Treasury Bills) divided by the standard deviation of those excess returns. Based on this measure, value investing has largely dominated results for the last 20 years (see "Accumulated Average One-Year Sharpe Ratio" chart). Solid returns and a lower risk profile make value more attractive than other options. Today, the reward/risk profile of large cap growth over the last year is both unusual and unsustainable (see "One-Year Sharpe Ratio (Reward/Risk)" chart). Caveat emptor - buyer beware - applies for today's buyers of large cap growth.





Euphoric New Year

The late Sir John Templeton, renowned mutual fund manager, once wrote that "bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." By year end 2017, skepticism had given way to optimism but euphoria had not yet arrived. There remained concerns over high valuations, geopolitical tensions, and policy uncertainty from Washington, DC that signaled a lack of bullish consensus.

If the most recent measures of consumer sentiment are any indication, euphoria is finally making its appearance. The AAII Investor Sentiment Survey rates optimism at its highest in several years. According to the Michigan Consumer Sentiment Index, individuals believe it's the best time to own stocks since the survey's inception in 2002. And the Investors Intelligence Sentiment Index is now stronger than at any time since just before the crash in 1987. Furthermore, Merrill Lynch and Charles Schwab report cash levels have fallen to record lows. It seems the passage of tax reform has added fuel to bullish fires, encouraging investors to put every last dollar to work.

As we discussed in recent letters, volatility is at record lows while margin debt is at record highs. We believe the addition of unbridled optimism to the existing low volatility and leverage means the bull market will soon need to take a break in the form of a 5% - 15% correction. It is too early to say if a correction will be larger, though that can always take place. Today's euphoric optimist is yesterday's buyer, whose only option is to hold fast or become tomorrow's pessimist/seller. As always, what goes up must come down.

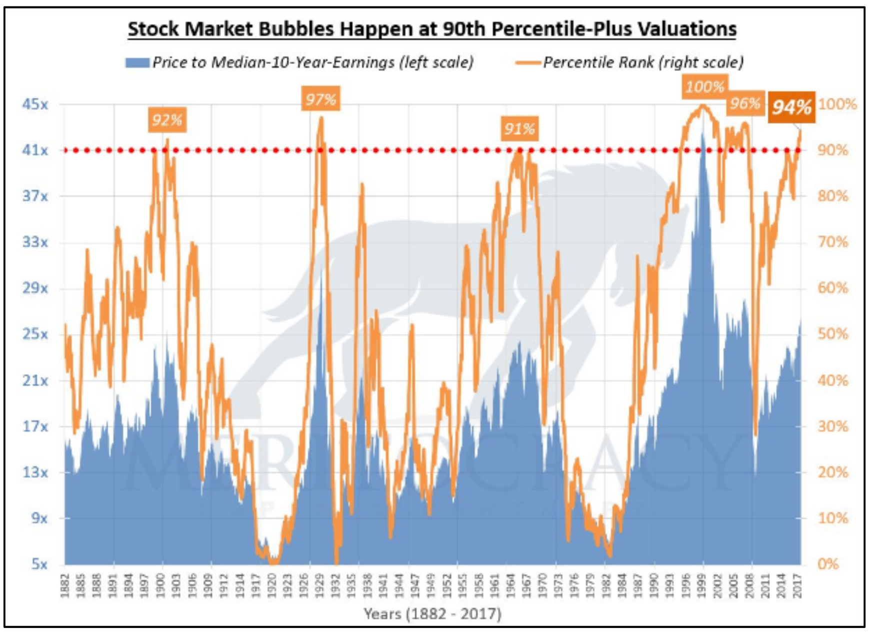
Tax Cut Fueled Economic Growth: Reality or Illusion?

There is much debate as to whether tax reform will create significant economic growth and, more specifically, who will benefit. Our interest is whether the changes are already priced into the stock market. Any discussion must consider the potential impact on both short-term liquidity and long-term real growth.

Corporate cash repatriated from abroad will boost corporate debt pay-downs, stock buy-backs, dividend payouts, and capital expenditures. However, these devices will provide only a short-lived bump to liquidity. Furthermore, the stock market has already rallied 35% alongside passage of the legislation. In 2004, the tax on repatriated cash was reduced and the market had surged roughly 35% in the prior year in anticipation of the 2004 tax decrease. Sound familiar?

While lower tax rates should make US corporate operations more competitive globally, it is difficult to gauge impact on long-term growth. Shifting from equality-minded, slow-growth tax policies to pro-growth should result in increased economic expansion, but to what degree and for how long? As earnings rise, the anticipation of more growth drives the stock market ever higher. Many investors lose sight of the fact that much of this increase in growth rates may be temporary. They also seem to believe it can happen while interest rates remain low for a very long time.

Current stock valuations are rich by most measures. Within the 200 industry leaders we follow closely, our research suggests the median company is now 25% above fair value. 2000 and 2007 are the only years in the last three decades that have reached valuation premiums of greater than 25%. In our experience, valuations do not get much higher than this.



At the broader S&P 500 level, we again see this unusual excess valuation courtesy of Meritocracy Capital Partners' Howard Ma, who publishes a measure of price-to-10 year median earnings (see "Stock Market Bubbles" chart). It indicates the stock market is more expensive now than 94% of the time since 1882.

Eyes on the Fed

Mild inflationary pressures and rising stock prices could encourage the Fed to become more aggressive in raising interest rates. The Fed has already tightened monetary policy significantly, drawing closer the end of this expansion cycle (see "10-Year Minus 2-Year Treasury" chart on next page). Over the last decade the Fed's expansion of its balance sheet, which ballooned from under $1 trillion in 2008 to over $4 trillion today, was very good for stocks. The process of contracting the balance sheet to more normal levels began in October 2017, so far resulting in a 2% contraction in assets. This new "diet plan" may pose significant

challenges for the stock market. If inflation moves significantly outside of the Fed's 2% target, then the Fed may apply the brakes more vigorously and bring the bull market to a screeching halt.

Nimble New Year

There have only been four bull markets in excess of 10 years long since 1926. Stock prices are high although inflation remains benign by historic standards. Most notably, it has been over 30 years since the tax code was modified in such a drastic fashion. Dramatic changes to the math can cause seismic changes in markets—sometimes rapidly. At Robinson Value, we steward your portfolio with the utmost care. No matter the direction of the wind or condition of the seas, we endeavor to get the details right in the vigilant management of equity portfolio risks. We appreciate your vote of confidence and will work hard to continue earning it, one investment at a time.

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