

## The Market Corner: No Good Deed Goes Unpunished

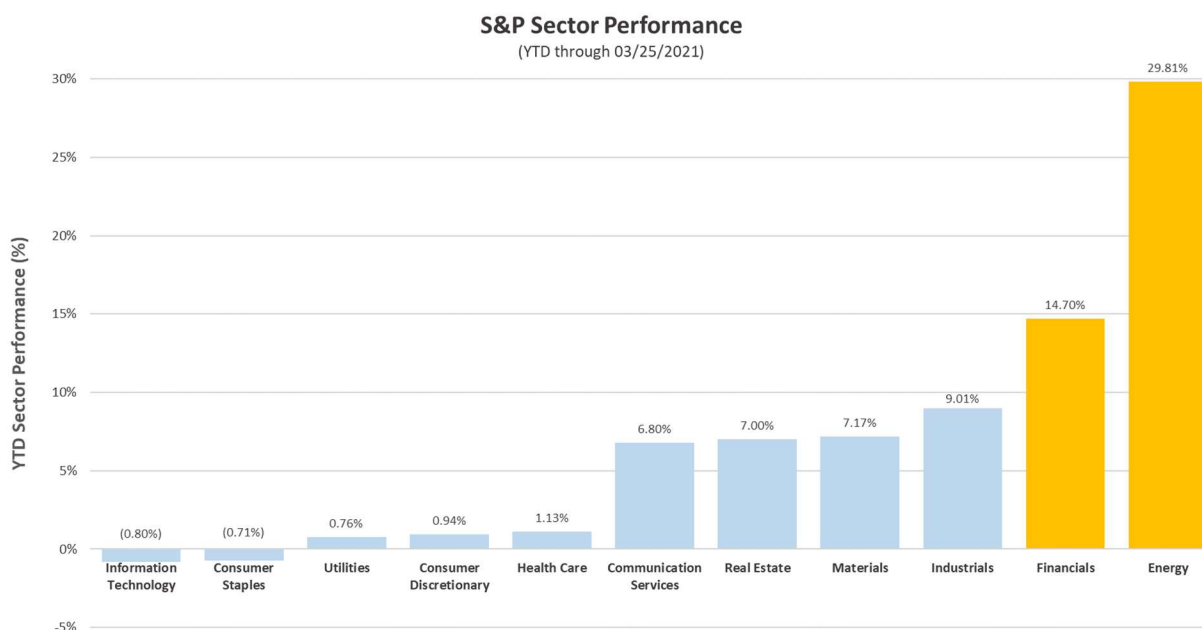
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As we headed into this year, Wall Street rolled out its “2021 outlook,” as is the long-standing tradition. The various buy and sell-side firms proclaimed what sectors, stocks, and asset classes they think will perform best in the upcoming year. The consensus seemed to quickly settle on several themes and conclusions that appeared suspiciously consistent across many firms. Perhaps this should not have been surprising since sticking with the “herd mentality” often feels safe when making predictions, and feeling safe has probably become a priority after a highly stressful 2020. Those themes included:

- 1) We are in a cyclical recovery, so buy the cyclical stocks
- 2) Interest rates are rising, so sell longer duration equity (growth) and buy shorter duration (value)
- 2) The U.S. dollar has outperformed for too long, and we have overpriced equity markets, so buy Emerging Markets/Non-US assets

The first two have played out in spades so far this year, as illustrated in the chart below. These points are a bit overlapping and correlated in our mind. “Value” stocks also tend to be “Cyclical” because U.S. investors seem to reward consistency with higher valuations, though not always. Regardless, we have seen huge rebounds in both Energy and the Financials, particularly Banks in the latter category, as confidence in the recovery of the U.S. economy has grown during 2021.

**Figure 1: Cyclical Stocks Are Outperforming So Far in 2021**



Source: Bloomberg LLC

This market dynamic, of course, raises the question of ‘will this trend continue for a more substantive period?’ We would note that we are thinking in terms of several years, not months since we are investors, not traders. Typically, we are looking for companies that are clearly set up to have lasting, above-market performance over long periods. This requires a strong balance sheet and enduring business position with “moats,” as evidenced by high margins, significant cash flows, and strong, sustainable growth with healthy market share in their target market. Let us examine the recent market trends in that context and see the underlying reality versus perception.

We are the first to (proudly) admit that the types of companies doing well this year are seemingly the antithesis of what we describe above. Energy, mainly traditional “carbon-heavy” energy, is by its nature a commodity and unable to maintain strong margins across long periods of time. This is the very reason pseudo cartels like OPEC exist: you can make decent returns during periods of exceptional cooperation between producers, but there is always an incentive for the various players to cheat the system. These circumstances typically lead to over-production and over-capacity, spoiling the financial returns for everyone. There will be periods of rebound off of low-price levels and limited expectations, which is exactly how the 2020 pandemic set us up. We do occasionally find a stronger player with an excellent balance sheet and strong management that positions them well for an extended recovery hence our limited position in ConocoPhillips in the INC (Sustainable Income Strategy) portfolio.

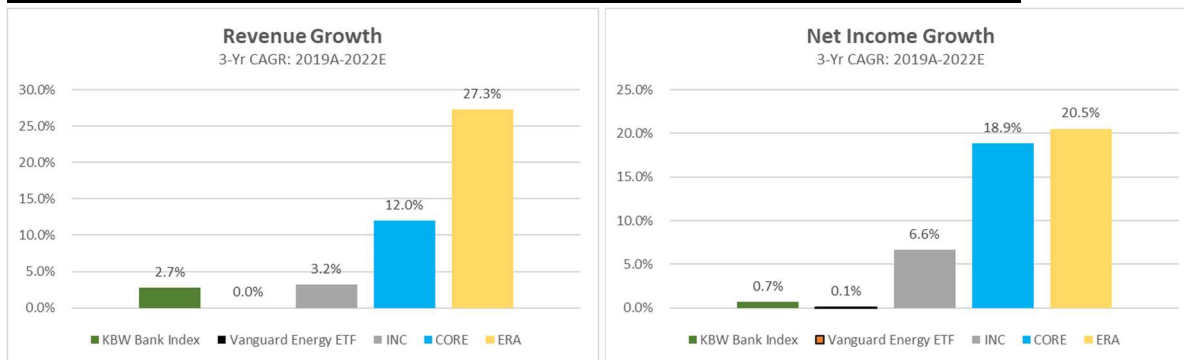
That said, we hardly see a strong case for owning significant portfolio positions in big oil over the long term given the business's commodity nature. We put more weight in the structural caution flags we see around the industry, such as advances in solar and wind power and the accelerating rise of the electric vehicles. These innovations seem even more pervasive when combined with solid battery and grid infrastructure, which seems likely to displace large segments of the current energy industry.

Similarly, we look at the banking industry as one suffering from over-capacity, high leverage, heavy regulation, high capital intensity, relatively pedestrian and often disastrous returns through cycles, and facing a fair amount of disruption as technology displaces the traditional physical branch model. In all fairness, they too are seeing a rebound from 2020 as they reverse the heavy credit loss reserves they took in the depths of the Pandemic downturn. But will the industry come out of the pandemic revitalized and on a better long-term growth path with regulatory overhang and technological disintermediation evaporating? We are doubtful.

While we can talk broadly on why we do not find many of the current “value” names all that valuable, we would rather look to the numbers. In this case, the data is instructive on what one is really getting in the trend to rotate out of higher quality names (which to us encompasses business model attractiveness, balance sheet, *and* growth) into value. Yes, they offer some lower absolute valuations; however, the long-term and seemingly unattractive trade-offs on growth, leverage, business model attractiveness, and sustainability are clear in our mind, even if the street tends to get bouts of short-term amnesia.

Markets seem quite excited about the expected rebound in Energy and Bank revenues and earnings in 2021, which we understand conceptually. However, suppose one considers the combined effects of the downturn and subsequent rebound to get a longer-term picture *across the cycle*. In that case, things seem noticeably less attractive to us, even more so in comparison to what we already own in our 3 equity strategies. This is illustrated in Figure 2 below.

## Figure 2: Do Cyclical Downturns and Rebounds Compound Value Over Time?

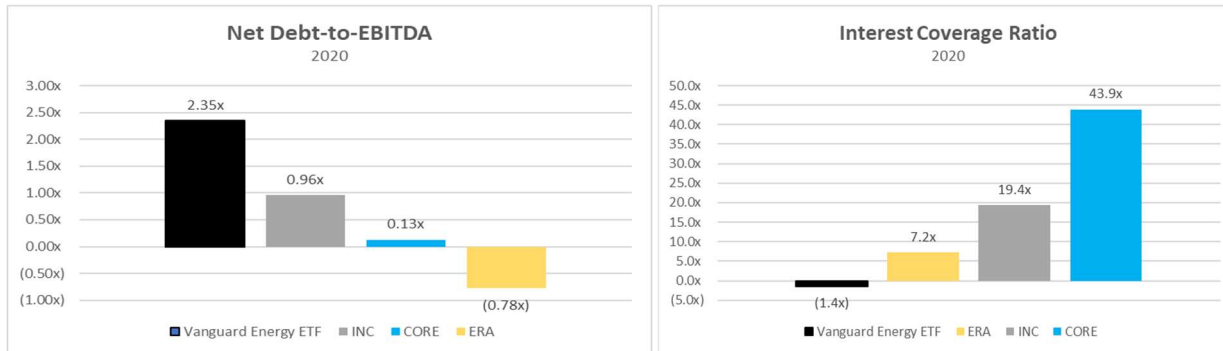


Source: Bloomberg LLC

As far as balance sheets go, both Energy and Banks are not sectors that tend to garner much confidence in our mind. Banks are among the most levered industries, running around 10x asset leverage to equity,<sup>1</sup> leaving little margin for error. Hence, they are often exposed to capital raising and its associated dilution at the worst possible time in a cycle: the bottom.

Energy, though less levered, is also highly capital intensive, globally competitive, and is subject to large boom-bust cycles over time. We illustrate the average Net Debt to EBITDA (lower is better) and Interest Coverage Ratio (higher is better) for the oil industry using the Vanguard Energy ETF as a proxy and compare that to the averages of our three equity strategies, which all compare favorably by pretty wide margins.

### Energy Company Balance Sheets Don't Really Keep Us Warm At Night



Source: Bloomberg LLC

To our eyes, at least, these kinds of numbers call to question the wisdom of running with the herd on short-term-focused strategies like “sector rotation” and “cyclical recovery.” That concern is compounded if one cares about short-term capital gains and tax consequences. That may mean we underperform for periods when those strategies seem to be driving overall market returns. Still, we remain focused on finding and investing in quality companies over the long-term. If perhaps things are changing more permanently than we realize right now and the underlying attractiveness of those industries is truly brightening, we will certainly reassess. For now, count us as noting the trend and watching with interest.

<sup>1</sup> FDIC, Statistics at a Glance, 12/31/2020 (FDIC Statistics at a Glance - Industry - 4th Quarter 2020)

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