QUARTER 3 • 2017

Investing INSIGHTS

from Evanston Advisors

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October 2017

Fall is upon us! The days are becoming markedly shorter, the leaves are beginning to turn, and for those of us here in the Chicago area, the dreaded winter weather is not too far away. It seems that 2017 has gone by way too quickly.

When writing these letters, I often pull out what I wrote in prior quarters and sometimes even go back to earlier years. At times, it seems that what was written in the past has become once again relevant. For example, in an earlier letter I wrote: "For over a year the majority of the gains in the stock market… have been attributable to only a handful of stocks." In another: "the market's gains have been so narrowly focused… leaving investors to wonder why they are not seeing the types of returns that are frequently praised by the media." Yet another: "The valuation levels of many companies concern us, as there is no economic justification for them." These three statements are eerily similar to things I have been saying this year. For most of the year, Growth oriented investments have significantly outperformed Value oriented investments. In other words, the market has been ignoring company fundamentals such as earnings and valuations, and rewarding companies that are believed may grow rapidly, regardless of profitability.

"… the market has been ignoring company fundamentals such as earnings and valuations…"

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The statements quoted earlier were extracted from three separate quarterly letters written in one year: 1999. That was a time when, like now, we were told that "fundamentals don't matter" and that "Value investing is dead". Like now, the market continued to reach new all-time highs. And like now, the market was quite overvalued (the market is currently valued about 25% higher than long-term norms). In fact, the only non-recessionary period that had higher valuations than we are at currently was the dot-com era. Another interesting data point: the market value of equities (i.e., the total value of all publicly traded companies combined) is currently about 157% of the U.S. Gross Domestic Product. The only time it's been higher? Again, the late 90s, prior to the dot-com bubble popping.

So how long can Growth outperform Value? Historically, it doesn't usually last for very long. Even in the frothy late 90s there were periods where Value outperformed Growth, though on an annual basis Growth topped Value in both 1998 and 1999. A study done last year by Bank of America/Merrill Lynch found that in the last 90 years, Value on average returned over four percentage points more per year than Growth, and beat Growth in three out of five calendar years. And though it's obvious in the year-to-date chart that Growth has been significantly outperforming Value so far this year, what's not as obvious is that Value began closing that gap in the third quarter:

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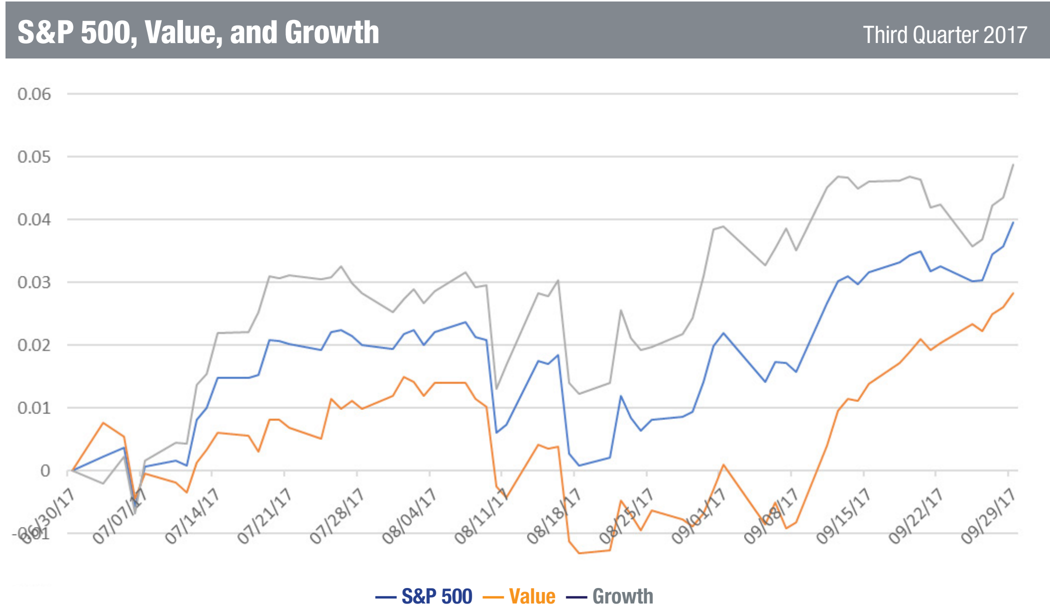
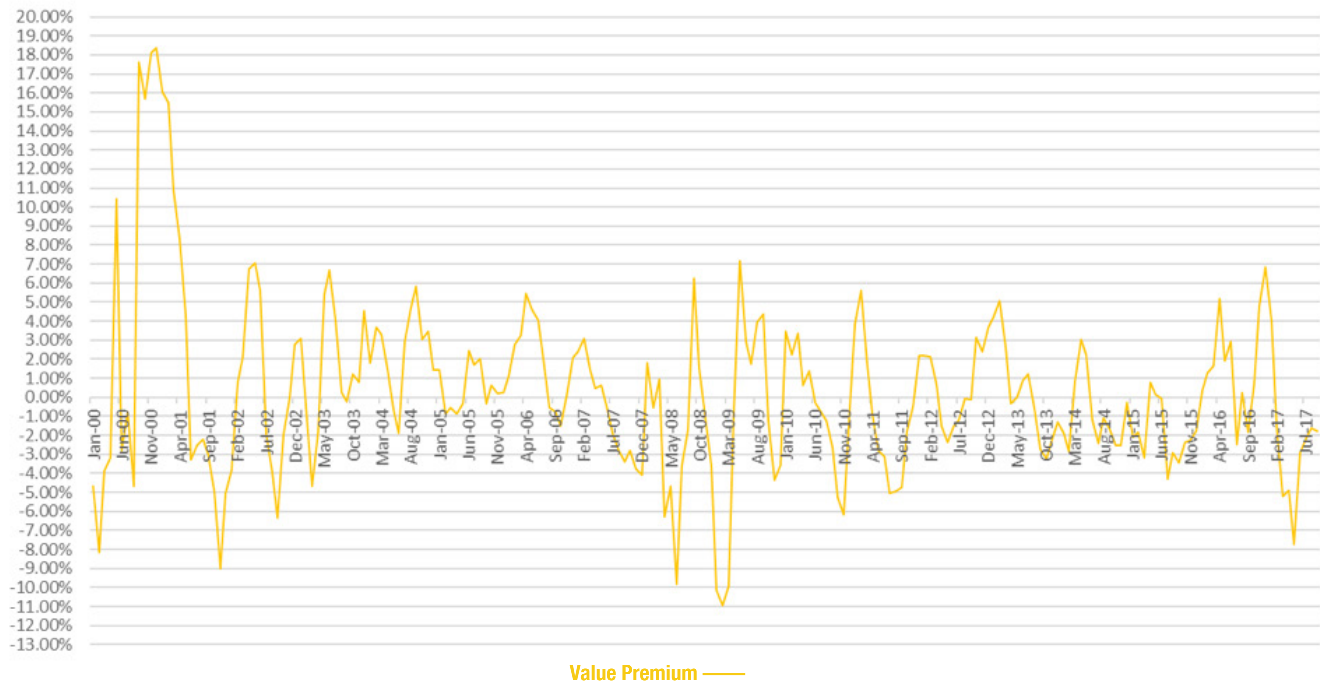


September was quite strong for Value, returning more than three times what Growth did.

Last quarter I presented a chart that showed the Value Premium, i.e., the return of Value over/under Growth over rolling 3-month periods since January of 2000. This premium is equal to the return of the S&P 500 Value Index minus the return of the S&P 500 Growth Index over rolling 90-day periods (not just calendar quarters, but Jan-Mar, Feb-Apr, etc.). In periods where Value outperforms Growth, the premium is positive, and negative when Value under performs. I've updated that chart, as we have three additional 90-day periods ending July, August, and September.

Value Premium

Rolling 90 day periods



Notice that the recent spread that has been favoring Growth has lessened pretty significantly.

In the 1999 letter I discussed how the market's return was concentrated in a handful of names. To a somewhat lesser extent, the same is true today. The "FANG" stocks (Facebook, Amazon, Netflix, and Alphabet aka Google) make up about 6.5% of the S&P 500, but are responsible for 17% of its return so far this year. These stocks have an average P/E ratio that is fully five times that of the market! The ten largest companies in the index make up 19% of the market value of the index, but account for 1/3 of its return so far. The average P/E ratio of these ten companies is 48, more than double that of the market.

The current market valuations, and especially the valuations of Growth companies cannot be supported by the fundamentals. I expect that we may see a correction at some point in the not too distant future.

As another point of reference, only 9 of the past 80 calendar years have gone by without the market being negative at any point during the year. We have not been negative at any point in 2017. That said, in the event of a correction, I do not believe that our portfolio will experience the same magnitude of slippage as the frothy Growth names, as there is underlying fundamental justification for the valuations of our holdings.

My outlook for the rest of the year:

- I continue to believe that the market is quite overvalued, and Growth names are significantly overvalued. I maintain my expectations for high single digit returns for the S&P 500, which suggests a pullback from where the market is now.
- When a pullback occurs, Growth stocks are likely to decline significantly more than Value stocks, as their valuations cannot be justified based on their fundamentals.

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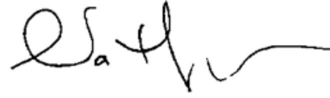
- The Fed continues to express its determination to continue "normalizing" interest rates. This suggests one more increase in rates in 2017, most likely in December.

As you are probably aware, Equifax, the credit monitoring agency, experienced a major data breach recently. Data breaches, email phishing, and other attempts at identity theft have become all too common. We have had a number of clients express concern, and as such, we have enclosed a white paper to assist in managing through a data breach, as well as monitoring your credit information to detect any unauthorized access to or use of your personal information.

If you have any questions, please feel free to contact us.



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