EUBEL BRADY & SUTTMAN
ASSET MANAGEMENT

MARKET REPORT
SECOND QUARTER 2019

Key Takeaways

- U.S. equity markets continued marching higher in the second quarter.
- Economic growth has moderated and U.S. stock valuations on average aren't cheap.
- Domestic and global monetary authorities hope to boost economic growth by taking a more accommodative stance.
- The initial public offering (IPO) market has been hot. This is another item that causes us to take pause.
- Keep reading for The Good Stuff.

Total Return as of June 30, 2019						
			Annualized			
	QTD	**YTD**	**1 Yr.**	**3 Yr.**	**5 Yr.**	**10 Yr.**
S&P 500	4.3%	18.5%	10.4%	14.2%	10.7%	14.7%
NASDAQ	3.9%	21.3%	7.8%	19.7%	14.1%	17.3%
Russell 3000						
Index	4.1%	18.7%	9.0%	14.0%	10.2%	14.7%
Value	3.7%	16.1%	7.3%	10.2%	7.3%	13.1%
Growth	4.5%	21.4%	10.6%	17.8%	13.0%	16.1%
Russell Mid Cap						
Index	4.1%	21.4%	7.8%	12.2%	8.6%	15.2%
Value	3.2%	18.0%	3.7%	9.0%	6.7%	14.6%
Growth	5.4%	26.1%	13.9%	16.5%	11.1%	16.0%
Russell 2000 (Small Cap)						
Index	2.1%	17.0%	-3.3%	12.3%	7.1%	13.5%
Value	1.4%	13.5%	-6.2%	9.8%	5.4%	12.4%
Growth	2.8%	20.4%	-0.5%	14.7%	8.6%	14.4%

Overview

Fundamentals no longer matter. Only the Federal Reserve's monetary policies are relevant. We are *kidding*, of course, fundamentals always matter in the long run. Domestic and global economic growth has slowed, or is forecasted to slow, to a level that causes monetary authorities to be at the ready with their accommodative pump. Yet, U.S. equity markets continued marching higher in the second quarter bringing year-to-date returns well into double digit territory. The S&P 500 logged its best first half since 1997 and the disparity between growth and value indexes (accompanying table) is notable.

It is well documented that equity markets are discounting machines – considering economic prospects in the coming six to 12 or so months. However, when the cost of money is so cheap – the 10-Year Treasury's yield was 2.0% at quarter-end - rational behavior can temporarily get pushed aside. Evidence is mounting that investors are throwing caution to the wind and embracing this new paradigm where roughly $12.5T of debt, globally, trades with negative yields. In other words, investors in certain parts of the world essentially pay rent to store their capital in government bonds. This is not normal.

Some valuations today remind us of the go-go years of the late 1990s when certain large-cap companies' stocks were held in high regard and traded at very lofty valuations. For those companies and many of their brethren, *actual* growth rates turned out to be much lower than *projected* growth rates. Although some of those companies did well operationally in the subsequent decade, their stock prices were largely stagnant (or down) as the earnings and cash-flow per share had to grow into the valuation ascribed to them at the time. Today, on average, U.S. equity prices aren't cheap and future growth prospects are seemingly modest. No time to be adventuresome, in our opinion.

U.S. Equities

Ten of 11 economic sectors supported the S&P 500's 4.3% quarterly increase, including dividends. Energy (-2.8%) was the only detractor after a strong first quarter. Financials (+8.0%) led the way, followed by Materials (+6.3%), Information Technology (+6.1%) and Consumer Discretionary (+5.3%). Healthcare was the weakest contributor (+1.4%). Those stocks sporting higher P/Es (i.e. growth) outpaced their lower price-to brethren, again.

The IPO market has been robust of late and some companies have initially priced with incredible (unrealistic) growth expectations embedded in their prices. For example, some enterprise technology companies recently traded at 25-30 times revenue (not earnings, but revenue). If *actual* growth rates come in less than *projected* growth rates, stocks trading at such high valuations will likely suffer. Clearly, investors are only focused on upside in these situations and have disregarded risk. This type of behavior generally does not continue indefinitely.

In today's world, more than ever, venture capital firms support startup companies. Many times, it is those venture capital funded companies that eventually launch IPOs. According to PitchBook-NVCA Venture Monitor, more than $628 billion has been invested in venture deals over the last decade. Interestingly, an estimated $132.1 billion or 21% of that amount was invested just last year. Rarely does such a cheery consensus lead to superior long-term investment returns.

Fixed Income & Commodities

Corporate bonds' total returns, as measured by the BofAML 1-to-10 Year Index, increased 3.1% during the quarter. U.S. Treasuries and Agencies, as measured by a similar index, increased 2.3% for the quarter.
Commodities, as measured by the Bloomberg Commodity Index, increased 2.5% during the quarter, yet many farmers throughout the Midwest continue to struggle with low corn, soybean and wheat prices. Oil (WTI) finished the quarter down only 3%, after declining more than 14% intra-quarter. Geopolitical tension and fluctuating economic forecasts have kept volatility elevated.

The Good Stuff

Does value investing still work? Before answering that question, we must first frame what value investing is and is not. As with many things in life, people like to measure what is easy – even when what is easy isn't the best thing to measure. For example, many providers of statistical data (and indexes and ETFs) define *value* and *growth* stocks based on a few simple metrics, like book-to-price and/or historic and forecast growth rates. Stocks meeting certain criteria go in the value bucket, others go in the growth bucket and some have a portion of their value allocated to each bucket (i.e. they straddle the fence). Data and index providers know that consumers can process these simple concepts easily which can lead to quicker adoption and greater utilization. We don't blame them for being good marketers; however, stock investing can't be summarized with one or two simple metrics.

Value investing is much more than a statistic. It's a way of thinking. Our value-oriented investment process guides us toward investments that can be purchased at a discount to their estimated value. When we correctly assess the value of an investment and make purchases at a discount to that value, a margin of safety exists. The larger the margin of safety, the more we can be wrong in our assessment of value and still have a favorable outcome. We prefer a wide margin of safety, but sometimes must settle for a modest one. The process helps keep us from overpaying for investments, on average. This is important because the price you pay initially, relative to value, is a key determinate of future returns. A primary tenet of our investment process is to minimize the risk of permanently losing capital. This means we will sometimes leave money on the table or forego returns. We work hard to not permanently interrupt the compounding process, because that's our real purpose – compounding wealth, knowledge and relationships as we strive to provide clients with financial peace of mind.

In addition to not overpaying, we prefer to invest in companies with durable economics – ones that can sustain margins, produce an acceptable return on capital and grow. We think of these type companies as core holdings. Sometimes a low-quality company or non-core holding will become so cheap, relative to estimated value, it's worth making an investment. We generally do not hold non-core holdings as long as core holdings, yet our average holding period is typically longer than many managers. All things equal, longer holding periods lead to higher after-tax returns for taxable investors.

Some investors would argue that lower discount rates (required returns) have an outsized impact on *growth* stock valuations, because more of their potential value resides well in the future. Conversely, *value*-oriented stocks are generally less dependent on high growth rates in the future and their valuations are theoretically less impacted by changes in discount rates. It is an interesting argument.

We suspect the coming decade will be kinder to value-oriented and active managers alike. Oh, yes, value investing still works and if human behavior does not change – investors at large continue to be motivated by fear and greed – it should continue working well into the future.

Charlie Munger. In case you've never heard of Charlie Munger, he's the very candid Vice Chairman of Berkshire Hathaway. Mr. Munger is a wealth of wit and wisdom. We've always found his comments helpful in staying grounded. We hope you find the following nuggets as practical and useful as we do.

- "Sit on your ass investing. You're paying less to brokers, you're listening to less nonsense, and if it works, the tax system gives you an extra one, two, or three percentage points per annum."

- "It is an unfortunate fact that great and foolish excess can come into prices of common stocks in the aggregate. They are valued partly like bonds, based on roughly rational projections of use value in producing future cash. But they are also valued partly like Rembrandt paintings, purchased mostly because their prices have gone up."

- "It's waiting that helps you as an investor, and a lot of people just can't stand to wait."

- "Move only when you have the advantage – you have to understand the odds and have the discipline to bet only when the odds are in your favor."

- "You have to be very patient, you have to wait until something comes along, which, at the price you're paying, is easy. That's contrary to human nature, just to sit there all day long doing nothing, waiting. It's easy for us, we have a lot of other things to do. But for the ordinary person, can you imagine just sitting for five years doing nothing? You don't feel active, you don't feel useful, so you do something stupid."

- "We just keep our heads down and handle the headwinds and tailwinds as best we can, and take the result after a period of years."

Looking Ahead

Currently, the number of compelling investment opportunities is more limited than usual. An increase in downside market volatility could change that quickly. We remain keenly focused on individual company fundamentals and price-to-value relationships, and are eager to capitalize on attractive investments as they arise. Patience, discipline and judgement are key, in our view: the patience to wait for the right opportunity; the discipline to say no to all the bad ones; and the judgement to know when to place the order. Through our continual learning process, we strive to hone these skills daily.