Morgan Stanley

INVESTMENT MANAGEMENT

Applied Equity Advisors Monthly Commentary

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This year we have experienced rolling bear markets, regionally and sectorally within an overall secular bull market. While this has negatively impacted our performance through Q2, we are loath to sell down what has hurt us and chase what has already worked. Momentum tends to underperform and mean reversion is more prevalent in markets like this.

Let's review the reasons for the weakness and what we are doing about it.

1. Bond proxies (defensives) rocketed in June. Utilities, REITs, telecommunications and consumer staples were very strong performers. To put in context, the magnitude of outperformance versus the market ranked in the 99th percentile for utilities and 92nd percentile for consumer staples over any one month period.[1]

We wrote in the May commentary:

> My long held belief that the low volatility bubble (defensives) would unwind is occurring as groups like staples have massively underperformed the markets. Post yield curve inversions, the defensive's period of underperformance should end. Therefore, it's still early but we have started to increase our exposure here; primarily in consumer staples but in time in health care as well.

While we have begun to reduce our underweight in bond proxies, the magnitude of outperformance and our continued cumulative underweight hurt performance.

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Historically, defensives do not begin to outperform consistently until four months **after** the yield curve inverts.[2] Not before (the yield curve has not inverted yet). Was June just an oversold bounce, or is this time different? Month to date in July, these sectors are some of the worst performers, suggesting that patience here is appropriate.[3]

We do expect to continue to gradually increase our weighting but we do not intend to chase them.

2. While we have a modest overweight to growth, we also have substantial positions in certain value sectors like financials. The financial sector was down YTD through Q2, as were our two largest financials.

The spread of performance between growth and value has become so extreme that, relative to history, value stocks are nearly one standard deviation cheap relative to the market.[4] And since the end of Q2, financials have posted very good numbers. Our two largest financials both beat consensus Q2 earnings estimates.

Ultimately stock prices tend to catch up to fundamentals and financials appear to be an area where stock prices are lagging.

3. While we had reduced our exposure to emerging markets since the end of 2017, the magnitude of the drawdown in emerging markets has hurt our two Global strategies.

Peak to trough, with emerging markets down nearly 20%, we think the magnitude of underperformance to the US is rather extreme.[5] There appears to be a lot of imbedded bad news surrounding the implications of tariffs, a stronger dollar, and Fed rate hikes on emerging markets. Yet global economies remain strong, and the major emerging markets countries are financially stable.

One interesting data point: Crude pushing a 52 week high and emerging markets hitting lows is a highly unusual event. They most often tend to be positively correlated. In fact, since 1990, there have only been six times this has occurred, and the resolution has been for emerging markets to rally on average +12% over next 6 months, not for crude to roll over.[6]

We'll see if the relationship holds. But with the Chinese Internet stocks underperforming the US FAANGs by over 30% YTD, we are not yet going to throw in the towel on our sizable Chinese exposure in our global strategies.[7]

4. We own two FAANGs in all active strategies. We do not own Amazon or Netflix in any of our active strategies. Unfortunately, Amazon and Netflix accounted for over half the return of the S&P 500 through Q2.[8]

The two FAANGs we own both trade at a forward P/E of 25 x, not cheap but not outlandish. Amazon and Netflix are both north of 100x PE.[9] While I understand these last two companies are disrupting their industries, I am old enough to remember that argument for justifying the valuations for Wal-Mart and Cisco in the late 1990s. We do not own either. Wal-Mart and Cisco are both earning today one heck of a lot more than they did in the late 1990s. Their business models proved to be very successful, but competition eventually came in proving their sky high multiples to be unsustainable.[10]

We do not see Growth overall as particularly expensive, but we do see parts as such.

As we stated at the outset, we are experiencing a rolling correction. It has occurred in many of the value areas and the non-US markets. Perhaps now it is the US technology's turn under the burner. For our strategies, we would largely expect no major portfolio rotations. We have some growth and value and non-US. We quite likely need more bond proxies as we stated. But what is most important is not to chase what has already worked because in mean reversion years, the opportunity set is in those areas where the stock prices have lagged the fundamentals not in the momentum names.

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[1] As measured S&P 500 Utility and Consumer Staples sector relative to the S&P 500 since 1990

[2] Morgan Stanley Research

[3] As of July 23rd, 2018

[4] As measured by top decile of value within Russell 1000 ranking based on price/book, price/earnings and price/free cash flow. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results.

[5] As measured MSCI Emerging Markets Index peak on January 26th to trough on June 28th. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results.

[6] Sentiment Trader. July, 2018

[7] As measured by NYFANG Index versus KWEB Index ETFs as of [8] 8

[8] July 24th[8] Goldman Sachs Global Investment Research

[9] Factset as of July 24th

[10] Wal-Mart earnings are up 400% over the past 20 years but the stock has appreciated by 173%. Cisco's earnings are up 675% while the stock is up 178%. Factset, July 1998 to July 2018.