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Equity Market Commentary

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*** Today's Market is Offering Up Some Fat Pitches.**

*** Can Your Managers Capture Them?**

As we articulated in last week's Slimmon Take, the purpose of this commentary is to follow up the more macro discussion with a second Slimmon Take that focuses on investing opportunities.

Before we do, just one note. Year-to-date, the equity market has performed well, largely on the heels of better-than-expected Q4 earnings and an economy in far better condition than some of the bears had predicted. This has caused some strategists' bearish earnings calls to be pushed out yet another quarter.

With Q4 reports behind us, we are entering a consistently *seasonally tough time for the market, until early to mid-March.*[1] I wouldn't be surprised to see the market give back some returns. Yet don't get too spooked! *Instead, listen to what companies are saying about their businesses.*

As I wrote last week, I am a firm believer that accurately predicting how macro conditions will impact the market *is virtually impossible to successfully repeat year-in and year-out*.

My belief is that the path to successful investing is understanding human behavior because it's the only consistency to investing from one period to the next.

Simply put, the fear-to-greed-to-fear cycle never changes. At the extremes, equities become oversold in the fear stage and overbought in the greed stage.

[1] Jonathon Krinsky. BTIG. February 20th, 2023.

With a 37-year tenure in the investing business, I have become convinced that most money is made when perceptions move from very bad to less bad and likewise, the most money is lost when things move from great to just good. Very simply, *at the tails of the fear-to-greed cycle, stock prices have the highest deviation from their underlying value.*

The pattern is not just at the market level, but also happens for specific sectors or regions. Given the Applied Equity Team is a long equity manager mandated to be fully invested, we spend much more time on the latter than the former. We diligently focus on overweighting areas we consider to be those *Fat Pitches* where pessimism is rampant and underweighting areas where greed is immense.

The question is, do the *Fat Pitches* occur exclusively in growth stocks? Or exclusively in value stocks? As a portfolio manager, how do I capitalize on the big *Fat Pitch* opportunities if they don't fall into my assigned style bucket? Any straying regardless of the upside opportunity is a big no-no with the style-box monitors.

This is the fallacy of style bucketing for active managers. In my opinion, over the past three years in the US, there have been three *Fat Pitches* on the buy side. (Plus, one ginormous *Fat Pitch* on the sell side.) Two of the buys have come in a growth sector and one buy in the value sector.

For asset allocators, consistently timing their reallocations between style-constrained managers to capture the *Fat Pitches* is *extraordinarily difficult*. Remember, I was a financial advisor in the 1990s. If an investor makes the most money at the tails (from bad to less bad), it's very hard to precisely time switching style-driven managers to capture the next *Fat Pitch*. Not to mention, it's virtually impossible to get clients to buy the stuff that has been hammered due to what Warren Buffett is famous for saying:

> *Investors continue to make investment decisions with their eyes firmly fixed on the rear-view mirror window.*[2]

I guarantee every advisor has at one time or the other heard these exact comments: "Why would I want to buy that? It's doing terribly." Or "Why would I want to sell that? It's doing great". In essence, an unwillingness to move at the tails.

The Applied Equity Advisors Team embraces "Core" strategies for one simple reason: *flexibility*.

Flexibility allows us to take advantage of the *Fat Pitches* regardless of whether they come in growth, value, defensives, not to mention regionally or sectorally.

We believe in buying quality companies. However, can quality companies get crushed when their style or region falls out of favor? Absolutely. Where will the best opportunity be in three years? NOBODY KNOWS. But they will come. Investors' behaviors will not change. AEA only needs to remain flexible enough to be able to recognize and capture them.

Ok, enough philosophy, now on to opportunities.

Quickly, here are some of the recent *Fat Pitches* AEA capitalized on:

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[2] 102 Warren Buffett Quotes on Life, Success, & More. December 21, 2022

1. Buying the *travel and leisure reopening* stocks during the height of the COVID lockdown. I was on Bloomberg TV in the spring of 2020, and when I announced travel and leisure stocks as an opportunity, the commentator said to me: *"Andrew, who would ever take a cruise again?"*.

   Travel and leisure are growth stocks.

2. Energy prices remained dormant for most of 2020 as "the world was awash in oil", or at least that was the common refrain at the time. That created a *Fat Pitch* in quality energy names. (Full-disclosure, US Core and Global Core captured this, but Global Concentrated did not.)

   Energy are value stocks.

3. Finally, the "ginormous" *Fat Pitch* on the sell side. In March 2021, we wrote that uber growth/tech stocks were outrageously priced, and it was going to end badly. We quoted Doug Kass:

   > *In every stock market cycle, there is a dominant investor who captures the market's zeitgeist by incorporating and reflecting the ideals and beliefs of the times. And there is no price too high to pay for these concepts……in this case disruptive technologies.*[3]

   Tech is a growth sector.

Now, what are some of today's *Fat Pitches* that we are positioned for?

Let me state: the *Fat Pitches* in the rear-view mirror always seem obvious in retrospect. *Of course, we were going to want to take a cruise again after covid was over! And, duh, who didn't know those uber tech names were outrageously priced?*

However, *current Fat Pitch opportunities are less obvious and certainly less comforting*, as they tug at your emotions. That's why the valuation mismatch is off, thus creating a *Fat Pitch*. Will they *all* work out? Unlikely. But I believe most will, and the track records for our portfolios support this.

1. Chinese equity boom and bust cycles are far more cathartic than those in the US. The one consistency to the bust cycles is that investors become convinced that China is "uninvestable" due to associated macro risks. The last three bust cycles in China, consistent with what we have recently experienced, were followed by boom cycles that, at a minimum, led to a 100+% return.[4] Most investors miss the first leg due to pains of the bust being so raw. MSCI China is up 44% from its low but with plenty of upside as the memories of the most recent bust cycle fade.[5]

   China is a member of the emerging market cohort.

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[3] Barrons, February 2021.

[4] In 1998 after a -82% peak to trough decline in MSCI China, the next rally was +149%. In 2003 a -66% decline was followed by a +102% rally. In 2008 a -66% decline was followed by a +155% rally. Bloomberg.

[5] Bloomberg as of February 21st, 2023.

2. After any horrible year for equities, investors inevitably pile into defensive, high dividend yielding stocks as pessimism builds (see Slimmon's TAKE from last week). The result is that the defensive stocks get very expensive relative to economically sensitive stocks. Yet the time to buy defensives is during a good year for the equity markets, *not after a horrible year as was 2022*.

   Defensives are…defensives.

3. As the market has rallied this year, investors have chased back into the darling growth stocks, particularly the very expensive ones that had been destroyed last year. Yet inflation sensitive stocks have been left behind. However, based on AEA analysts' conversations with companies, what's clear is that the economically sensitive companies are doing just fine. We have seen numerous positive estimate revisions in our value names. Plus, they are cheap.

   Inflation sensitive are value stocks.

4. The S&P 500 has a problem. It is heavily weighted in a group of stocks that have done extraordinarily well for investors but are coming under increasing US government scrutiny. Hostility toward businesses is rising in D.C., especially toward the mega-cap tech stocks. We don't think these stocks appear particularly expensive, but they are heavily owned and comprise a big part of the S&P 500. Perhaps the greed factor is reflected in how over-owned they are as opposed to extended valuations.

   Mega-caps are growth stocks.

Will *all* these come to fruition? As I said before, unlikely. The stock market is a humbling beast, it constantly checks for any sign of arrogance. But at the tails, the risk-reward set up means we don't need all of them to.

One final point, as an active manager one would think we would be against a passive approach. *Not true*. There is nothing wrong with getting market exposure using an ETF approach.

However, given human behavior never really changes, this gives me tremendous confidence in active management as these emotions will always offer up investing opportunities. Or as we call them, potential *Fat Pitches*.

That is, presuming active management has the structure in place to capture these extremes.

Andrew

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