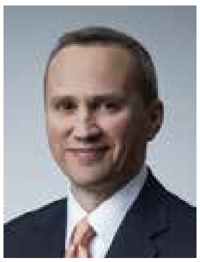
Strategist's Corner
March 2019

Market performance has materially changed from late 2018, but have the facts?

Author



Robert M. Almeida, Jr.
Portfolio Manager and
Global Investment Strategist

Hope is not an investment thesis

Investor pain in the final quarter of 2018 has seemingly faded from memory, based on the re-risking across global equity and credit markets in the first two months of 2019. This prompts the question: Were investors too pessimistic then or are they too optimistic now? To my mind, the answer is yes to both. The real answer is that the market suffers from recency bias — the tendency to remember recent events better than those that happened earlier — and it tends to get whipsawed by nonmaterial information. Have the facts materially changed since last quarter to cause such volatility? Let's review.

Broadly speaking, there were three sources of hope that investors seemed to latch onto in the early months of 2019: a change in tone by central banks, particularly the US Federal Reserve, to a more dovish stance; hopes for a resolution of the US–China trade war; and an end to the longest government shutdown in US history.

These types of macro events are difficult — perhaps impossible — to reliably predict. Given that, should they be considered in any investment thesis? Long-term, business and industry fundamentals drive cash flows, so maybe the question should be more to the point: Is macro information just noise when it comes to asset prices?

Here are some things I consider material: Is a potential target for investment likely to gain or lose market share over the next five years? Has it historically been a price giver or price taker? Under what circumstances? More important, will management be able to raise prices because the business possesses something unique that will be in demand for the next five to ten years? What are the risks that the business's value proposition will be commoditized? What is the cost of running the business today versus the possible cost in five years? Most important, how does all of this impact its margin structure compared with what has been discounted by the market?

What's changed?

So, have the facts — or what is material to asset prices — changed?

1. Corporate profits are strong, particularly in the United States. However, they are slowing.
2. Valuations, however, are not unreasonable. "Fair" is a description that has been used by many last year and still today. However, fair is based on trailing 12-month profits. If profits are decelerating, are those valuations still fair?

Watch for fundamental shifts

Here are a couple of examples of industries where we have seen substantial fundamental changes to business models that have required a change in our investment thesis.

Throughout this low-growth economic cycle, Internet platforms and technology have steadily disrupted businesses across sectors worldwide, rapidly changing the economics of many industries. For example, video game publishers were historically largely single-product companies and often highly dependent on having a hit game, leading to highly variable cash flows. In recent years, the industry business model changed as the Internet afforded publishers the ability to move from physical discs and distribution through retailers to an all-digital direct-to-consumer distribution model. The result was a significant decline in costs and a shift up in margins along with less dependence on the console cycle.

However, over the past 18 months a new business model has arisen: free online multiplayer games. As MFS US growth portfolio manager Eric Fischman expressed in a global sector meeting, "Fortnite may have changed the equation by offering a free game and a high degree of player interactivity. The publisher makes money on in-game purchases versus upfront payment for the game itself. This potentially alters the economics of the industry and the long-term growth drivers."

Another example where fundamentals have changed is the cruise line industry. Cruise line operators have always possessed high barriers to entry, such as the necessity of significant upfront capital expenditures — cruise ship construction costs range from $500 million to $1.5 billion each — scale and brand equity. However, the operators have been highly leveraged franchises dependent on the consumer's willingness to spend on leisure, resulting in a wide range of cash flow outcomes and volatile financial returns.

A broader change affecting the industry has been society's growing tendency to spend more on experiences than physical goods — as I wrote about last month — and better capital management. The industry is seeing unit growth from a variety of age cohorts, from retirees to millennials to even Generation Z. As MFS US credit analyst Lauren McCarthy shared, "The real cash flow growth has come from increased onboard revenue generated by on-ship entertainment such as wave riders, water slides, etc. The cruise ships are getting larger and better, and thus the ship itself is becoming part of the experience, along with attractive routes." This translates into potentially better free cash flow via multiple monetization levers compared with past periods.

Investing is simple, but it's also really hard. Simply put, cash flows drive stock and bond prices over the long term. The hard part is remaining disciplined, focusing on information or data points that are material while ignoring the rest.

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