# *Economic & Market Outlook*

## Executive Summary

~ Over the past decade, US equities have significantly outperformed their long-term averages. A large contributor to their performance has been multiple expansion, resulting in elevated valuations for the median US stock.

~ Valuation dispersion is also high, which presents opportunities for the enterprising investor.

~ Most of the opportunities we see are "value" stocks that have been left behind. On a relative basis, our portfolio is overweight energy (via pipelines), financials, and industrials.

~ We admire many of today's "growth" stocks, but we remain steadfast believers that even the greatest companies can be bad investments if the price is too high.

**2021 Asset Class Returns**

| | | Q1 | Q2 | Q3 | Q4 | YTD |
|---|---|---|---|---|---|---|
| Global Stocks | *MSCI ACWI* | 4.7% | 7.5% | -0.9% | 6.8% | 19.0% |
| US Stocks | *S&P 500* | 6.2% | 8.6% | 0.6% | 11.0% | 28.7% |
| Int'l Developed Stocks | *MSCI EAFE* | 3.7% | 5.4% | -0.3% | 2.7% | 11.9% |
| Emerging Mkt. Stocks | *MSCI EM* | 2.2% | 5.1% | -8.0% | -1.4% | -2.5% |
| Investment-Grade Bonds | *Barclays Agg.* | -3.4% | 1.8% | 0.1% | 0.0% | -1.5% |

*Source: Bloomberg*

It's that time of year again when fund managers and Wall Street strategists opine on what lies ahead for the markets and, in turn, how investors should be positioned for the coming year. The forecasts for US stocks range from "muted" to what you might call "cautiously optimistic." The consensus view on Wall Street is S&P 500 earnings will grow 9.0% next year, but investors will place a heavier discount on those earnings given the likelihood of a more hawkish Fed. The resulting forecast is for modestly positive returns for US equity investors. We have summarized the major bank forecasts in the table below.

**Wall Street Price Targets**

| | S&P Target | Price Change |
|---|---|---|
| Morgan Stanley | 4400 | -7.7% |
| Wells Fargo | 5,100 to 5,300 | 7.0% to 11.2% |
| Goldman Sachs | 5,100 | 7.0% |
| RBC | 5,050 | 6.0% |
| Bank of America | 4,600 | -3.5% |
| Credit Suisse | 5,200 | 9.1% |
| BNY Mellon | 4,900 to 5,100 | 2.8% to 7.0% |
| JP Morgan | 5,050 | 6.0% |
| BMO | 5,300 | 11.2% |
| Average | 4,967 to 5,011 | 4.2% to 5.1% |
| Median | 5,050 to 5,100 | 6.0% to 7.0% |

*Source: Bloomberg*

We have no clue what the S&P 500 will do next year. We have always viewed Wall Street's ritual of publishing S&P price targets as fun but also futile. The price targets presuppose Wall Street's strategists can accurately predict future cash flows, and most absurdly, anticipate how investors will value those cash flows come year-end. They never get it right and to be fair, we wouldn't either, but we understand their hesitation to predict another blockbuster year for stocks.

## US Equity (S&P 500) Valuations

Investing math is simple. The more you pay for a stream of cash flow the lower your prospective return and the less you pay, the higher your prospective returns. But there is a wrinkle. Luck can juice your returns if the next buyer comes along willing to pay an even higher price. The opposite can happen too.

**S&P 500 Returns and Next 12-Month Valuation Multiples**


*Source: JP Morgan*

The last decade has been great for US equity investors. The S&P 500 has returned 362.1% or 16.5% per annum. To put that number into perspective, the long-run nominal return for US stocks (dating back to 1926) is 10.5%. For the past decade, US equity investors have earned an additional 6.0% each year above historical norms. That is the difference between $4.6 million and $2.7 million for a portfolio that started with just $1.0 million.

The recipe for these outsized returns is the combination of an attractive entry valuation, earnings growth, and a lot of luck. Ten years ago, the S&P 500 traded at 1,257 and generated operating earnings of $96.4. Investors were paying the bargain price of 13.0x to buy US equities. The S&P 500 just exited the year at 4,766 and it is anticipated 2021 operating earnings will come in at $201.9. Note that investors today are paying a far higher premium of 23.6x, which equates to an 81.1% increase in the price paid for each dollar of earnings. Below is a decomposition of S&P returns over the past decade. Note how impactful the luck component (changes in valuation) has been to returns. Without the benefit of a next higher bidder the S&P 500 would have returned only 141.0% or 9.2% annualized, a great return, but a far cry from what we experienced and slightly below historical norms.

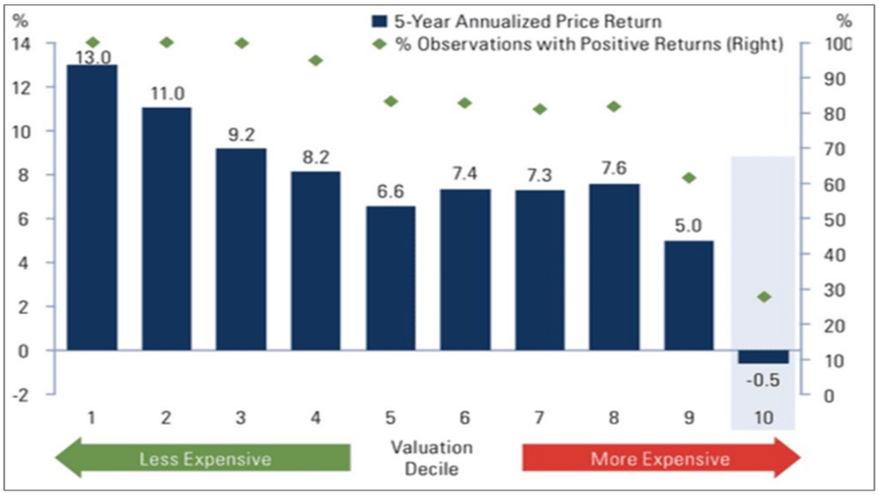
**S&P 500 Return Decomposition (2011 to 2021)**

$$(1 + EPS\ Growth)\ x\ (1 + \text{Luck})\ x\ (1 + Income) - 1 = Total\ Return$$

$$(1 + 109.3\%)\quad x\quad (1 + 81.1\%)\quad x\quad (1 + 21.9\%) - 1 = 362.1\%$$

Our gut feel is US equity returns will be lower going forward. Since 1950, the median growth rate in earnings over 10-year horizons has been 5.8% and the current dividend yield on the S&P is 1.3%. Assuming zero luck (or misfortune) roughly equates to annual returns of 7.1%. But who knows? The only thing we can say is the more you pay for a stream of cash, the lower your prospective return unless a greater fool is willing to bail you out. And there is always the unfortunate possibility that future investors will offer less as opposed to more.

**Historically Elevated Valuations Often Portend Lower Returns**



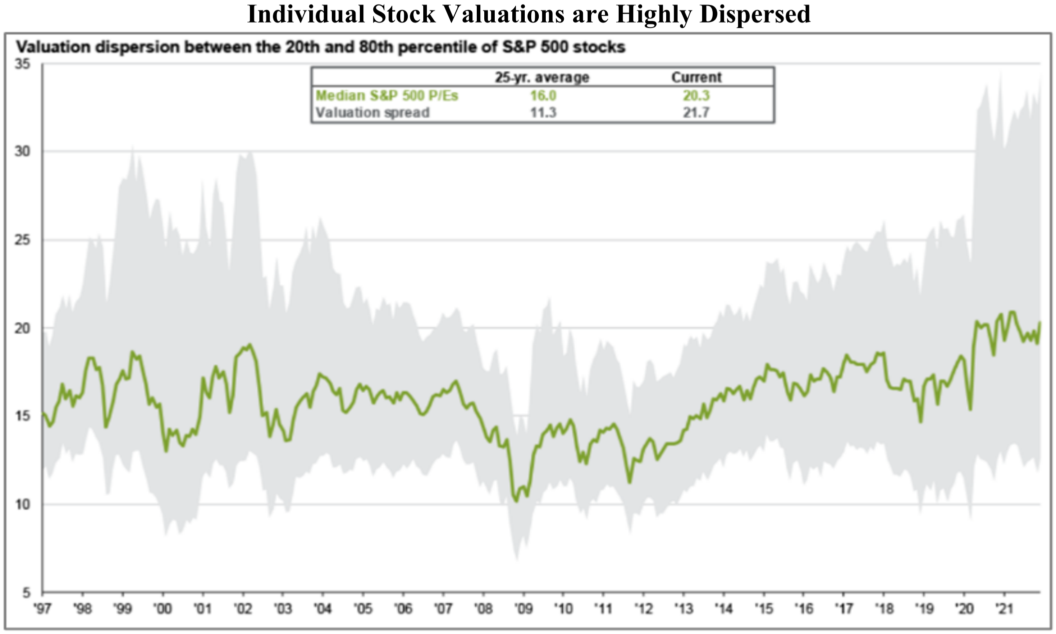

*Source: Goldman Sachs*

## Looking Below the Surface

Focusing our discussion on the index can be somewhat misleading because the index isn't always a fair characterization of the stocks that comprise it. Right now, the 10 largest stocks in the S&P 500 account for over 30% of the index's weight. Rarely has wealth been so concentrated among so few. This is both a positive and a negative. The above-average earnings growth that the S&P 500 has enjoyed for the past decade was due in part to these larger holdings. Apple (6.8%), Microsoft (6.2%), Google (4.2%), Amazon (3.6%), and Facebook (2.0%) are all highly profitable businesses that continue to grow at above-average rates.  The five aforementioned stocks contributed 81.2% to the S&P 500's 362.1% return over the past decade. Conversely, the aggregate valuation of the S&P's top holdings has also grown. At present, the top 10 stocks trade at 33.2x next year's earnings compared to just 19.7x for the remainder of the index. We wouldn't call these 10 companies grossly overvalued, we even think a few are attractive, but we feel confident arguing they are unlikely to generate the same shareholder returns over the next decade. *Note – Apple, Microsoft, Google, Amazon, and Facebook averaged 29.6% compound returns for the past 10-years.*

When you look at the individual valuation multiples of every S&P 500 constituent (see chart below) you will find they are extremely dispersed. This compares to periods, like the aftermath of the financial crisis, where valuation spreads were tight. Dispersion is good news. It means that while the S&P 500 appears expensive on its surface, there are ample opportunities to find attractively valued securities within the market. Most of these opportunities are in stocks that trade at heavily discounted valuations, but there are also opportunities in great companies that appear "expensive" on the surface.

**Individual Stock Valuations are Highly Dispersed**



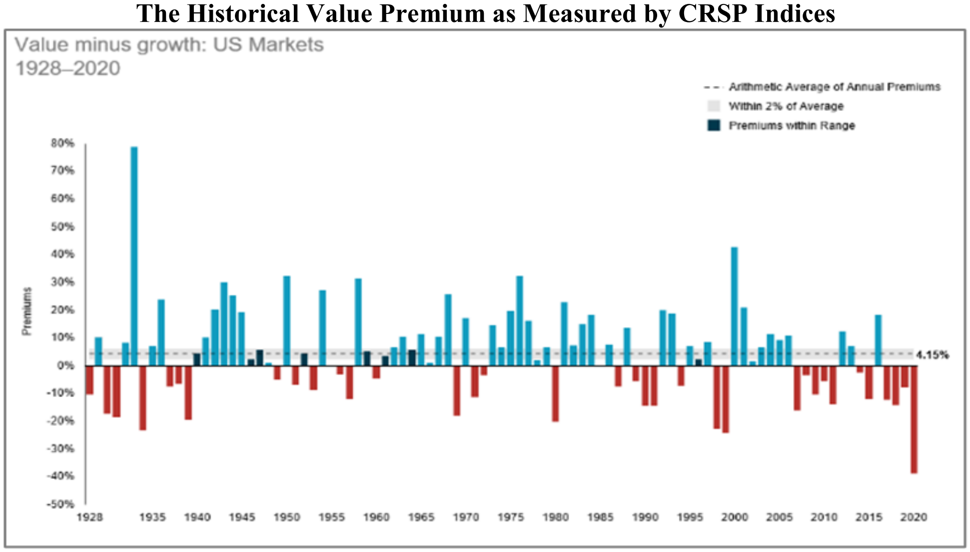

*Source: JP Morgan*

## The Bottom Few Deciles of Valuations

The stocks that comprise the bottom few deciles of valuation are what academics call “value” stocks. They are stocks that, on average, trade at lower multiples of cash flow – sometimes justifiably, but often not. They tend to be companies and industries that have fallen out of favor with the markets. Today you will find loads of financial, energy, and industrial companies that fit this bill like Berkshire Hathaway, JP Morgan, and Exxon Mobil. The converse of “value” stocks are “growth” stocks, companies whose valuations fall into the upper deciles. These stocks are often market darlings, offering faster rates of revenue growth. Today, “growth” stocks are synonymous with technology stocks. The Russell 1000 Growth Index counts Apple, Microsoft, Amazon, Tesla, and Nvidia among its top holdings.

Historically, “value” stocks have outperformed “growth” stocks. The issue with “growth” stocks, at least in theory, was investors systematically overpaid for that growth. “Growth” stocks did sport higher levels of revenue and profit growth, even in the future, but investors consistently paid too much for those future dollars. And while “value” stocks were far less exciting, investors tended to systematically pay too little for their future cash flows. This relationship between “value” and “growth” was so well documented, across time and varying markets, that academics posited there existed a value premium. By holding a diversified portfolio of “value” stocks, one could expect to generate returns above the market averages.

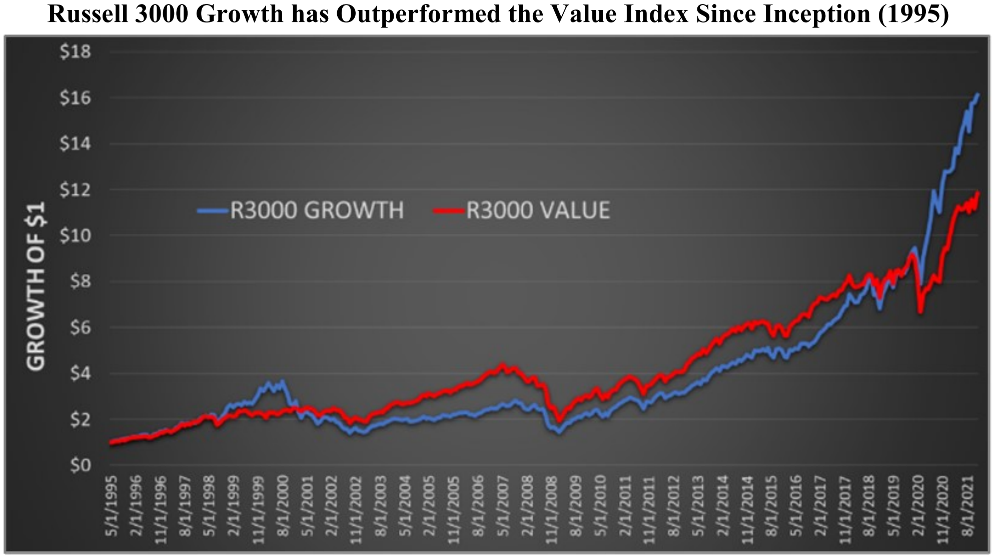
**The Historical Value Premium as Measured by CRSP Indices**




*Source: Dimensional Fund Advisors*

Since the global financial crisis, the value premium has been non-existent. “Growth” stocks have outperformed “value” stocks by their widest margin in recorded history. Decades of “value’s” historical outperformance have been erased, calling into question the whole notion of the value premium. It is within this downtrodden cohort, the bottom few deciles of valuations, where we see the most opportunity, but more on that topic later.

**Russell 3000 Growth has Outperformed the Value Index Since Inception (1995)**




*Source: Bloomberg*

## Measuring From the Top

The time frame we choose to examine data has a direct bearing on the inferences we will draw from it. This is such an obvious statement, but investors never seem to get it. Internally, we call this problem "measuring from the top." Consider the track records for the Russell Growth and Value Indices at varying points in time. The first table (below) shows the annual compound returns of each index from the vantage point of an investor on June 30th of 2000. We picked this period because it is analogous to what we are witnessing today. From 1998 till early 2000, "growth" stocks significantly outperformed "value" stocks. "Value's" underperformance in that short span was so significant that it clouded over decades of past outperformance (see the 20-year return comparison). "Value" investing, in the academic sense, was largely considered dead, and many of its practitioners were forced to close due to redemptions. The market had gone from believing in a value premium to believing in a growth premium. The conclusions being drawn by investors in June of 2000 were a direct result of the year in which they were measuring performance.

| 6/30/2000 | 3-Year | 5-Year | 10-Year | 15-Year | 20-Year |
|---|---|---|---|---|---|
| Russell Growth | 27.80% | 28.70% | 18.90% | 17.30% | 15.40% |
| Russell Value | 10.80% | 17.70% | 13.20% | 12.00% | 11.80% |

*Source: Bloomberg*

Here is where things get interesting. What happens if we shift our measurement period by a small amount? The table below shows the same data recorded a mere two years later. Notice that the narrative has completely changed. "Value" moved from a consistent laggard to a consistent outperformer over both the short-run and longer-run time horizons presented. An extreme year or two has the potential to color decades worth of data.

| 6/30/2002 | 3-Year | 5-Year | 10-Year | 15-Year | 20-Year |
|---|---|---|---|---|---|
| Russell Growth | -14.60% | -0.40% | 8.40% | 8.10% | 11.40% |
| Russell Value | -1.90% | 6.50% | 12.00% | 9.40% | 12.20% |

*Source: Bloomberg*

If you spend enough time watching the markets you will quickly learn that price dictates the story, not the other way around. As investors, we build narratives around what has happened. We weigh the recent past the most heavily. Today's narrative is that "value" investing is dead, like the late 1990s, and that investors are well served to ignore valuation multiples.

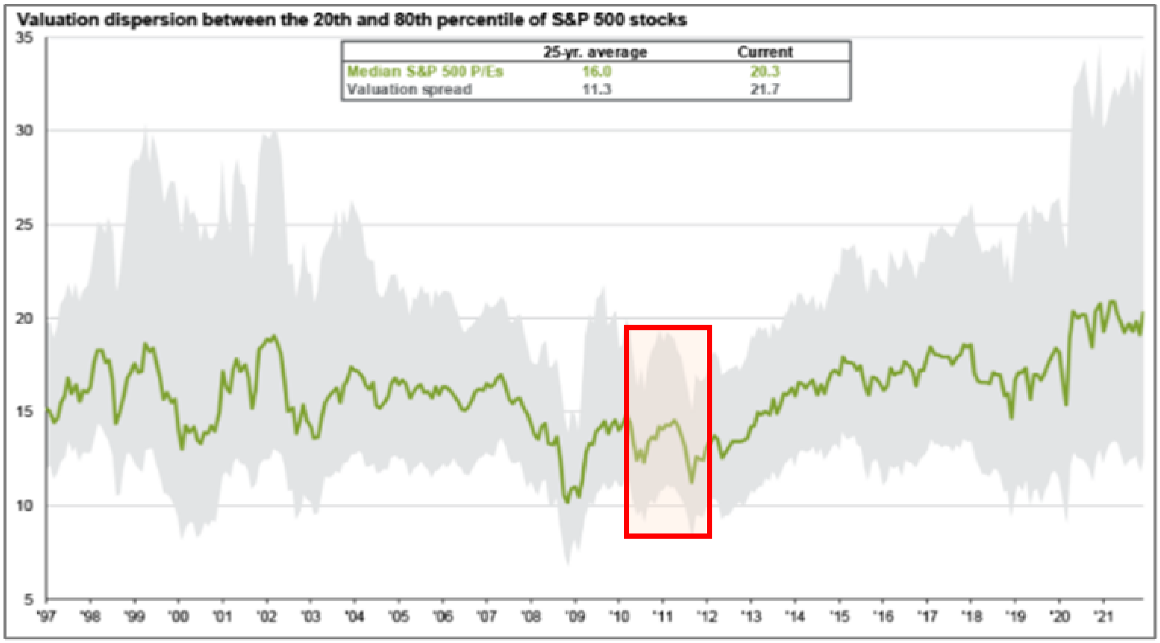
## Red Herrings

Throughout this commentary, we have been careful to write "value" and "growth" within quotation marks. We have been referring to an academic definition of the two, one a group of low valuation multiple stocks and the other a group of high valuation multiple stocks. In practice, this distinction can be both misleading and distracting. True intrinsic value is captured when you buy an asset at a discount to the present value of its future free cash flow. In this regard, value is directly tied to a company's future revenue growth, the profitability of that revenue, and the price you pay for that company. As Buffett would quip, value and growth are joined at the hip. An investor focused solely on valuation multiples will miss this point, just as an investor focused solely on revenue growth may overpay for an asset.

Ten years ago, investors were pricing "value" and "growth" stocks at roughly the same multiple of cash flows. On the following page, we have reposted the dispersion chart from earlier in this commentary. Notice how all securities traded at similar multiples of cash flow in 2011. This made no sense given the stocks that comprised "growth" indices generally offered higher levels of both profitability and revenue growth. At that point in time, Apple was the largest holding (5.8%) of the Russell 1000 Growth Index. It was trading at just 8.9x free cash flow and in the two prior years had grown top-line revenue by 66% and 52%, respectively. In hindsight, "growth's" outperformance makes sense.

*< See Next Page for Dispersion Chart >*

**In 2011, "Growth" and "Value" Stocks Traded at Similar Multiples of Cash Flow**



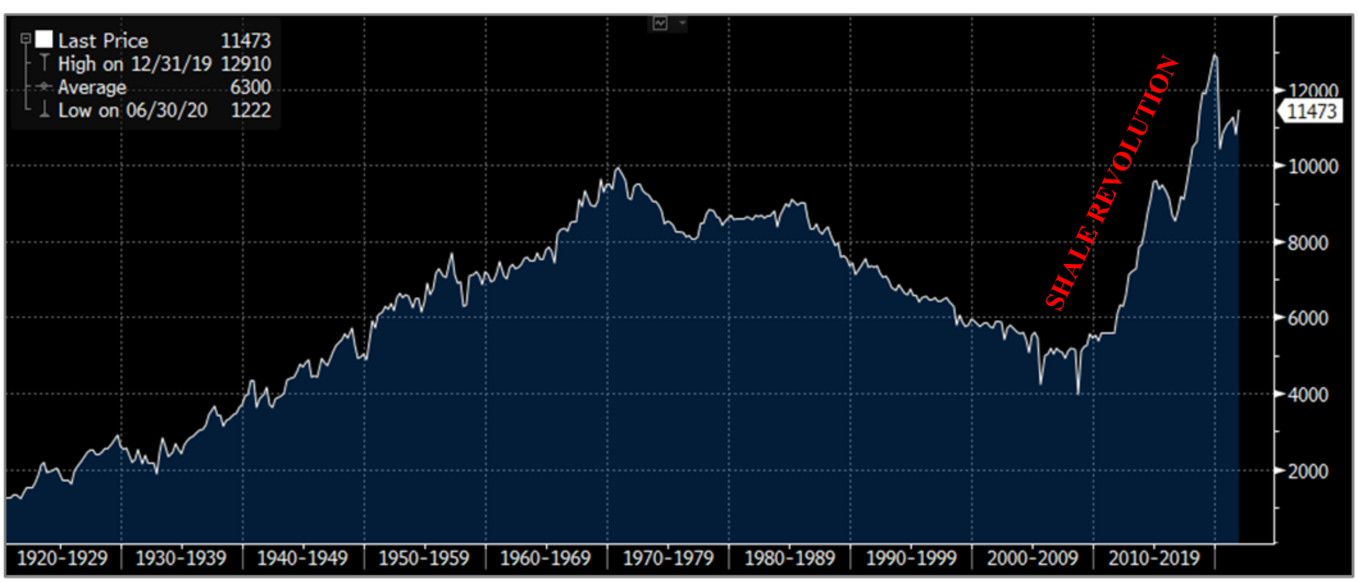

*Source: JP Morgan*

Fast forward to today, investors are paying much larger premiums for high-growth companies. Apple remains the largest constituent of the Russell 1000 Growth Index, now 11.5%, but this time around it trades at 30.6x free cash flow and its growth profile is far more mature. By no means is this a "bubblesque" valuation, but it is a stark contrast to its 2011 valuation. Simply put, the risk/reward associated with owning Apple has changed, just as the risk/reward associated with "value" and "growth" stocks has changed. Betting on "growth's" continued outperformance is far from a layup.

## The Worst Performing Sector of the Past Decade

What works over the coming decade is likely to look different than the past. Opportunity sets change. Take the energy sector for example. Over the past ten years, it has returned 12.4% cumulatively or 1.2% annually. The sector's weight in the S&P 500 has fallen from 12.1% to just 2.7%. To say energy is despised is an understatement. Many investors won't touch traditional oil and gas investments.

**US Crude Oil Production**




*Source: Bloomberg*

So, what has changed? First, capital that was once abundant is now scarce. The past decade's bad results and a growing movement towards more environmentally-conscious investing have restricted the supply of capital. For the first time in over 15 years, management teams are being held accountable to ask what is the best use of their cash? Is it new development, M&A, buybacks, paying down debt, or dividends? A recent Rystad study found that energy reinvestment rates (the percentage of cash flow pumped back into new drilling projects) had fallen from an average of 130% to 46% in Q3 of 2021. The mantra is no longer, grow production at all costs. Drilling restraint is leading to record levels of cash flow generation, which is being redirected towards debt reduction, dividends, and buybacks. Second, the capital discipline being exercised by energy companies is keeping supply in check. New oil and gas discoveries, i.e. new reserve additions, are the lowest they have been in 75 years. The global supply of reserves relative to production is at its lowest level in 11 years. Finally, equity valuations are low. Our estimates show that North American independent producers will have generated ~15% annualized free-cash-flow yields (6.8x), on average, in the last quarter. Said differently, US independent energy companies are generating enough unencumbered cash to repurchase 15% of the company in just one year.

We don't know what the exact future holds for this sector, but if management teams can maintain today's capital discipline, then it seems reasonable to expect better results going forward. In short, the ills of the past have set the stage for a better future.

## The Most Extreme Valuations

Now contrast the energy sector, trading at bottom decile valuations, with certain software stocks, trading at top decile valuations.

Software-as-a-service is inherently a better business model than upstream oil and gas production. Most listed software companies enjoy highly predictable/recurring revenue streams. The actual costs associated with delivering software-as-a-service are negligible, leading to gross margins as high as 90%. After you acquire a new customer, every incremental dollar of gross profits theoretically falls to the bottom line. Most importantly, cloud-based software solutions drive a lot of value for their end customers. We can't imagine operating our business without the front and back-office software we utilize, and if our vendors raised prices, we would oblige them. Can you imagine conducting business through this pandemic without tools like Zoom? Simply put, software-as-a-service can be an incredible business model.

Since 2011, the S&P software sub-index has compounded at 22.9% or 684.6% cumulatively. That is 21.7% more per annum than the energy index. The explosive returns are a combination of two factors. First, revenue growth has been incredibly strong because the demand for their services is there (and will continue to be). Second, investors have come to appreciate just how great some of these business models are or have the potential to be, as evidenced by their willingness to pay ever-increasing multiples of cash flow or in software's case, multiples of sales.

**August 2020 TechCrunch Headline**

TechCrunch+

**Go public now while software valuations make no sense**

BigCommerce and the big WTF of today's market prices

*Source: TechCrunch*

Here is an example to illustrate how demanding software valuations became post-COVID. The business in question is DocuSign, a company whose signature solutions we utilize daily (and love). Earlier this year, DocuSign carried a +$61 billion enterprise value against revenues of ~ $1.8 billion. In other words, investors were valuing the company at roughly 33x sales. True free cash flow was still negative, but the company was approaching break-even. We made some basic revenue and margin assumptions, that we viewed as aggressive, to back into the internal rate of return a private buyer might expect to receive from the company's cash flows. For our revenue growth assumption, we utilize sell-side revenue forecasts through 2025, and after that time, we assume revenue growth is 90% of the preceding year.

On the margin front, we assume free cash flow grows from 2% of revenue now to 40% of revenue in twenty years. Importantly, we assume the growth rates are sustained even though 100% of free cash flow is being paid out to shareholders. Long-story-short, we think we made optimistic assumptions, but the net result was an implied IRR of only 5.1%. We would add that flexing those assumptions doesn't alter the outcome significantly. For example, assuming you hit 40% free cash flow margins in 10-years (opposed to 20) increases the implied return by a mere 0.7%. We have done similar exercises with other software providers (Cloudflare, Snowflake, DataDog, Ansys, Atlassian, etc.) and we almost always arrive at similar conclusions. Either our assumptions are too stodgy, or Wall Street doesn't care about valuations.

**Our DocuSign Growth & Margin Assumptions**

| | 2023 | 2024 | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 | ... |
|---|---|---|---|---|---|---|---|---|---|
| Revenue Growth | 24.80% | 25.30% | 18.80% | 16.90% | 15.20% | 13.70% | 12.30% | 11.10% | ... |
| FCF Margin | 2.00% | 4.00% | 6.00% | 8.00% | 10.00% | 12.00% | 14.00% | 16.00% | ... |

*Source: Bloomberg , Consensus Estimates, Annandale*

## Conclusion

A year ago, we compared the stock market to the horse races. At the races, the odds (or payout) fluctuate up until the time of the race because each gambler's bet influences the final payout. If there are 101 gamblers at the racetrack, each wagering one dollar, and 100 of them bet on the same horse, then their prospective profit is only a penny. However, the lone individual who went against the consensus stands to make $100 for his $1 bet. The stock market works in a similar manner. When investors universally agree a business is great, and wager with their savings, the prospective return of that investment falls. It is the simple investing math we laid out at the start of this letter. Today's growth investors fail to understand this nuance, that no business (or business model) is so great that it makes for a good investment at any price. The converse is also true, that even a mediocre business (like upstream oil and gas) can be a good investment if the price is right.

If you take one thing away from this commentary it should be that opportunity sets change. A strategy, sector, or market that has performed well in the past isn't guaranteed to do so going forward, and conversely, just because something didn't work doesn't mean it won't work going forward. Naïve extrapolation is an enemy to all investors. The best risk-adjusted opportunities we see today are in "value" stocks, despite their abysmal track record over the past decade. As a result, we own more low-multiple stocks, like banks, insurers, industrials, energy producers, and pipelines (our largest industry exposure) than your typical investor. While our exposure to many of the hyper "growth" stocks is, at present low, we would be ecstatic to buy them when they trade down to more reasonable discount rates (lower valuation multiples). And to be clear, we do not expect them to trade at parity with today's breed of "value" stocks. We just can't justify a price tag that requires a vivid imagination.

We appreciate the trust you have placed in us, and we are hard at work looking for ways to grow your portfolio without taking undue risk.