A Narrow Market

June 28, 2024

The past few years have been quite a whirlwind for investors, and we want to take the opportunity to review our investing philosophy and compare and contrast it against some interesting phenomena taking place in the capital markets these days.

First and foremost, CORDA's foundation is a belief in income and growth investing and owning great businesses that place emphasis on sharing profits primarily in the form of dividends. We have discussed how a disciplined investment strategy should consist of a philosophy that seeks to take ownership of these businesses when they are out of favor with the investing public or trading at a discount to fair value. Another way of saying this is that we are a value buyer, willing to strike when we see a sale price. This does not mean we are strictly a value investor per se, as we want to own growing and thriving businesses. In some cases, we will own a business that does not pay dividends. Imagine that? All told, this approach allows for a margin of safety in the near term should your valuation parameters be overly optimistic and you happen to pay too much. For example, you have heard us often mention how we favor businesses that have shown the ability to raise dividends over time and are good stewards of their capital with exceptional management leading the way. This means that they have demonstrated a track record of allocating capital wisely, whether through dividends, share buybacks, or maintenance spending. In addition, we evaluate whether they are funding growth initiatives internal to their business or industry group so that your investment will have the potential to increase in value as well.

If you're invested in a business that continues to grow and earn more money, it doesn't excuse us from pain, however. Lulls and pullbacks in stock prices are still going to happen. More on this a bit later in this letter. But, if the business and fundamentals are there for a given company, the market will come back to it. To mitigate pain, especially for the more risk averse investor, we have suggested an allocation to fixed income, especially in more normal environments that we are experiencing now with interest rates closer to 5%. While the likelihood of lesser total returns in the long run is greater when holding bonds, in the short term, bonds allow for potentially smaller overall declines when the equity markets correct or have bear markets. Whatever your plan to achieve your goals, through our value-based investment philosophy, we believe we can produce a satisfactory outcome over time.

Another way to explain how we think about investing is by sharing some observations from Berkshire Hathaway's shareholder conference held this past May. We have attended these meetings over the years and with Warren Buffett in his twilight, we always want to take advantage as much as possible.

While some of you may agree or disagree with Berkshire Chairman and CEO Warren Buffett on certain matters, we believe his investment philosophy is world class. What we have witnessed over the years is that there is very little variance from the underlying viewpoints and overall investment philosophy delivered each year, and even though Warren did not have Charlie Munger at his side this year, he was still on point. Bottom line, we are simultaneously energized and encouraged each year after being witness to the event who many call the “Woodstock of Capitalism.” In the paragraphs below, we’d like to share with you some of the nuggets of wisdom that emanate from the dais each and every year.

What is special about the Buffett strategy is the staunch adherence to owning businesses and not “stocks.” This is crucial to understanding his philosophy and why he has been extremely successful. We at CORDA think in those same exact terms and when you communicate with us, you will hear the corresponding vernacular. It is a slip up when we call businesses “stocks” or “names.” The next time you watch CNBC, pay attention to how often the commentators and special guests use the term “name” when discussing different businesses. And one key difference to what oozes from the Oracle of Omaha versus other pundits is how “Short-Term-itis” is alive and well on both Wall Street and Main Street; to be truly different and to stand out, you must have the long view.

One significant perspective from Buffett we have heard often is never bet against America. Buffett said, “All you had to do was figure that America was going to do well over time.” The question we pose today: How well do you think America will do over the next ten, twenty, or thirty years? Are you willing to bet against the U.S.?

There’s always talk about how divided America is today and Buffett seemed to squelch that notion. Not only had America survived a Civil War, but in Buffett’s lifetime he has heard the claim “more divided than ever” on multiple occasions. In his 93 years, there have been 15 Presidents; 8 Democrat and 7 Republican. During this period, we’ve had wars, assassinations, expansions, recessions, terrorist acts, banking and housing crises, other scandals and defaults, death, destruction and a host of dreadful things, yet per capita GDP has grown over 600% since his birth. Charlie Munger once said; “There is a tendency to think our present politicians are worse than people we have had in the past. We forget how terrible the politicians of the past were.”

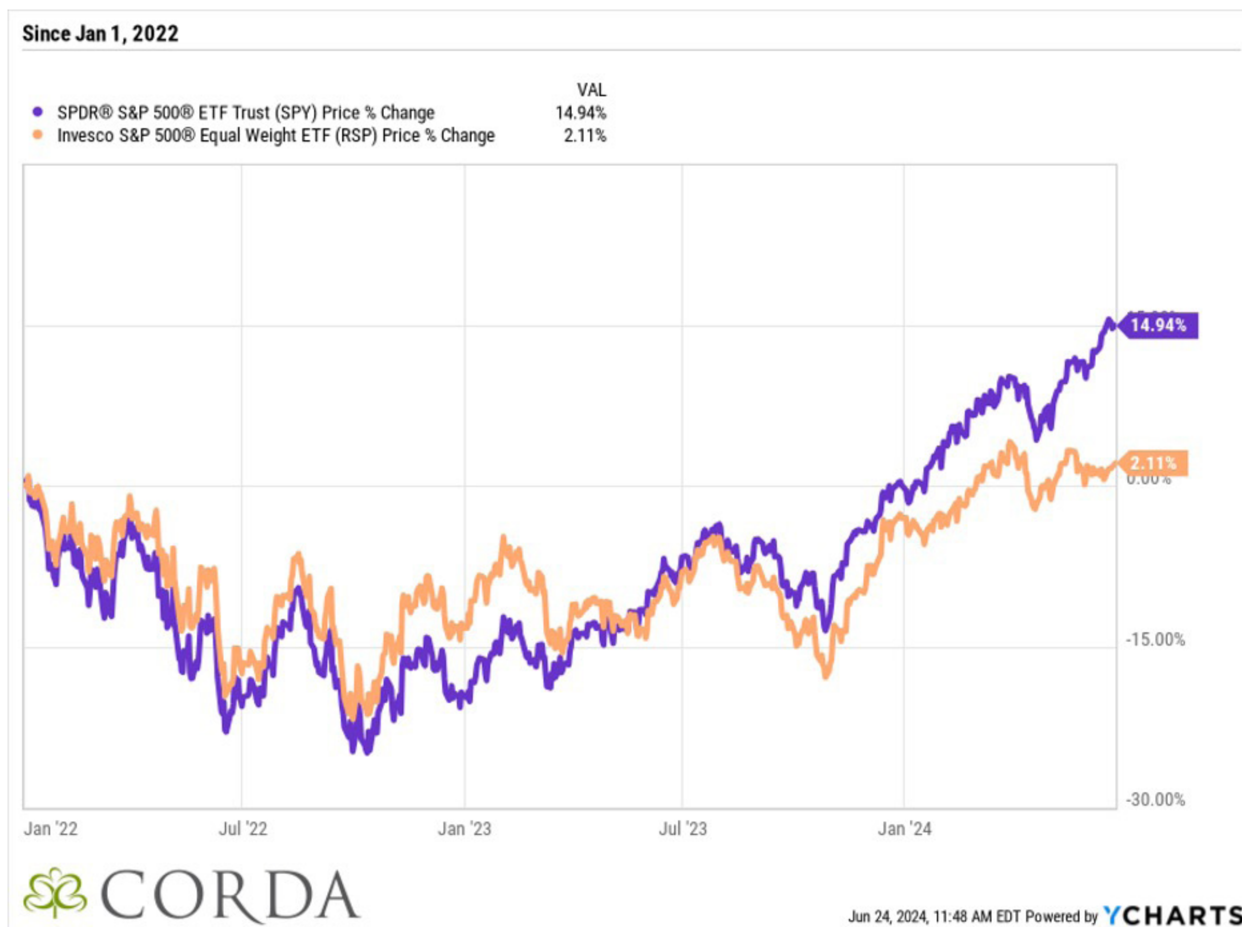
Laced throughout the 6-hour meeting is a common thread: Buy what you know, avoid trendy themes, and ignore economic forecasts. He has proffered this advice many times over the years. It is illuminating to see him put it into action. “No one really knows what path the economy will take” Buffett said, “so it doesn’t make sense to base investment decisions on forecasts. I can’t think of a time when we made a decision on a company that was influenced by a broader view of the economy. If investors try to time their purchases according to economic forecasts and trade when those forecasts change, they will make a lot of money for their brokers, but not much for themselves.” There’s a genuine déjà vu feeling when we hear these words, and it reminds us to stick to our core competency. What we mean by this is seek a high level of certainty about the value of a business we are investing in, avoid getting swept up in group think and paying too much when there are high expectations for a company built in, and invest when expectations are low and the business is on sale, thereby increasing the likelihood your results will be good. In a nutshell, that’s our philosophy to the core and in the coming pages you will see why.

Buffett also stresses the importance of not losing money. You have heard him say; Rule #1 is don’t lose money and Rule #2 is to refer to Rule #1. Building a circle of competence, knowing what you know, but also what you don’t know, and avoiding traps and trends are critical for success. Also, investing with a suitably long-time horizon will negate the consequences of selling when the market is temporarily down. The political and economic noise that permeates the airwaves causes investors to trade too often. Patience is key.
Be like Warren is a good battle cry! We at CORDA will act with conviction, we’ll seek to identify stable and strong businesses, we’ll focus on those with good dividends and with the propensity to raise dividends and

seek to buy them at a low valuation. We'll look for businesses with sustainable returns on capital, exceptional management, and strong moats. Then we'll exercise patience. That's our plan as we cope with a narrow market.

What we mean by a narrow market is one that is dominated by Nvidia and a handful of other mega cap technology companies. Did you know that the S&P 500 is up about ~15% since the start of 2022 while the average stock is up about 2%? Chart #1 below shows how the S&P 500 by Equal Weight is up 2.11% since Jan 1, 2022, versus the S&P 500's 14.94% return. The influence of the Magnificent 7, as many have dubbed them, on the S&P 500 is forcing the average higher, while most stocks are nearly flat in the last 2.5 years. One tidbit here, can you believe Nvidia (NVDA) accounts for 44% of that S&P 500 return since January 1 of 2022?!

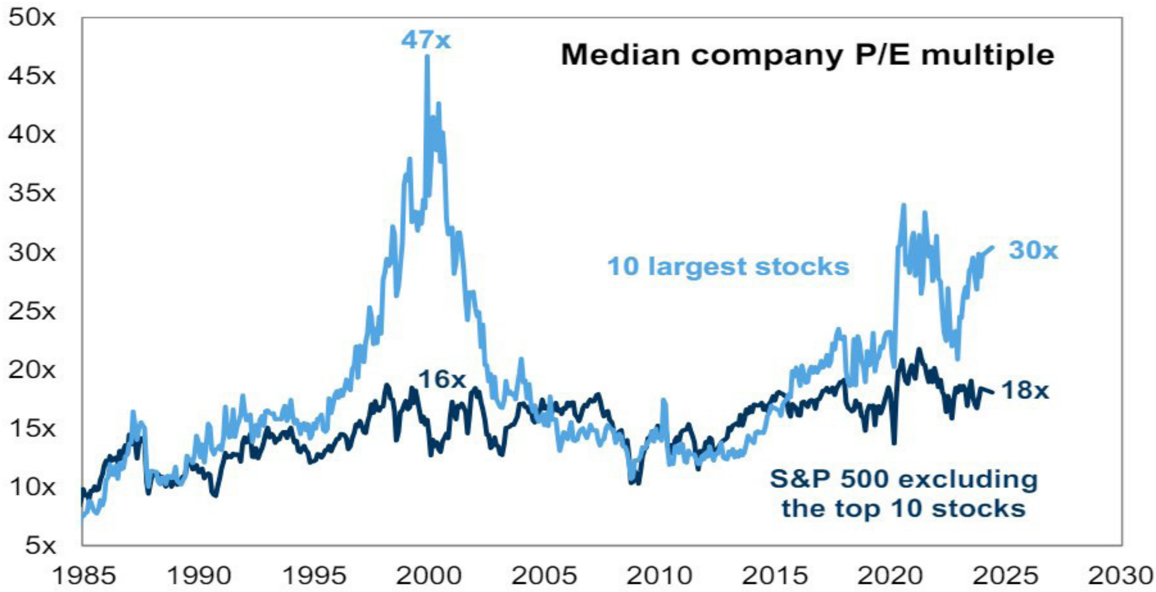
Chart #1:



Keep in mind, if you were to buy the S&P 500 today, 20% of your investment would be made up of Microsoft, Nvidia, and Apple. The next 10% would be Amazon, Meta, Alphabet, and Berkshire Hathaway. That's a heavy concentration in just seven businesses.

If the average stock is little changed over the past few years, what are the overall valuations of the market telling us, if anything, about the potential future direction of the stock market?

Chart #2:

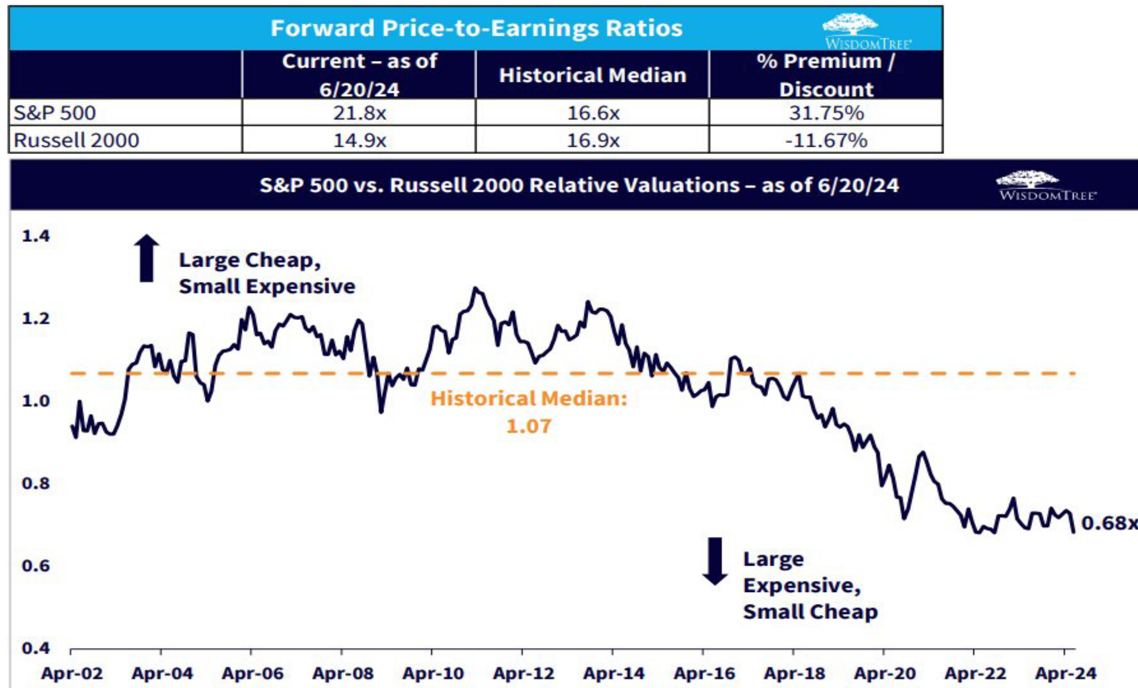


Source: Zerohedge

According to Chart #2 above, the median P/E multiple of the S&P 500 excluding the ten largest stocks is 18. That's quite a difference versus the 30x P/E multiple for the ten largest companies!

Another way of looking at a similar comparison is by using the Russell 2000 benchmark composed of 2000 small company stocks, and how it compares to the S&P 500.

Chart #3:



Forward Price-to-Earnings Ratios

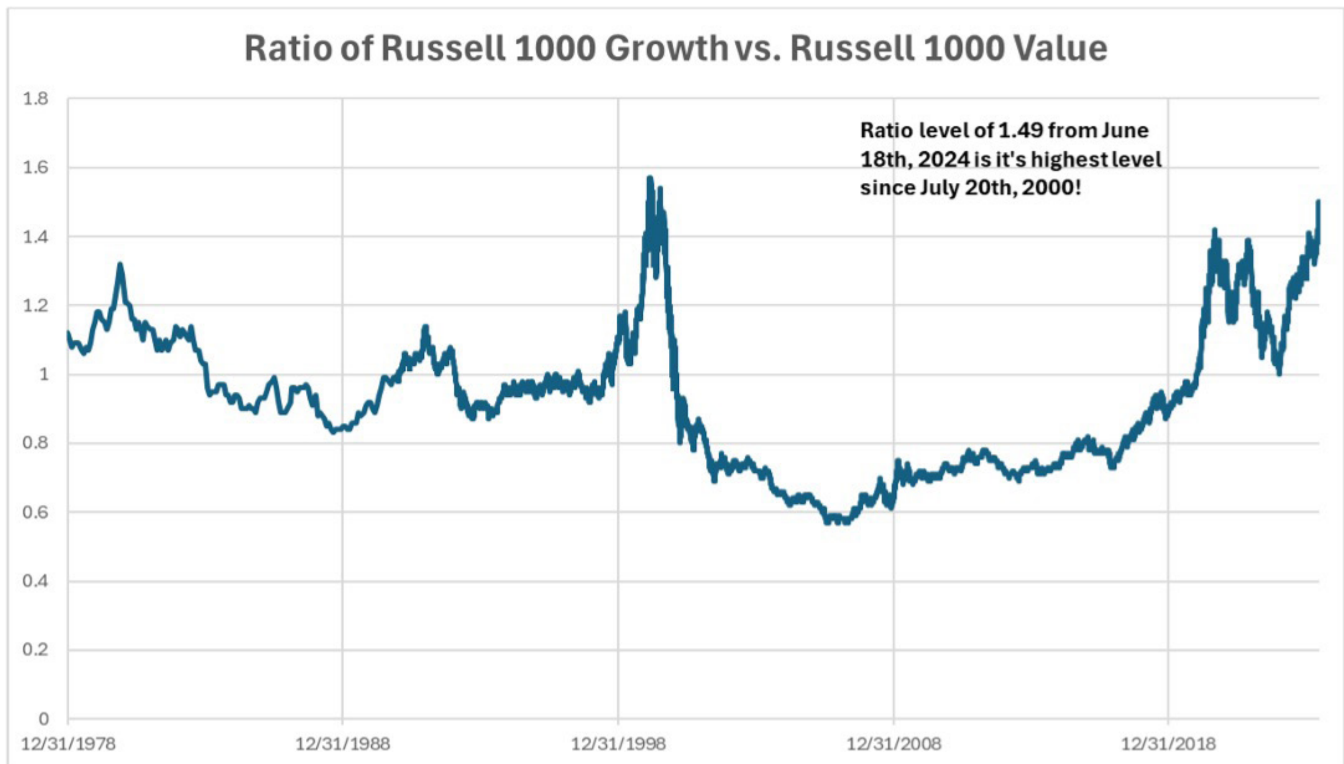
	Current – as of 6/20/24	Historical Median	% Premium / Discount
S&P 500	21.8x	16.6x	31.75%
Russell 2000	14.9x	16.9x	-11.67%

Source: WisdomTree, FactSet, Russell. You cannot invest directly in an index. Historical forward P/E measured since 12/31/1997 for the Russell 1000 Value and Growth and 4/30/2002 for the Russell 2000 and S&P 500.

In this example by WisdomTree, the forward P/E multiple of the S&P 500 is 21.8, which compares to a median 16.6 multiple going back to April 30, 2002. This would imply a 31.75% premium to its historical median. When you do the same analysis for small stocks via the Rusell 2000, the current forward P/E = 14.9 against a median of 16.9 which suggests an -11.67% discount. Where might be the opportunity? Note the historical median ratio when comparing the S&P 500 to the Russell 2000 is 1.07, and right now the current reading is 0.68, virtually at its lowest point.

We wanted to look at this ratio when comparing a straight Value Index versus a Growth Index and found a similar result.

Chart #4:



Going back over 45 years, we studied the ratio of the Russell 1000 Growth Index relative to the Russell 1000 Value Index and found we are matching the levels last seen at the dot.com era when growth stocks were frothy during the summer of 2000! This is something we'd flag and suggest caution is warranted depending on what part of the market you are investing in. Be wary!

What is startling is assessing market performance after the period dating back to the summer of 2000 and the dot.com bust, as some people call it.

Chart #5:

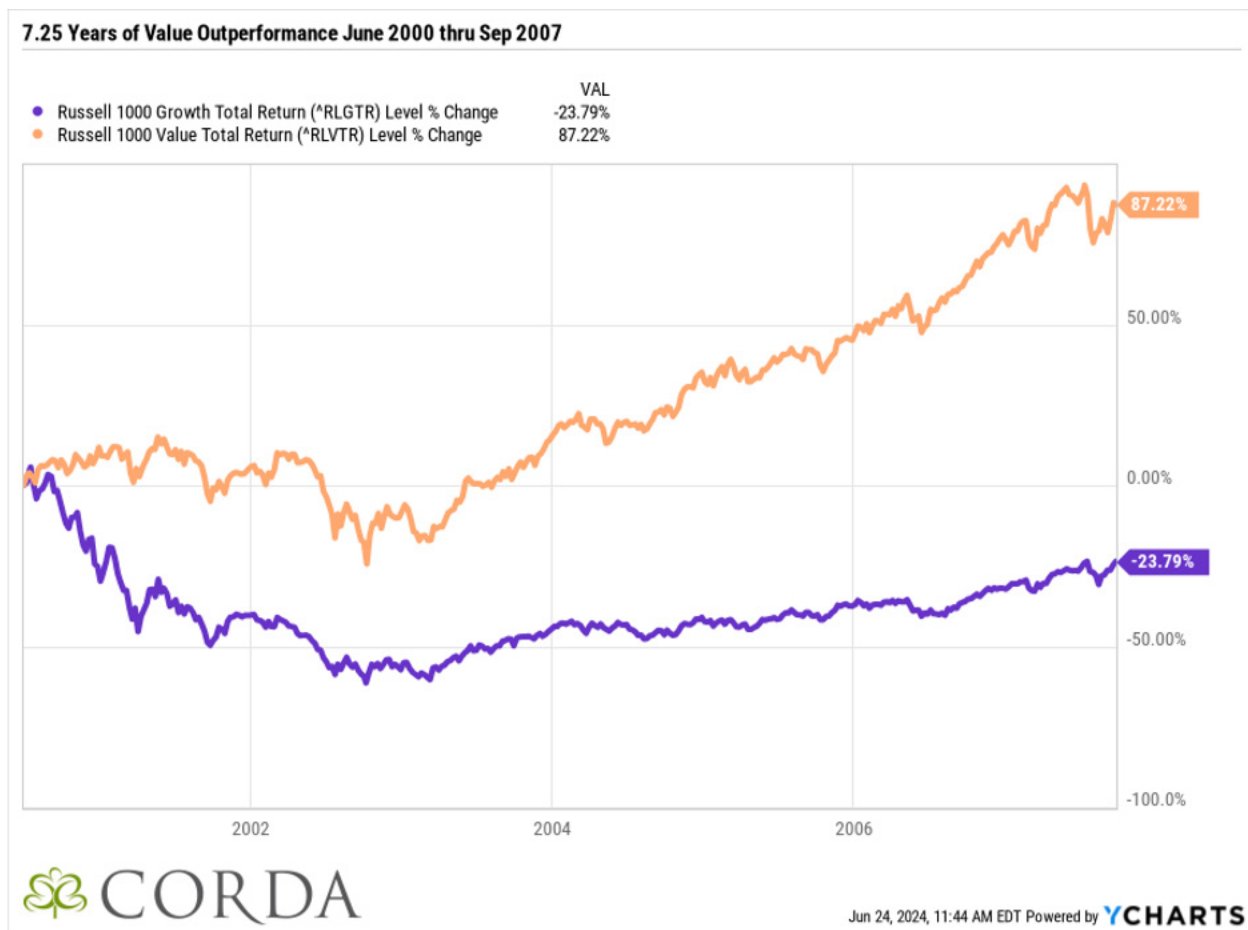


Chart #5 above depicts how the value versus growth segments of the market performed after the dot.com bust. The period analyzed is from June 30, 2000, through September 30, 2007, and it shows how the Russell 1000 Value category returned 87.22% against the Russell 1000 Growth category's -23.79% loss. That is something to ponder, isn't it?!

Switching gears for a second to the bond market, one point about fixed income. The market is fixated on Jay Powell and the Federal Reserve Bank's official stance about interest rates. Powell continues to suggest "higher for longer," and how the Fed will be data dependent and won't nudge rates lower until they have confirmation that inflation has been tamed. That said, we'd argue that since we are now back to NORMAL rates around 5%, maybe the Fed should just stand aside for the time being.

Chart #6:

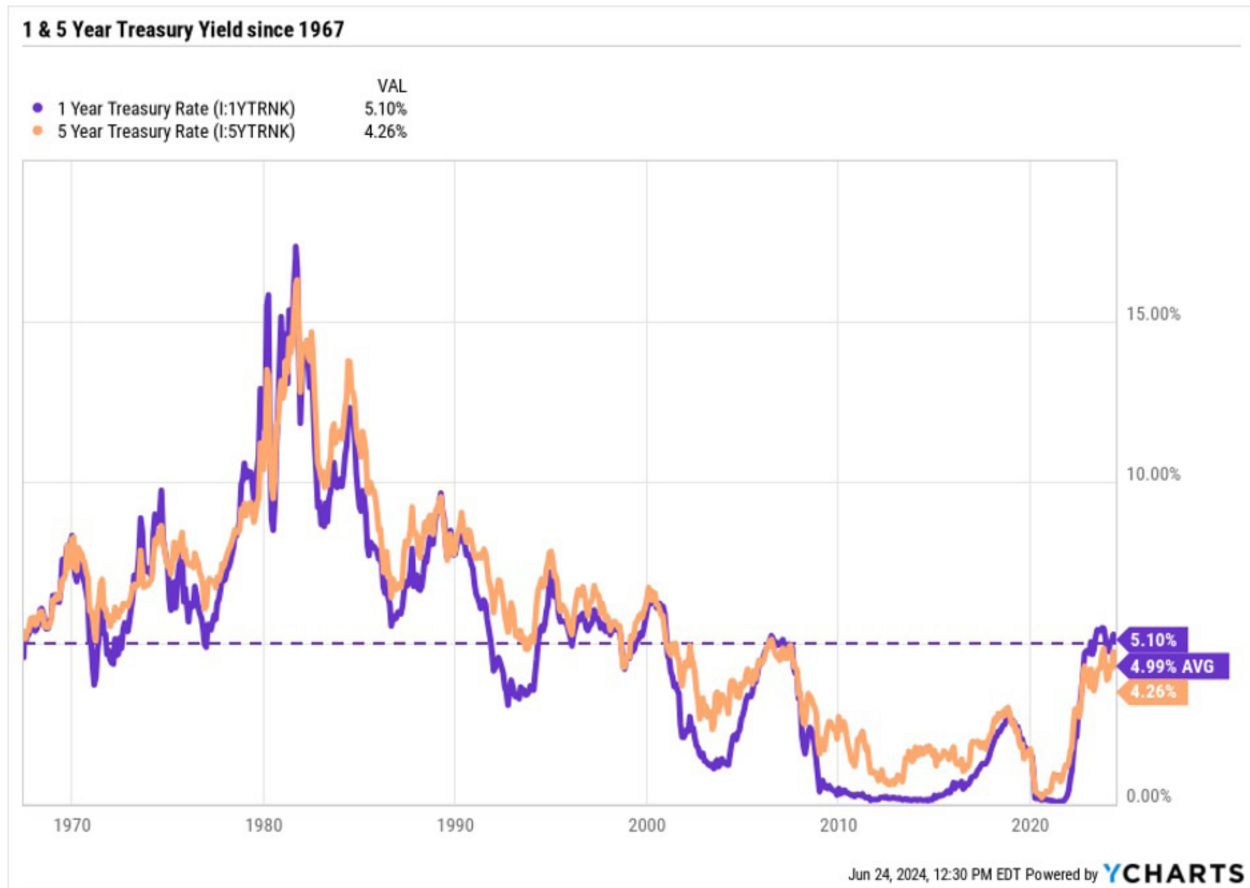


Chart #6 above shows how the average interest rate of the 1 Year Treasury note over the past 50 years is 4.99%. That compare to the 5.10% rate an investor could pick up today on a Treasury note maturing in 12 months. We are right in line with the averages. We'd caution all market participants to be careful what they wish for should they hope the Fed lowers rates in the near future. Should the Fed lower rates later this year or next, it might be due to an economy tipping over into a recession. That might mean higher unemployment and lower growth. If the Fed is merely lowering rates to be less restrictive due to inflation coming down, that might be viewed as something a little more positive than simply a bout of recession. Time will tell.

Lastly, with what appears to be overvaluations in the largest stocks and an undervaluation in smaller businesses, according to JP Morgan, institutional investors are less keen to be buyers of equities across the board right now.

Chart #7:

Figure 2: Are you more likely to increase or decrease equity exposure over the coming days/weeks?

Source: J.P. Morgan.

According to this data from JP Morgan, Chart 7 above shows institutional investors have a low-risk appetite for stocks right now, with only 17% of respondents suggesting how they plan to increase exposure in the coming weeks. This is clearly a contrary signal and one which might indicate the market can climb higher.

In closing, it seems the market is telling two distinctly different stories of late. One where the biggest companies have pushed the market higher, yet their valuations are exhibiting warning signs for those willing to listen. However, if you move outside of the largest companies and look at smaller stock valuations and other characteristics, you can make the case for sound fundamentals and discounted prices. That's the area we continue to find opportunities.

We will continue to invest in a confident and disciplined fashion with a tilt towards Warren Buffett's #1 rule - "Don't lose money." Of course, there is no crystal ball that allows for the absolute avoidance of pullbacks and corrections, but to avoid permanent loss of capital, we'll continue to invest in sound, well capitalized businesses that can withstand the tests of time. Our income and growth strategy may seem like it has lost some of its luster in this narrowly led market, but there will always be periods when lulls, pullbacks, and flatlines happen. Fortunately, our dividends have been and remain secure and we've had a consistent number of increases over the years. Lastly, the bond market is offering some nice yields as we wait for the market to rationalize itself. That said, there is an ebb and flow to the capital markets and although history doesn't always repeat itself, it often times rhymes. We are patient but sense the tide may be moving out for some businesses and sectors and in for others. We plan to capitalize!

Have a great summer and we'll be talking to you soon. All the best from the CORDA team.

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