

“History never repeats itself, but it does rhyme.” Mark Twain

The stock market has experienced volatility of the negative variety year-to-date. The S&P 500 was down -16% through the end of August. The market return, however, does not tell the entire story. Growth stocks (high growth/high valuation) had out-performed value stocks (low growth/low valuation) for some time, and the gap widened significantly during the COVID shutdown. The stay-at-home tech stocks (like Zoom, Peloton, Netflix, Amazon, etc.) grew revenues rapidly and enjoyed high valuations supported by artificially low interest rates. Two years after the shutdown, however, growth stock valuations (price/revenue ratios) are contracting as the Fed raises rates and executes a quantitative tightening program. And then the double whammy -- estimated growth rates for many of these companies are declining from what were clearly unsustainable levels.

The Russell 1000 Growth Index is down -23% year-to-date through August 31 while the Russell 1000 Value Index is down -6%. The gap in valuations has begun to narrow, but it took a number of years for the extreme valuations to develop in the growth stocks, and it will likely take a number of years to normalize. As a result, this is most likely not a “buy the dip” kind of market for the growth stocks. Instead, it is best to buy selectively, paying close attention to fundamentals and valuation. In fact, we believe this is always the best approach.

Mark Twain said, “History never repeats itself, but it does rhyme,” and there have been good examples in the past. Political and economic factors vary during these periods, however, there is strong similarity in the way the factors play out in the stock market. In the 1960s, a common theme was that there was a group of companies (the “Nifty Fifty”) that were so special they should be bought at any price and should never be sold, so valuations reached lofty levels. During the 1970s, valuations of these companies fell to levels more in line with the overall market and fundamental realities set in for some of the companies as well. It turns out that some of the companies were not all that special. For example, Polaroid, Kodak, and Simplicity Pattern manufactured products for the past, not the future. It took a decade for the market to wring out the excess.

Likewise, after the tech bubble burst in 1999-2000, some companies ceased to exist while others suffered significant valuation declines. In the years leading up to 1999, the sky was the limit for tech/telecom company valuations. The market peaked in 1999 and did not reach that level again until 2006. A good example is Microsoft which hit the high \$50s in late 1999 only to correct to around \$20 as the tech bubble burst in 2000. It reached the high \$50s again in 2016. There was nothing wrong with Microsoft in 1999, but it took a long time to regain lost value because it was simply significantly overpriced in 1999. If you owned appropriately valued stocks during this time period, you experienced a quicker recovery after the correction.

We look to the future when making investment decisions, but we are informed by history. We believe market timing is a fool’s game, so we don’t do it. It is clear, however, that an investor could have moderated losses during the correction of the “Nifty Fifty” and the tech bubble by owning appropriately valued stocks. We put a great deal of effort into what we own and why we own it. Our approach is rooted in a defined process and valuation discipline, seeking value and focusing on buying an investment at less than our estimate of intrinsic worth. Our objective is to participate in the up markets but have support in down markets, outperforming the broader markets over market cycles. As a result, you have a strong portfolio of companies with stock prices supported by solid fundamentals based on an achievable long-term outlook.