SECOR Asset Management

A Value Investor's Dilemma

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A summary of recent discussions prompted by Howard Marks memo[1] ("Knowledge of the Future, April 14, 2020) lamenting market distortions introduced by government/Fed involvement in the markets.

Recent memo from the Oakmark distressed debt guru questions the wisdom of the Fed purchasing non-investment grade debt.

- Government overstepping its bounds, distorting "free" markets
- Moral hazard; government protecting companies and investors from the consequences of their risky behavior/leverage
- Marks: "Markets work best when participants have a healthy fear of loss."
- Marks: "Mr. Powell has made clear that **even with interest rates at zero, the Fed's firepower is limitless**. "When it comes to lending, we are not going to run out of ammunition," he said Thursday [March 26] in an interview on NBC's "Today" show."

1 https://www.oaktreecapital.com/insights/howard-marks-memos.

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Observations and implications for a valuation-sensitive equity investor.

- The Fed appears to be following a similar playbook to the Global Financial Crisis (GFC) by expanding their balance sheet to purchase risky assets to stabilize markets

- The free, or at least subsidized, put option implicit in the Fed's behavior supported equity valuations for the last decade

  - Artificially low risk-free interest rate
  - Distorted the equity risk premium
  - Better than average earnings-per-share growth aided by borrowing-funded stock buybacks

- The ensuing low interest rate environment provided a tailwind to longer duration Growth stocks relative to shorter duration Value stocks, supporting a prolonged Growth cycle which has yet to reverse

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Fight the Fed? - Markets will find their level eventually/the impact of Fed meddling is temporary, or maybe not.

- On the one hand, the Bank of Japan has been following a similar playbook for decades and it has not had the desired effect.

- However, both the Fed and investors received positive reinforcement from the GFC experience. Disaster was avoided, the economic damage was contained and equity prices appreciated strongly. The rise in inflation that many predicted never materialized. Whether through skill or luck, the response appeared to work (probably beyond even the most optimistic expectations)

- The GFC is the closest analog to today's investment landscape in turns of severity/speed of the downturn and it doesn't seem irrational that regulators and investors would extrapolate from the last instance

- Investors have developed a Pavlovian Buy-the-Dip mentality with the expectation of a Fed backstop if/when things go bad
  - Just a few months before the current crisis, with relatively healthy US and global economies, President Trump was aggressively leaning on the Fed to reduce rates
  - Fed Chairman Jerome Powell: "We are not going to run out of ammunition."[1]

[1] Wall Street Journal 30 March 2020

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The last decade for a value investor in 6 bullets:

- Watch from the sidelines as equity valuations go from somewhat expensive to extremely expensive
- Equity markets finally pull back due to a completely unexpected external shock - a global pandemic - and equity prices fall from their extreme valuations to valuations closer to long-term averages, but still not cheap
- Valuation-sensitive investors tentatively begin to buy, rationalizing that even though absolute valuations are not great, they are the best they have seen in years and do not want to suffer the regret of doing nothing
- The value investor keeps lots of dry powder, however, as valuations still are not exceptional and there is a decent probability that they become so as the fundamental picture deteriorates and uncertainty abounds
- This window of lukewarm opportunity remains open for just a few weeks until the Fed pulls out its bazooka and blasts equity valuations back in to expensive territory. The memory of the last lost decade for value investors is still fresh in their minds as the window slams shut
- Return to the beginning and repeat……..

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