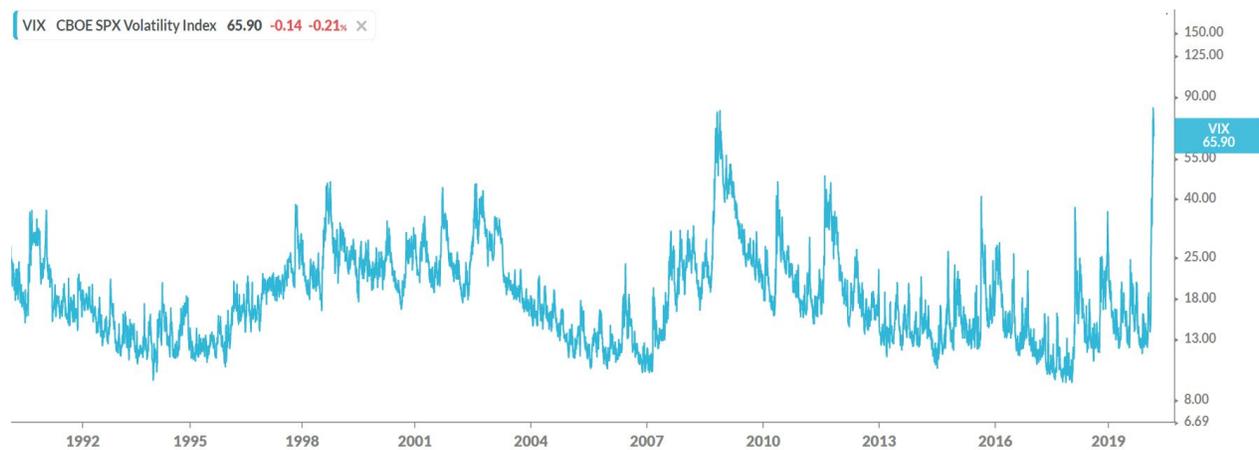


March 23, 2020

### Blizzard, Winter, or Ice Age

The past two weeks have been a brutal market blizzard during what is now almost certainly an economic and investing winter.

Blizzards are defined by extreme volatility and uncertainty—and we've had historic amounts of both since February 20<sup>th</sup>. I believe that to survive a blizzard you must focus on placing each foot in front of the other. Executing your plan or process, reigning in leverage (if applicable), and avoiding blunders in the confusion. We know that price volatility clusters at periodic peaks of uncertainty—these are market blizzards.



Source: Koyfin

A winter is a sustained period of equity market drawdown and negative economic growth and rising unemployment—an economic recession. We have faced many winters before, and while the circumstances that trigger a given winter are always somewhat unique, we've always recovered and reached new highs in both the economy and the stock market. In a winter, cost structures change and weak hands (even considering bailouts or loans) fold. Winters have been some of the better times to invest cash into equities, by far.



We work with a lot of professional financial intermediaries: financial advisors and investment consultants who manage money for their clients. Talking to many of these people over the past two weeks, it is clear that having enough cash on hand is like having a warm fire during winter, and I personally don't see anything wrong with making asset allocation changes to secure that fire. But full out panic and liquidation has been the *clearly wrong* strategy in past winters, especially for younger investors or those with years of cash on hand. I think it's important to remember that the reality isn't that people sell at market bottoms, markets bottom because everyone sells. With the S&P 500 down nearly 35% from its peak at the time of this writing, we've faced the swiftest drawdown on record. For many it has already been incredibly difficult to stick with a long-term equity allocation. Most behavioral investing errors happen in periods of uncertainty like the one we face today.

That brings us to the largest open question: is this a winter like we've faced before, like those visible in the chart above? Each one was hard and painful, but each was followed by a normal spring and summer on the other side. Or is this an ice age? A period more like the Great Depression or other long periods of decline and stagnation? James Bullard at the St. Louis Fed warned recently of the potential for 30% unemployment and a 50% decline in GDP—both significantly worse than the extreme levels of the Great Depression.

The October 19<sup>th</sup>, 1918 issue of the *Arkansas Gazette* highlighted the many ways in which the Spanish flu had decimated local businesses. A department store's revenues were down 50%; merchants were down 40-70%; businesses were losing an average of \$10,000 per day (\$133k in 2007 dollars). Demand was up in drug stores, and for certain products like beds, mattresses, and bedsprings<sup>1</sup>.

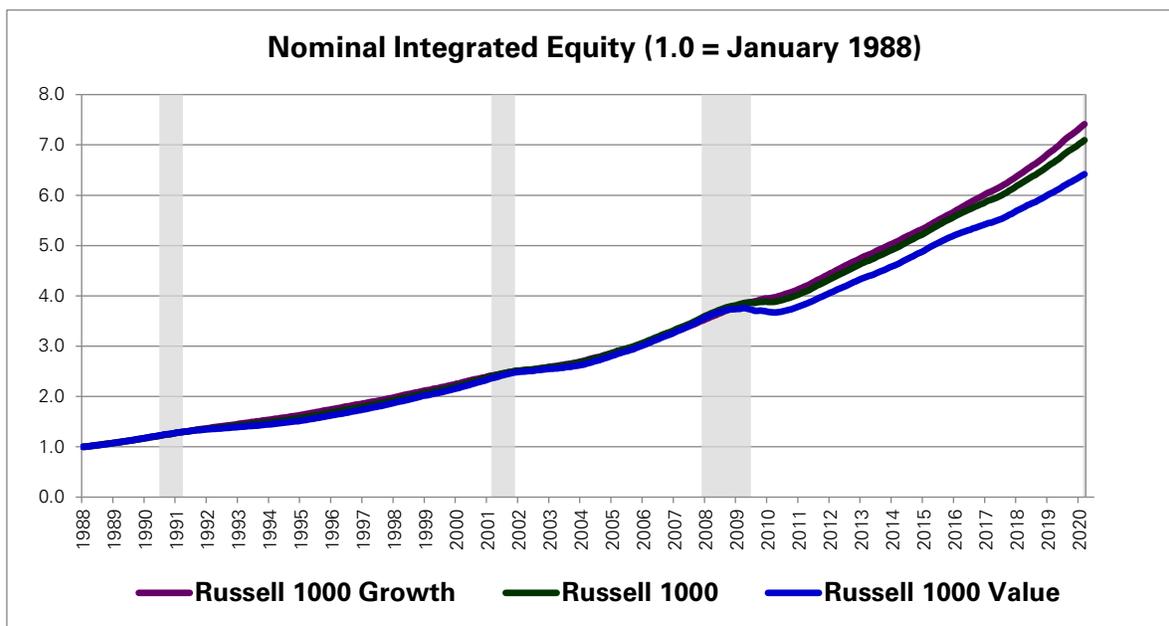
Can the same thing that happened in Little Rock in 1918 happen writ large across the entire U.S. (and global) economy and last for years? Without a serious, swift, and aggressive response, it is possible. But the best data that we have suggests it's improbable.

We are now in one of those scary periods where returns are determined as much by investor behavior and psychology as by fundamental outcomes. In periods of psychological market stress, data, evidence, and process are *critical*. We turn to that data to build expectations of where we may go from here.

### How to Value the Market, and What Returns to Expect From Here

We are entering a situation in which traditional methods of market valuation may become less useful as business fundamentals fall precipitously. In that type of situation, we think the best way to value the broad market is by measuring its "integrated equity," which we define as all capital retained and reinvested by companies, properly adjusted for inflation. Here's what a chart of total integrated equity looks like since 1988. Notice the slight dip for value stocks in the financial crisis (due to write downs and

earnings losses). Notice that the measure remains smooth and steady over time, even through periods of deep recession.



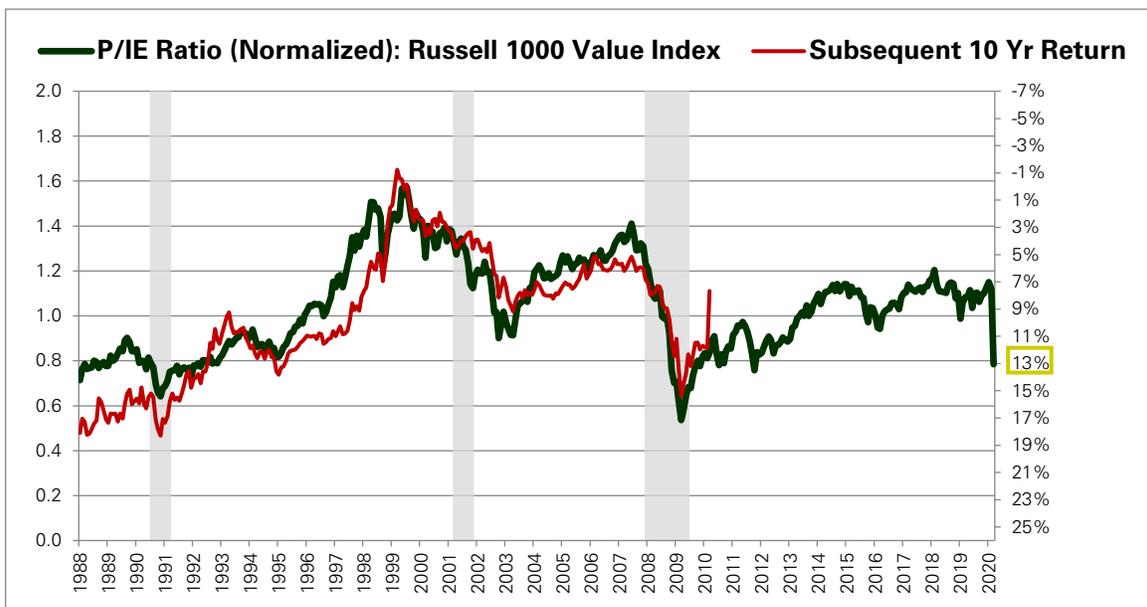
Source: OSAM Research

The cheaper you can buy stocks based on their integrated equity, the better. Here is an update on the estimated future 10-year returns from our price-to-integrated equity calculation. These return predictions have changed drastically since the beginning of the year:

P/IE 10-Yr Return Predictions		
	Jan 1st	March 23rd
<b>Russell 1000 Growth</b>	<b>0%</b>	<b>3%</b>
<b>Russell 1000 Value</b>	<b>7%</b>	<b>13%</b>

Source: OSAM Research

We expect 3%/year for growth stocks (still quite low despite the drop) and 13%/year for value stocks. This is the highest prediction we've seen for value since the highest ever in March of 2009 (a prediction which proved close to accurate), when the model predicted a return of nearly 17%/year.



Source: OSAM Research

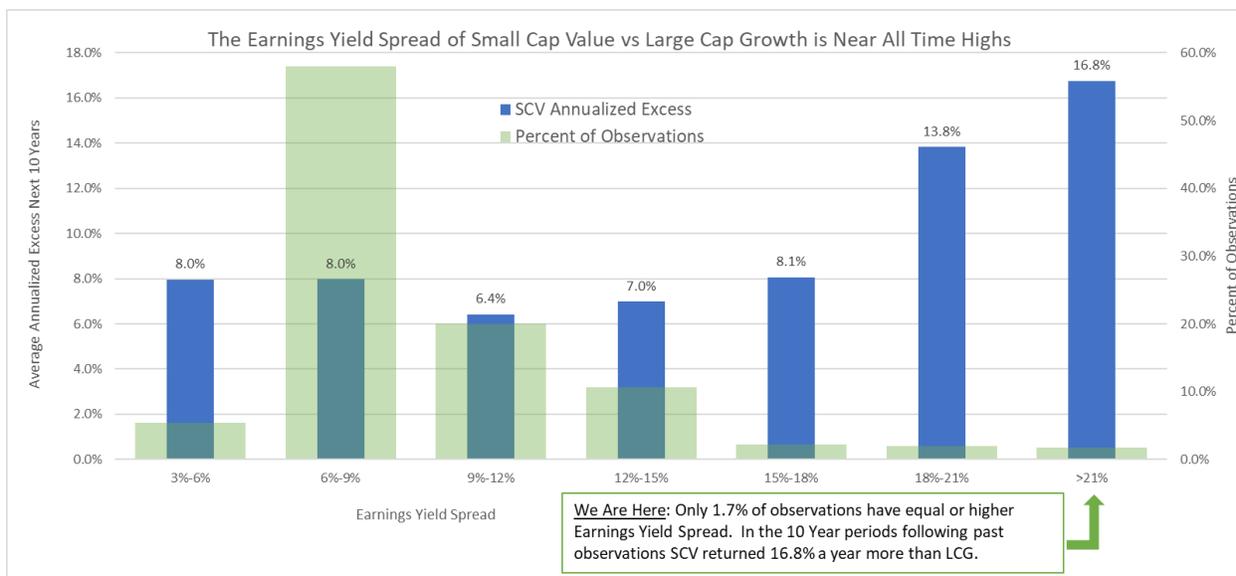
These are index return predictions. We think that the way Russell builds indexes is not ideal for investing purposes, and that better tailored value strategies will achieve returns significantly higher than the 13%/year which we expect from the index.

### How to Build Equity Portfolios Now

This is where I talk our own book. Normally we don't comment on how factors look relative to one another in the near term. But there is nothing normal about the markets right now. In fact, we are witnessing relative investment opportunities in smaller, cheaper stocks that we thought we'd never see again after the madness of the tech-bubble in 2000.

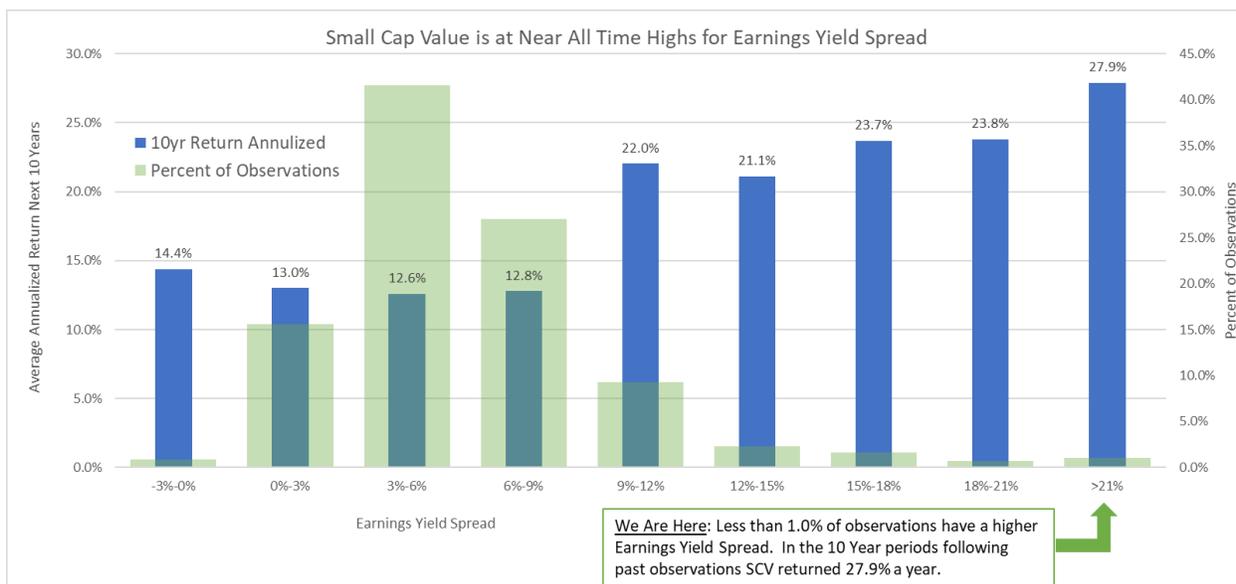
There are many ways we can evaluate the value of smaller cheaper stocks. We can see how cheap they are relative to fixed income yields, we can see how cheap they are versus their own history, and we can see how cheap they are relative to the large growth category of stocks that have led this market cycle since 2009 and *thus far* have led the market in this drawdown.

In each case, we see historic readings. As one example, when we compare the earnings yield of the cheapest small stocks (cheapest decile by price-to-earnings) to the most expensive decile of large cap stocks, we see a spread of more than 21%. Following extreme periods like this historically, small value outperformed large growth by 16.8%/year over the subsequent 10 years.



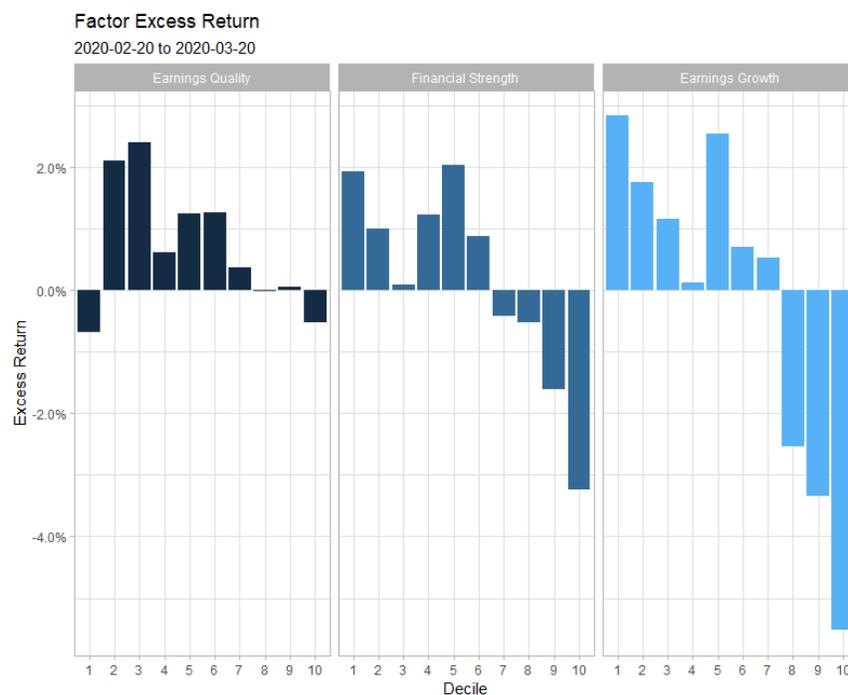
Source: OSAM Research

We can also compare the earnings yield on small cap stocks (cheapest decile) to the yield on the U.S. government 10-year bond. Most of the time, that spread is between 3-6%. Today it is greater than 20%. Following similar spreads in the past, small value stocks returned an average of 27.9% in the subsequent 10-year period.



Source: OSAM Research

We use small value here as a simple proxy for many quantitative strategies but must emphasize that we don't think you should just buy the cheapest decile of stocks. We know that many stocks will suffer huge earnings declines, and so quality and trend remain critically important in any investing modeling process. Since the market peak on February 20<sup>th</sup>, we've seen how important quality can be. In this chart you can see that across our quality factors, low quality stocks have done much worse than the market. We think these factors will remain important from here.



Source: OSAM Research

Value has been pummeled for years, and now even more acutely for weeks during the COVID market crash. As a result, we are now faced with historic readings and perhaps a historic opportunity. This isn't to say the market doesn't have more downside—I have no clue when the blizzard will end. But the data suggests the market as a whole will reward investors, and that it will reward investors focused on quality and valuations even more.

### Is the World Going to End?

Since I've been unable to sleep this week, I've been rereading Frank Herbert's *Dune* at night—the book where we get the famous quote: “fear is the mind killer” (which everyone and their brother is trotting out right now). It is a damn good passage:

I must not fear. Fear is the mind-killer. Fear is the little-death that brings total obliteration. I will face my fear. I will permit it to pass over me and through me. And when it has gone past I will turn the inner eye to see its path. Where the fear has gone there will be nothing. Only I will remain.

We are in a state of global fear and uncertainty. I've been asked a lot about what I'll call “ice age hedges”—through a combination of cash, productive hard assets, or even unproductive scarce assets like gold and bitcoin. I'll admit that because it's possible (though again, in my view, improbable) that we face a true ice age, I can't argue with ice age hedges of some type. Personally, I am not buying these things, and am keeping normal cash on hand—but I understand those that are.

With the country—and world—shut down, can we cross the chasm, help businesses survive the revenue drought, and re-emerge on the other side? I believe that we can. I am an optimist. I believe in the resilience of people, and of this country and the world. I believe that it is hard to bake this resilience and the human response into epidemic models, and so I am optimistic that our response to this menace will curtail the worst-case outcomes, and that we will avoid an ice age.

I have hope. But as Herbert writes in *Dune* soon after the famous *fear* passage, “hope clouds observation.” I agree. Fear is the mind-killer but hope alone is insufficient. We must quickly embrace reality and then seek to improve it. We must focus on the things in our control that we can make go up as prices go down, that we can improve as things devolve. In our case that means perfect execution, more research than ever, more transparent conversations than ever, more information sharing than ever, and a constant assessment and appropriate rebalancing of portfolios. I know everyone else is starting to do the same: asking how they can help, how they can fight, how they can survive and advance, better than before. I promise that everyone at OSAM will be a small part of that fight.

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### **Composite Performance Summary**

For full composite performance summaries, please follow this link: <http://www.osam.com>

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<sup>i</sup> [https://www.stlouisfed.org/~media/files/pdfs/community-development/research-reports/pandemic\\_flu\\_report.pdf](https://www.stlouisfed.org/~media/files/pdfs/community-development/research-reports/pandemic_flu_report.pdf)