DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter
Q4 2015
Doucet Value Momentum Portfolio
Doucet Value Income Portfolio
Fixed Income Strategy

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Modern Fed Speak & the Lost Language of Value Investing

"You've got to be very careful if you don't know where you are going, because you might not get there."
-Yogi Berra May12, 1925-September 23, 2015 rest in peace

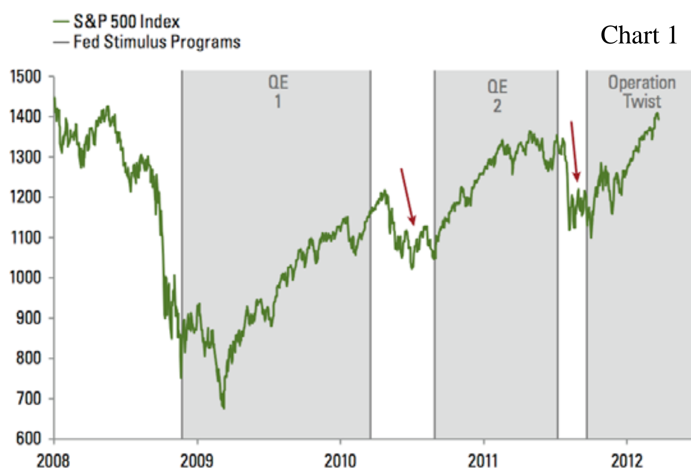
The new lexicon of the investing public is *Fed speak*. It dwarfs in frequency in conversations about previously important market metrics like valuations and earnings. There are over 100 Central Banks around the world jockeying for some advantage in the global marketplace, extolling the virtues of debasing and manipulating their respective currencies in the hopes of achieving full employment and creating 'good' inflation for their local economies.

English as a Second Language

It is only fitting that these machinations necessitate a language filled with acronyms like QE (quantitative easing) and ZIRP (zero interest rate policy). It is almost like the 80s again on Wall Street as highly educated people regularly talk like drug dealers when speaking of Fed accomodation with phrases like "Krugman Crack" and "Keynesian Candy" in homage to the present and the past pundits of 'easy money' policies. But perhaps worst of all is investors now give credence to previously unthinkable acts like a "helicopter drop", a phrase coined by famed economist Milton Freidman but popularized by Helicopter Ben Bernanke. There is now a consensus among central bankers that QE has failed in its attempt to increase the velocity of money. One solution some believe is to actually deposit cash directly into your account so you will spend it, since buying bonds in the open market has not accomplished its intended effect as evidenced by the fact that the rate at which currency is exchanged is at an all-time low.

Theater of the Absurd

This new-aged vernacular has assisted the investment world in lowering its collective IQ by multiple points as they have now been conditioned like Pavlov's dogs to buy on *bad* news (because more stimulus is likely to come as a result) and sell on *good* news (because heaven help us if investors start paying attention to fundamentals). Bad behavior is reinforced (and even encouraged) by financial news networks parading day traders and managers touting their own books in front of cameras yelling gibberish followed by things like "buy, buy, buy" and the next day screaming "sell, sell, sell," while they passionately proclaim value investing is dead and the Fed should not raise interest rates by 25 basis points lest they kill the great bull market. The cacophony of noises coming from all directions has made investing confusing, caused market volatility to spike, and been a source of frustration for both neophyte and seasoned investors alike. But as nonsensical as Fed speak has become, as downright absurd as Fed policy is and still could become, the market actually recently focused for a few weeks on investment fundamentals after a long hiatus and it may be at an important juncture where the true value of something actually matters again.



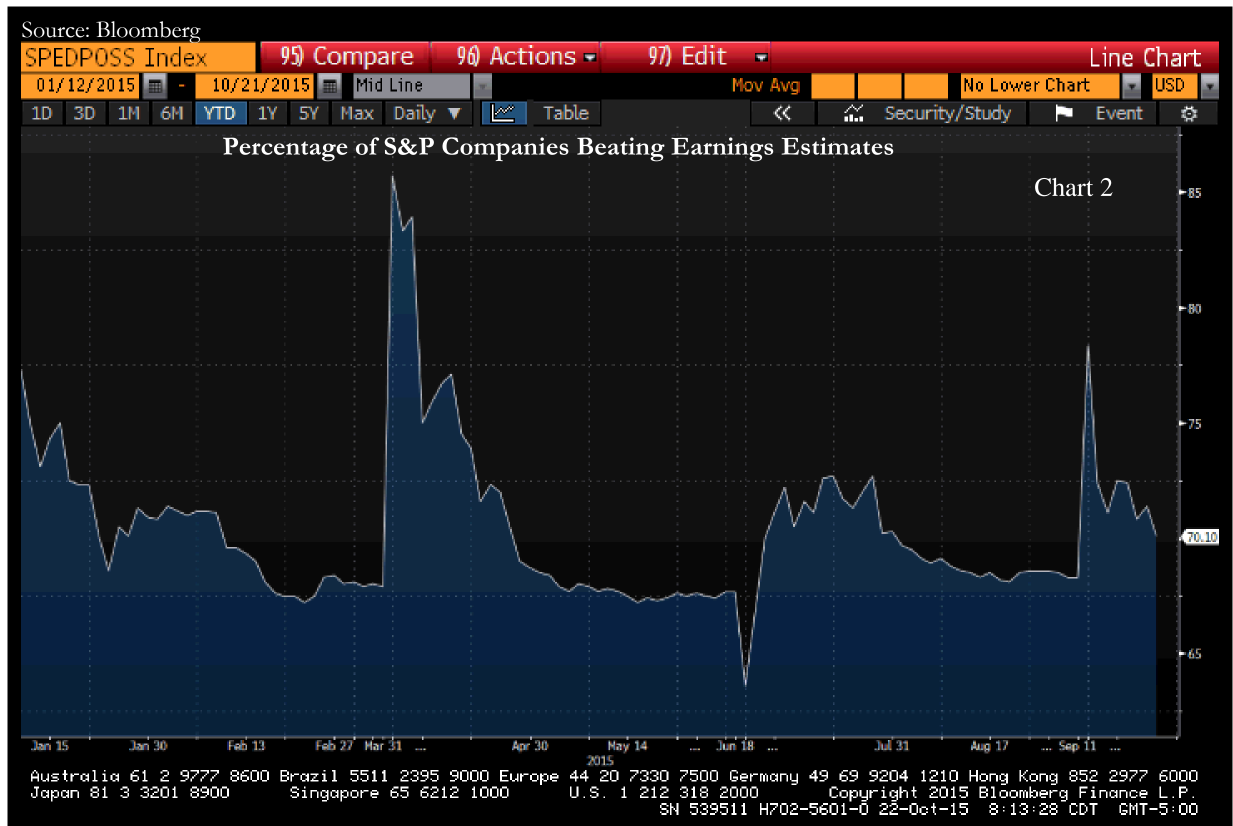
Source: LPL Financial, Bloomberg Data 03/23/12

We Have Liftoff - NOT

What history has taught us is that monetary

policy only temporarily inflates asset prices as shown in Chart 1. It is an economic sugar high, not a cure all. It is a fallacy to believe the Fed can accomplish its dual mandate of creating full employment and 2% inflation on its own. It attempts to be a form of trickle down economics, but it is much less effective, has a much higher price tag and carries with it potentially more dire consequences if left in place too long.

When the expectation of a Fed rate liftoff and an economic slowdown in China crept into the investor psyche this summer, the market began to focus on earnings fundamentals of companies and the result was the Dow fell 7.6% in the third quarter, its worst performing quarter since 2011. All major indexes followed suit and entered correction mode. While market multiples have come down to more reasonable levels, the S&P 500 still sits at an implied P/E ratio of 19.54, using trailing 12-month operating earnings, which is still way above the historical average of 16.6 dating back to 1870.[1] It will be difficult to compel investors to pay more for stocks on any kind of sustainable basis when revenues of the S&P 500 are declining and the rate of earnings growth is slowing. The past three earnings seasons have produced weak top line revenue numbers from most reporting companies, yet analysts remain unfoundedly optimistic about corporate earnings as Chart 2 clearly illustrates. Pierre Lapointe, head of global strategy and markets at Pavilion Global Markets agrees, stating "if this pattern continues, we're likely to see a disappointing earnings season." A recent Bloomberg survey forecasts S&P 500 profits to decline 6.9% from a year ago (mainly due to a decline in earnings from energy companies) and for earnings, excluding energy, of a paltry 0.1%,[2] not exactly a number that will help support higher market multiples. So as earnings slow, one of two things will have to happen; either the market will become even more bifurcated as investors crowd into the few remaining stocks continuing to show real earnings growth or simply stocks will have to get cheaper, bringing value investing back in vogue and causing investment fundamentals to once again rule the day.



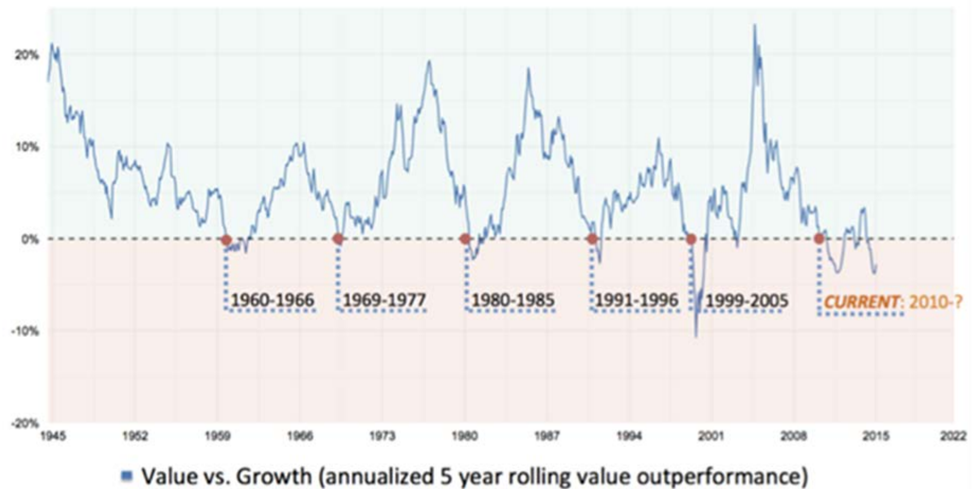
Ghosts of the Dotcom Past

As the Fed has kept a lid on interest rates over the past few years, investors have been willing to bid up the multiple on growth stocks. However, when earnings slow or interest rates rise, investors have historically been less willing to pay a high valuations for the same stocks. "Since 1926, value stocks beat growth stocks roughly three out of every five years," according to Bank of America Merrill Lynch. But QE helped aid the expansion of growth stock multiples over the past few years. Salvatore Ruscitti, a strategist for Montreal-based MRB Partners, suggests "growth is now a crowded trade" confirming what most already believe-growth stocks have become too expensive.

Over the past year, the Russell 1000 Growth Index is up 3%, while the Russell 1000 Value Index is down 7%. According to the famed Dartmouth School of Business Economics professor, Ken French, "since World War II, there have only been six periods when growth has outperformed value on a trailing five-year compounded annual return basis. We are currently in one of those periods; the last time this happened was during the dot-com era."

Reversal of Fortune?

During the past five periods when growth outperformed value, value subsequently delivered very strong results over the next five-plus years, as illustrated in Chart 3. In this respect, it currently feels like 2000 all over again and history could be ready to repeat itself. What people tend to forget is Warren Buffet's value fund, Berkshire Hathaway, was down almost 50% from June 1998 through February 2000 when value investing was last out of style, but then was up about 235% from that point through December 2007. It's "déjà vu all over again"; market volatility is rising, earnings growth rates are slowing, the markets are overvalued based on every fundamental metric, and there is an insatiable desire for growth in one's portfolio at almost any price. Much like in 2000, production levels in commodities across the board are beginning to soften and both commodity prices and credit spreads are beginning to widen, just to name two other similarities. All of this sets the stage for value on both the fixed income and equity side of the balance sheet to outperform growth over the next several years. Despite more stimuli coming from overseas and the Fed likely on hold until 2016, today's overall market "valuations certainly do not represent a historic buying opportunity" says Matthew Confina, an equity strategist from Morningstar. But he goes on to say that "unfortunately, the S&P 500 was richly valued before this downturn, so it will take a lot more than a small correction to get excited about the market as a whole." But the Fed and its counterparts will eventually run out of proverbial silver bullets and the investment climate will change from a growth mode to value. At that point, the investing world will have to learn the almost extinct language of fundamental investing all over again.



Sincerely,

Chris L. Doucet, CEO

Footnotes

[1] APViewpoint, Doug Short, 10/1/15

[2] David Wilson, Bloomberg Newsroom, 10/7/15

Admin Notes

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