RBC Wealth Management

The Crescent Group

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June 2019 Investment Commentary

During the first half of the year, the stock market partied like it's 1999, as the Dow Jones Industrial Average experienced its best first six months to a year since 1999. The 20% market decline and bear market we experienced just six months ago? A distant memory....[1]

The above paragraph describes the forces we see at work in the stock market as we write this commentary. In the past, pundits have associated various words with market environments like the one we currently find ourselves in – animal spirits, irrational exuberance, speculation, follow the crowd, bubble. With everyone else partying, it's tempting to forget the lessons of the past and get caught up in the euphoria. But investors who do that will suffer what always follows an overly indulgent party – a horrible hangover.

The stock market has indeed experienced quite a recovery from last fall's meltdown. Considering the market's impressive recovery this year, can you guess how much the S&P 500 has increased above the high level it set last year before the fall's market meltdown? A mere 1%. So while chasing after what's hot has generated strong short-term results, the longer-term picture over the past year has been almost no return[2].

In past commentaries, we've discussed time periods where the U.S. stock market as a whole generated no long-term return for investors. Over the time period 1964 to 1981, the Dow Jones index generated no return. More recently, from 2000 to 2013, the S&P 500 index generated no return. Warren Buffett cites overenthusiasm for auto and airline companies as a large part of the reason why the Dow Jones index generated no return from 1964 to 1981. Auto and airlines companies were the hot new technology companies of their time, and they promised to transform the world. They did transform the world, but over the long term they ended up not generating profits. These companies made up a significant portion of the Dow Jones index, and they became overvalued, which prevented their stock prices and the index from increasing over time. A similar phenomenon of crowd following and speculation occurred with technology companies in the late 1990's, and then real estate in the 2000's, leading to no gain for the S&P 500 from 2000 to 2013[3][4].

Today, we similarly see investor money chasing after what's gone up the most and done well recently. As in the past with auto and airline companies, the long-term competitive and profit dynamics of many of these companies have not been established. Investors have bid up the market value of these companies, which now make up a very large part of the U.S. stock market indexes. This could once again lead to the major U.S. stock indexes generating no long-term return over a period of time. Perhaps we are already in the early phase of such a period – it will be years before know for certain.

And herein lies the hangover we mentioned at the beginning of the commentary. Sure, there will be future market crashes over time, like the one we had last fall. But those are all temporary and don't have a long-term impact on investors who stay invested. The bigger risk is a period of no return for ten to fifteen years, similar to what we described above. No one's retirement plan calls for zero return over a long time period. So how do we protect our investors from such a long time period of no return?

First and foremost, we don't follow the crowd into what's popular. The fact that an investment has gone up a lot over a few years says absolutely nothing about what that investment will do over the next ten or twenty years. Just ask investors who bought Cisco stock in 2000. Cisco is a great company with sound profits and cash flows, but its stock price is *still* below where it was nineteen years ago[3].

Second, we only select investments where – after careful and prudent analysis – we can conclude that we understand the long-term profit dynamics of both the company and industry. Only under these circumstances can we calculate a reasonable price to pay for the investment.

That takes us to our third investment criterion, which consists of only paying fair value or less for an investment. As we described above, the reason Cisco's stock price is still below what it was nineteen years ago is the stock became highly overvalued. Seeking to pay fair value or less helps protect our investors against this scenario.

Our Group's approach to the current market brings to mind what Warren Buffett wrote in his shareholder letter published last year:

"The less the prudence with which others conduct their affairs, the greater the prudence with which we must conduct our own…What investors then need instead is an ability to both disregard mob fears or enthusiasms and to focus on a few simple fundamentals. A willingness to look unimaginative for a sustained period – or even to look foolish – is also essential."[5]

Best Regards,

The Crescent Group
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Sources:

(1) The Washington Post
(2) S&P Dow Jones Indices LLC
(3) Google Finance
(4) Fortune
(5) Berkshire Hathaway 2017 Chairman's Letter

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