First Quarter 2018 Commentary

Volatility returned with force during the first quarter. One morning the U.S. was planning to slap tariffs on a host of other countries, and the stock market would take a violent tumble. Then in the afternoon an official would say things wouldn't be as dire as expected, and the market would fully recover and then finish in the green for the day.

After many similar swings up and down over the first three months, the S&P 500 suffered a small loss of 0.8% for the quarter, its first negative quarter since the fall of 2015. The Dow Jones Industrial Average fared a bit worse, declining 2.0%. With the S&P having gained in 19 of the last 21 quarters, and this most recent decline being a small one, the U.S. stock market is still just 7.5% below its all-time high at the time of this writing.

Reports On the Demise of Value Investing Have Been Greatly Exaggerated

Have you ever thought of investing as being similar to religion? In a way, it is: both have many competing philosophies with ardent followers who believe their way provides the path to some exalted state (whether you call it heaven, or nirvana, or financial independence). The two main beliefs in the realm of investing are called value and growth.

Value investors like us worship at the altar of Benjamin Graham and Warren Buffett, and they buy stocks which are selling cheaply in relation to their earnings, cash flow, sales, or book value, with little regard for how quickly the companies are growing. Growth investors, on the other hand, care mostly about rapid growth—in earnings, sales, and other measures—or even the expectation of growth, almost regardless of valuation.

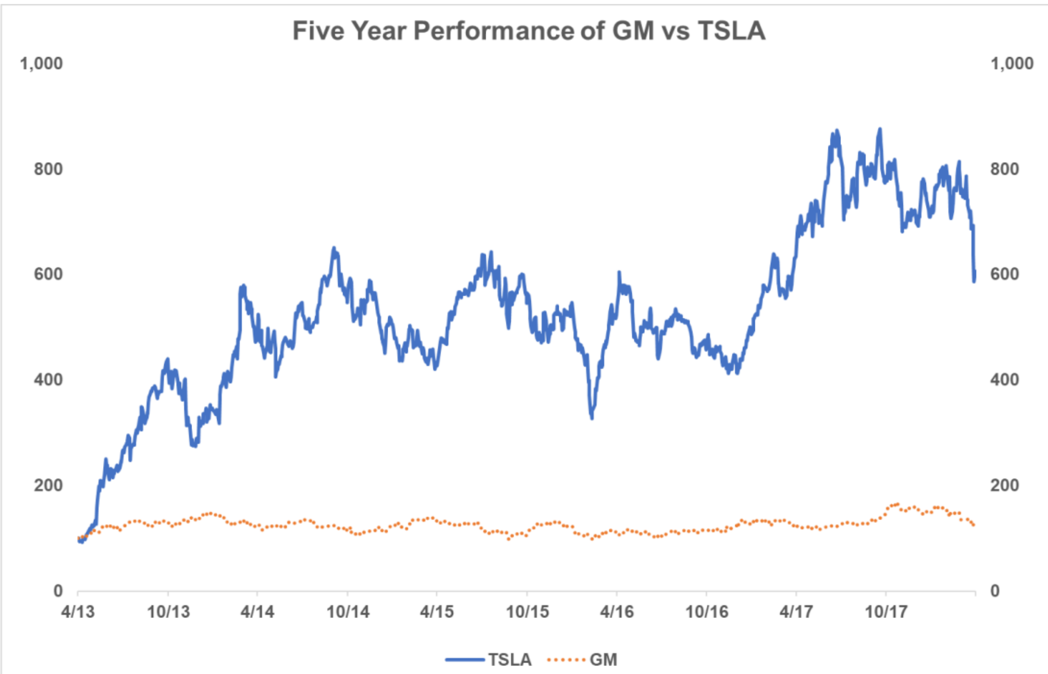
Right now, value investing is going through a bit of a confidence crisis, while growth investing seems to be leading its followers closer to nirvana with each passing day. The stock market darlings of today are the favorites of growth investors: Amazon, Netflix, and the like. These companies have propelled the market to recent highs, while value stocks have been left behind. A classic example of this dichotomy can be seen in the stocks of two companies in the same industry: Tesla and General Motors.

Tesla has been a recent favorite among growth investors. The company, led by the charismatic genius Elon Musk, is a pioneer in the development of electric vehicles and lithium-ion batteries. Producing no cars and having virtually no sales just a few short years ago, the company has grown to produce more than 100,000 vehicles and generate about $8 billion in annual sales. While growth investors argue that this is the company of the future, it has yet to turn a profit.

Value investors, on the other hand, prefer to invest in a different auto maker: General Motors. The company, founded more than a hundred years ago, produces about 9 million vehicles a year and has sales of close to $150 billion. In the last twelve months it has generated a profit of almost $10 billion, and the stock currently pays a dividend of about 4%.

The differences in the financials of the two companies could not be more stark. General Motors is highly profitable, while Tesla has never generated a profit. General Motors pays a hefty dividend, while Tesla does not pay one. General Motors generates 18 times more in sales than Tesla, while producing 77 times more vehicles. So, which stock has performed better? Of course, the answer is Tesla. And it's not even close. In fact, the stock market is valuing both companies at very similar market values: General Motors currently has a market value of $55 billion, while Tesla has a market value of $52 billion.

Below is a graph showing the stock performance of both companies over the last five years. Even after its recent tumble from its mid-2017 highs, Tesla's stock has outperformed GM's stock by a factor of ten, advancing more than 500%, compared with GM's total gain of about 50%.



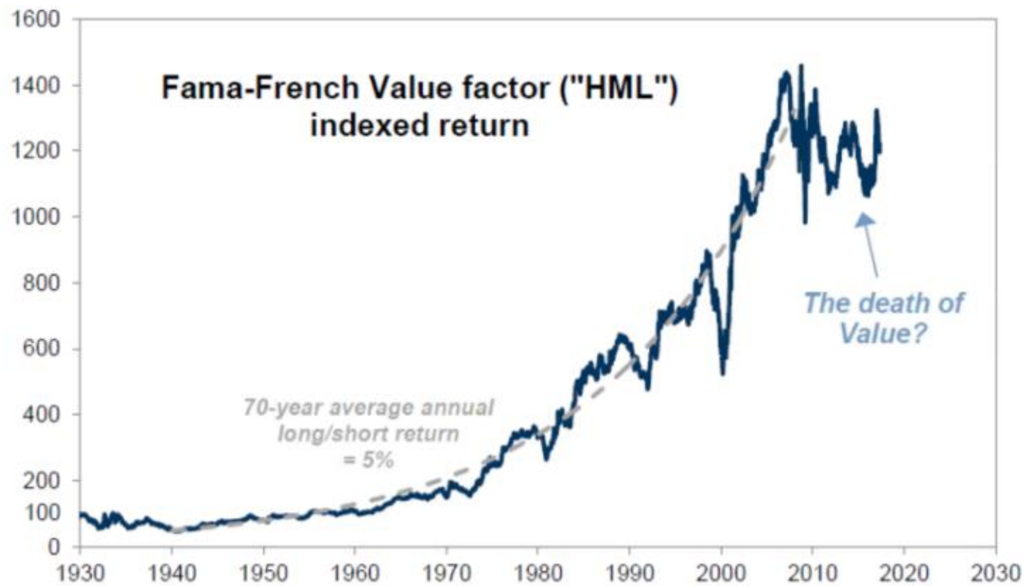
Source: Yahoo! Finance

Is Value Investing Dead?

While the outperformance of growth stocks has been particularly pronounced recently, it is a phenomenon that has been going on for a decade. A recent report by Goldman Sachs Global Investment Research examined the performance of the Fama-French value-factor strategy from 1940 through today. Eugene Fama and Kenneth French are two academics who, while they were colleagues at the University of Chicago Booth School of Business, developed a model to describe stock market returns. Their so-called value-factor model takes into account a stock's valuation by looking at how it trades relative to its underlying book value as shown on the company's financial statements.

The analysts at Goldman Sachs looked at a strategy of buying stocks with the lowest price-to-book ratios while simultaneously shorting those with the highest. They found that this long/short value-factor strategy produced an average annual return of 5% from 1940 to 2007. The strategy experienced a theoretical gain in seven out of every ten years on average, and never spent more than three years below its previous high-water mark.

In the last ten years, however, the performance of this strategy has been a disaster. As can be seen in the chart below, over the last decade the value-factor strategy has suffered a cumulative loss of 15% (which works out to about 2% per year), and it has declined in six of the last ten years.



Source: Kenneth French, Goldman Sachs Global Investment Research

This horrid performance leads to the question: is value investing dead?

The Death of Value Investing?

The Goldman Sachs report goes on to explain the drivers of this aberration in performance and comes to the conclusion that, in their view, this recent underperformance of a value strategy is cyclical rather than secular. In other words, value will not be a perennial laggard from now on. Rather, the investment tides will one day change, and value will begin outperforming growth once again. They state:

> *"Value has historically posted its strongest returns during periods of strong economic growth early in the economic cycle. The factor typically wanes late in the cycle as investors search for secular growth opportunities when economic growth slows. Concerns about the possibility of "secular stagnation" in recent years have compounded the investor hunt for growth. Those concerns now appear to be easing."*

As value investors ourselves we at Inkwell are a bit biased, but we tend to agree with this view. We can still vividly remember the period of the late 1990s when Internet stocks were all the rage and companies like Netscape, Lucent, Cisco, Webvan, and pets.com were the stock market darlings of the day. Value stocks, such as industrial companies, greatly underperformed. Back then, similar stories about the death of value investing were circulating and many “investors” were questioning whether Warren Buffett was out of touch with the current environment. After the Internet bubble crashed, value stocks had a period of massive outperformance, with the long/short value-factor strategy rising by nearly 30% in the subsequent five years.

Conclusion

The current environment has been a frustrating one for us value investors. But that is the nature of the investing game; no one single strategy works all the time in all market environments. Only time will tell when the tide will shift from growth to value, but we do believe that it is a matter of ‘when’ and not ‘if.’

We thank you again for your confidence, and we look forward to reporting to you again in three months.

Sincerely,

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