Market Commentary

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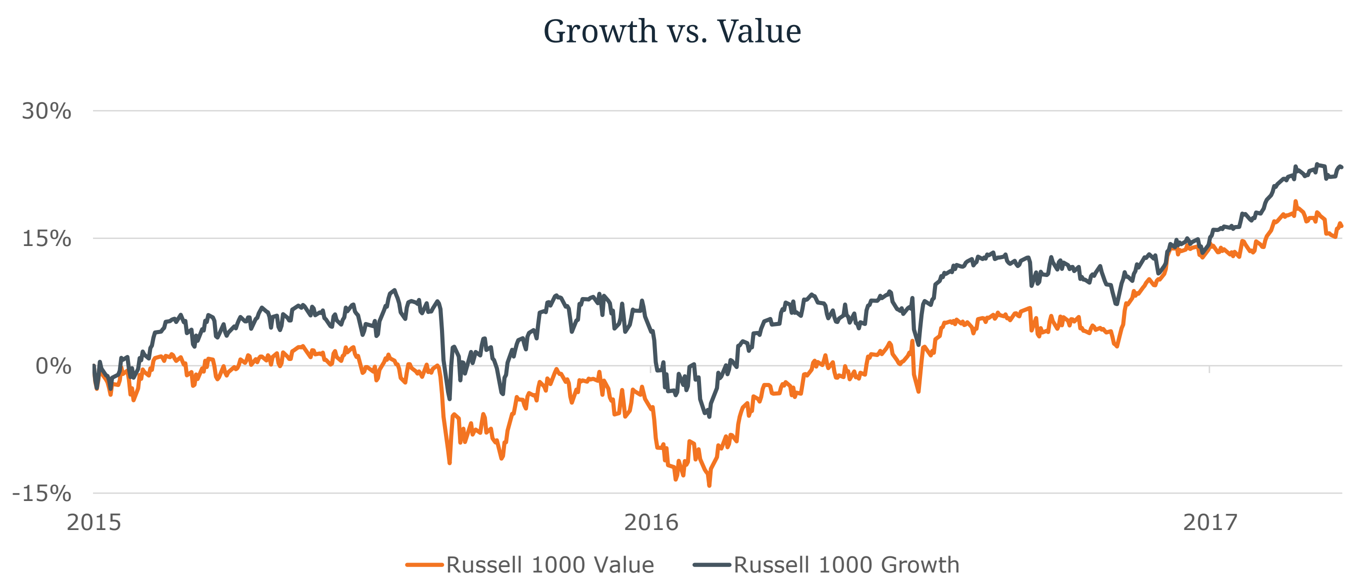
Markets continued their trajectory from late 2016 into early 2017, with most developed and emerging market equity indexes posting strong gains for the first quarter. In our year-end 2016 letter, we hypothesized that 2017 could be the first year this decade that the U.S. equity markets actually fail to outperform their international counterparts. The change in market leadership could be due to the sheer improbability of such a streak continuing indefinitely, the historic weakness in the first years of a "Presidential" investment return cycle, lower relative valuations abroad, or the discontinuation of U.S. dollar appreciation versus other currencies. So far the race is close, with the S&P 500 up 6.0% and the EAFE Index up 7.4%; substantially all of that spread caused by the dollar losing about 1.8% in the quarter. Emerging market indexes gained over 11% in the quarter. Similar to a sporting event, a small lead after the first quarter probably does not signify a clear trend. Annualizing first quarter gains (i.e., 25-30% for Developed Countries, and something in the high 40% range for Emerging Markets) also seems rather unsustainable.

The year 2016 marked the first year since the Global Financial Crisis (GFC) of 2008-09 when value investing decisively beat growth investing as a category, with value-style returns exceeding growth style returns by roughly 10 percentage points in most capitalization categories last year. While already ahead prior to the November 2016 U.S. elections, value stock categories such as financials, industrials, and transports leapt even further ahead late in the year, tantalized by the prospect of Reagan-esque deficit spending (raising real interest rates), lower corporate taxes, a lower regulatory burden, and other pro-business growth initiatives launched by an all-Republican government in Washington. The surge in value stocks faltered in the first quarter, with growth stocks reasserting themselves globally. The overall train of thought in the balance of this letter is to better understand why.



Source: Bloomberg

After value drew even with growth over the 2015-16 time period, growth stocks have re-established a large lead in terms of total return.

Value Flip

Stocks are forward discounting mechanisms, and their price movements attempt to discount what investors think about the future, whether it's realistic or not. In some cases (and we suspect late 2016 was one of them), they can get ahead of themselves. Value sectors rallied post-election in response to many of the above-referenced potential catalysts, notwithstanding whether most of the Republican agenda would actually be legislated, or watered down, or lead to a variety of unintended consequences. Many of the structural problems that have underpinned a far slower trend rate of economic growth in the developed world (low population growth, digital disruption, and increasingly automated production just to name a few) are not exactly going away. Internally, Cambiar has handicapped the magnitude of the Trump/Republican legislative agenda as being about ~40% achievable in its various parts. In other words, if the U.S. corporate tax rate of 35% is ideally desired to decline to 15%, perhaps 27% is the more realistic number. Similarly handicapping other agenda items leads to an outlook of modest increases in the supply of bonds and real interest rates, as well as an uptick in deficit spending.

Value stock indices are heavily populated by financial companies, which tend to be very sensitive to interest rate trends. Unsurprisingly, financials, bond yields, and value stocks as a category leapt forward in sync following U.S. elections, and subsequently lagged in relative performance terms when the upward momentum in bond yields topped out in early January, perhaps reassessing how much real change can be wrought.

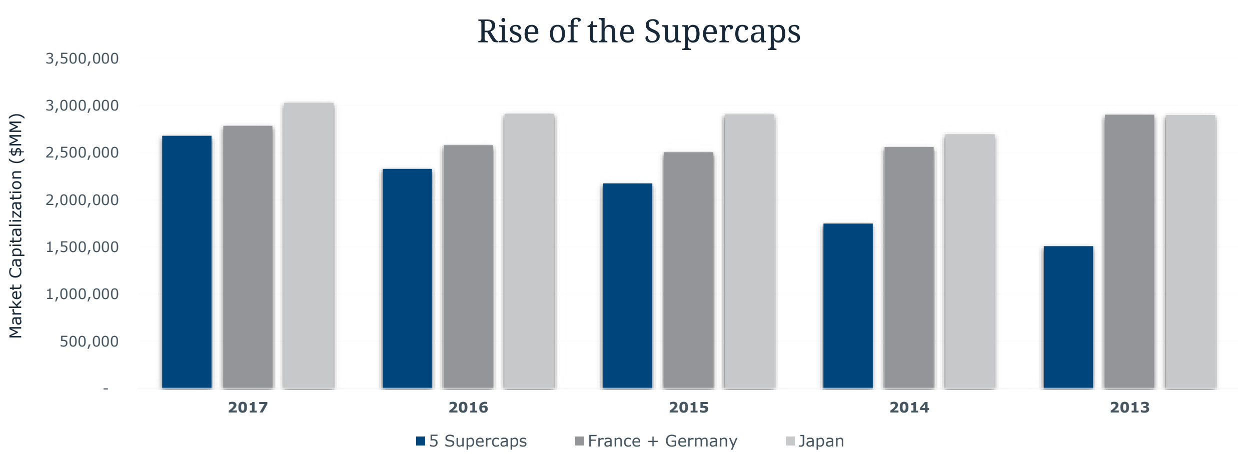
Whether or not value stocks truly "over-performed" in late 2016 or just needed to consolidate gains remains to be seen, but the change in market conditions in the first quarter suggests at least one of these narratives is true. Right around the Trump inauguration in January, market conditions flipped, and big cap growth stocks (which had lagged in late 2016) went on a tear while value names did little. The flip back from value to growth was most pronounced in small caps (growth benchmarks up over 5%, value indices down fractionally); that said, growth issues outpaced their value counterparts by a factor of 1.5x to 2.0x in most broader indexes.

Looking beyond the rate-trades and the correlation of value sectors to a (plausible or implausible) acceleration in nominal GDP growth, there is a larger question raised by both the revivalist spirit in recent populist politics and the brief revival of value stocks in general. Are either really achievable or just wistful thinking? Or is there an alternative narrative that is independent of the whole interest rate discussion: gigantic technology-led monopolies drawing profits from adjacent spaces into their own, gradually blotting out normal business coping mechanisms. In their respective wakes, value investment strategies have dithered unproductively.

Growth or Natural Monopolies?

In the classic board game *Monopoly*, players must get very lucky or outwit unsuspecting opponents into bad trades to piece together enough real estate to form a monopoly. Upon reaching one, there are still a lot of outsized investments to be made in "improvements" before you can begin to extract outsized rents. But once a player finally monopolizes a corner of the board and builds it up, it's mostly a downhill run from there – how fast will the player with the best positioned monopolies crush everyone else? Late in the game, there may be a flurry of implausible deal-making to create some form of competitive counterbalance, but it usually happens too late, barring some very peculiar dice rolls.

This kind of analogy seems more appropriate when applied to the realm of the largest global tech stocks than a conventional growth stock analysis. The 5 largest technology companies in the U.S. (Apple, Alphabet [aka Google], Amazon, Facebook, and Microsoft) collectively added more than $400 billion in market value in the first quarter of 2017, or about equal to the value of the entire U.S. transportation sector (that had performed so well in 2016). The appreciation in these five companies represents the preponderance of the gain in the U.S. stock market so far this year. At the end of 2016, the big five tech stocks constituted 5 of the top 10 stocks by global capitalization; now they constitute the top 5 – period. At just under $3 trillion in market capitalization between these 5 stocks, they are roughly equal to the entire value of the French (CAC 40) and German (DAX) stock market indices combined, and are within 10% of the value of the entire Japanese Nikkei Index. Normally, statements comparing companies to sizable countries are made in a tone of incredulousness. That is not the intent here. This scale of commercial success necessitates monopolizing large end markets and running the competition off the board. It's just surprising how underwhelming the competitive responses have been so far.



Source: Bloomberg. Market caps converted into USD. Japan (Nikkei 225 Index), France (CAC 40 Index), and Germany (DAX Index).

Traditional value investing as a discipline embeds some degree of mean reversion as a key intellectual principle. Underperforming business assets can outperform in the future due to cyclical factors and business management coping skills, leading to outsized gains in their stocks as investors reappraise their improvements. Alternatively, high-priced stocks that belong to rapidly growing businesses tend to be brought down a peg by their own success, or just slow rapidly as unique business conditions abate. Put differently, value investors will often fade meteoric business success in their long-term financial models, as gigantic unbridled success historically proves unsustainable and vulnerable to smaller, more nimble/entrepreneurial competitors. In contrast, growth styles of investing tend to discount the fade effect until and unless it becomes abundantly clear, and similarly distrust the capacity of struggling businesses to improve their fortunes. A more nuanced approach to value does not look at every winner as an eventual loser or the opposite, but does assume that size and scale and sheer numbers eventually lead to clear limitations on the continued compounding of the very biggest businesses. Eventually they slow down, or cannot continuously innovate with the same degree of success.

Given that framework, how would one explain the continued galloping success of the five "supercap" technology giants mentioned above? Take your pick: which of these is fading at the moment? All have enjoyed staggering commercial success in their relatively shorter business histories. It begs a separate form of questioning from a traditional or even not so traditional value framework. The big 5 tech businesses bear monopolistic market shares and positions as businesses that are not easily replicated or displaced from their respective strongholds.

With supercap technology stocks dominating the stock market in 2017, the question worth asking is who or what can stop these guys? And how? It has happened before. At their respective peaks in a distant past, Eastman Kodak, Xerox, and IBM were thought to be similarly unassailable in their product categories (film, photocopiers, and mainframe computers, respectively). It's not that anyone ever came along and made distinctly better film or mainframes, but the use case for their technology declined and the companies became much less relevant. At varying points in the less distant past, Apple was nearly vanquished by Microsoft-powered PCs only to reinvent whole new categories that it now dominates. Microsoft later faced questions of long-term relevance owing to its dependence on a traditional software model geared to desktop PCs, but its remaining server and office product suite have potentially broader audiences in a cloud-based model of computing. Even more recently, supercap technology businesses of the early 2000s such as Intel and Cisco have shown limited capacities to grow outside their monopolistic positions in microprocessors and routers this decade. This has led to low-ish valuations that embed a "fade" of their dominance as end market demands move away from their core strengths.

Hence it is not inconceivable that today's technology giants could face alternative forms of competition, or encounter a core market structure shift that they are not able to cope with very well. But for the time being, such prospects seem difficult to identify. With internet-based ecosystems leaping to the fore, companies that control the on-ramps to the internet (Apple devices, Google search & related devices), integrated online ecosystems (Facebook, Microsoft Office), and the ultimate ecommerce superstore (Amazon) have become the most valuable companies in the global stock market.

From the value lens, one hopes to prosper from the normalization game. That would be sensible in a more traditional industrial/competitive landscape. Does the following statement hold water? As __________ (name your preferred technology super cap stock) pushes deeper into ___________ marketplace, the entrenched competition __________ will adjust their resources and products and preserve much of their profitability, and potentially grow as their rate of innovation is forcibly upgraded.

So as Amazon pushes deeper into selling sporting goods and apparel on line, what should (what remains of) the traditional sporting goods companies do exactly? Invent their own lines of basketballs and football pads? It seems fairly unrealistic. Do traditional media giants have a sensible competitive response to search and social media? Search is one of the best and most insidiously monopolistic businesses around: people are going to use the internet, they are going to search for stuff, and if they are searching for stuff, they are likely looking for things to transact on. Searching = intent to transact. Consequently, search engines such as Google can serve up ads to the people searching through their engine at very little cost per user, and monetize the results. From an advertiser's perspective, online search is also better: you only pay for eyeballs that see your search results or click through to your website or who ultimately transact, and you can quickly learn a lot about what kind of people are interested in your products versus more inaccurate guesses. This approach is vastly more efficient than blanket ads on TV, where advertisers hope to hit their target customers and demographics on the right shows. It is very difficult to identify comprehensive possible competitive responses by traditional advertising-based media. Perhaps over time, the manner in which people search for things will change; for example, a lot of search activity in Asia is initiated from social chatting applications, rather than a browser. But the basic challenge of advertising to interested eyeballs seems effectively cornered by internet producers. There may be a relatively better opportunity for competition to Apple's devices and Microsoft's office suite, as both product sets appear to be increasingly difficult to innovate upon decisively. As of yet, the competitive threats remains thin. In a sign of a generation gap, the merits of posting my daily whereabouts and photos on Facebook continue to elude me. That said, it is a very good universal log-in tool, and clearly learns your preferences (and social circle's preferences), leading to ever-more intelligent and insidious ads directed at billions of eyeballs. At some point, it is not challenging to imagine payment and other financial activities emanating from smart mobile device-controlled platforms and social ecosystems, though so far traditional financial businesses have co-opted these mobile device ecosystems effectively.

What are the investment implications of all this? There may be no more sensible investment conclusion to arrive at than to acknowledge that these technology giants occupy natural and unregulated monopolies of a vast scale that show few visible cracks, and their scale leads to competitive strengths that "fade upwards" rather than downwards in terms of duration and return potential. A lot of this scale is expressed in national GDP-sized valuations assigned to these companies. To be clear, there remain many companies whose future earnings trajectories have not yet been materially impacted by what is taking place in tech land and within supercaps specifically; examples include Energy, Financials, and Industrials. Increased selectivity is needed within technology and adjacent industries such as retail, consumer products, and media. The potential for value traps in these industries are much higher, as many business models are likely to be pressured by the continued proliferation of the aforementioned supercap tech franchises. Amazon is the clearest example of disruption in this regard; the company's growth at the expense of earnings has wreaked havoc to the traditional physical retail store model. In some regard, reaching a clear and convincing counter argument to the these modern day monopolies appears much like the end game of a decisive Monopoly match – a winning strategy highly reliant on wishful thinking within the boundaries of a board game.

Thank you for your continued confidence in Cambiar Investors.

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