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Investment View

10 Rules of Thumb for a Volatile Market

Over the past 18 months, investors have witnessed a significant "repricing" of risk in specific areas of the market such as high yield bonds, Energy and Materials stocks, and Small Caps. Until recently, however, broad-based measures (such as the S&P 500, the Dow Jones Industrial Average, and equity volatility indicators) had registered little more than modest fluctuations. With major indexes having now posted notable declines to start the year, this is no longer the case. And while measures of volatility have yet to climb to alarming levels, we have seen the CBOE S&P 500 Volatility Index (VIX) climb off of the historically low levels seen for most of the economic and equity market expansion over the past six years.

Given the current uncertainty in the global economy, questions about the path of corporate earnings, and increasing signs of stress in the debt markets, we thought it appropriate to frame the current market environment before outlining 10 suggestions for negotiating periods of increased volatility. As bottom-up stockpickers, we have found them to be of critical importance when attempting to successfully invest through a cycle. And we have seen countless instances—a few firsthand—of what can happen when one or more of these characteristics are missing from the investment framework.

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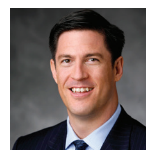

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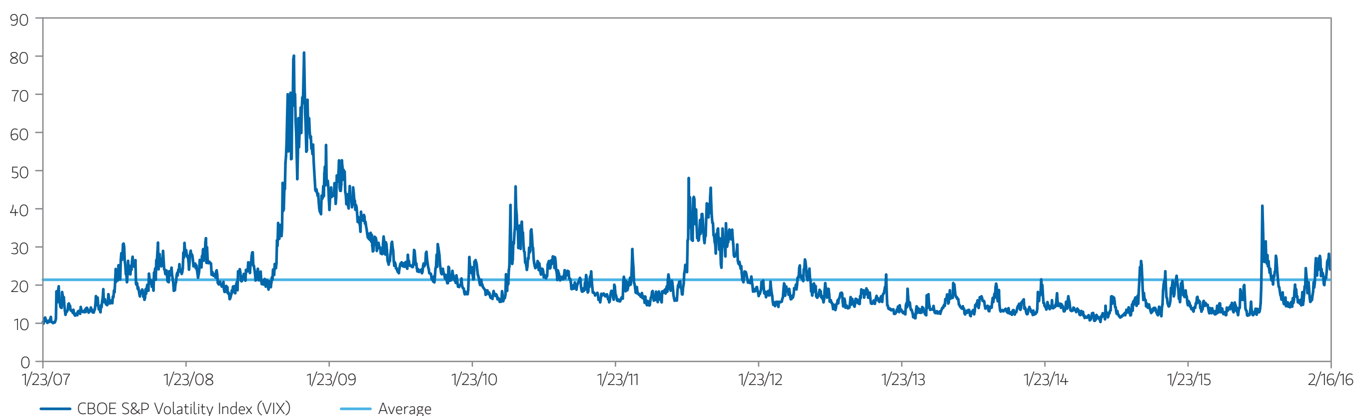
Display 1: **CBOE S&P 500 Volatility Index (VIX) Performance**



Source: Bloomberg.

This index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

Putting the recent volatility in context

Historically, equity markets have experienced meaningful pullbacks (7%-18%) with surprising regularity, as we witnessed in every year of the recovery except 2013. These are painful but by no means unprecedented parts of any market upcycle. Our work suggests that these become something more sinister when accompanied by recessionary conditions; they are what tend to end bull markets, in our view. As of February 16, 2016, the Russell 3000 is down 13% from its June 2015 high. More worryingly, though, the average stock in the index is down nearly 35% from its 52-week high, implying a fairly severe bear market for the average stock. This is what has made the pullback feel much worse than the indices would have us believe. As a result, the recent market action has led to more questions about where we are in the economic cycle (despite notable strength in employment and consumption). Our base case has been predicated upon a "lower for longer" mentality for economic growth, given the friction that deleveraging has placed on growth.

While no economic or market cycle mimics another exactly, there are typically a number of important preconditions needed to see the end of an expansion or a bull market. Currently, we see only a few warning signs out of more than a dozen reasonably reliable indicators. In our view, the top causes for concern include high yield bond spreads (~800 bps up from the low of ~330 in mid-2014), M&A volumes (at historic highs), and net debt to EBITDA at corporations (while not outright worrisome, they do show the impact of a full cycle of very attractive borrowing costs). Other factors that look more comforting include valuations, sentiment (investor and analysts), EPS growth (globally and in the U.S.), employment trends, capex growth (not at all frothy), and the yield curve.

Potential Positives

- Corporate earnings, ex-Energy, remain solid
- Corporations have taken structural costs out of the system, and many have an action plan in place to deal with a slowdown
- Employment is improving
- Central bankers remain ready to "do whatever it takes" to ensure growth[1]
- Flows away from cash and bonds continue to be a potential source of marginal demand for equities
- Economic data in the U.S. remain a relative bright spot when looked at from a global perspective
- Credit conditions remain quite conducive for growth, though concerns in the Energy sector have rippled through other areas of the high yield market
- Valuations remain reasonable
- Lower energy prices may help boost consumer discretionary spending in the U.S.

Potential Negatives

- Earnings growth has stagnated, with "beats" not driven by sales growth
- Margins have little room to expand, and recent wage inflation may begin to act as a headwind
- High yield bond spreads have expanded to worrisome levels
- The move toward a "normalization" of monetary policy has begun

[1] Jeff Black and Jana Randow, "Draghi Says ECB Will Do What's Needed to Preserve Euro: Economy," http://www.bloomberg.com.

- Economic growth globally remains sluggish despite unprecedented stimulus
- European recovery remains fragile
- Emerging market growth is slowing
- China's economy has endured numerous growing pains in recent years, and rising debt levels could limit a policy response to further growth
- Plenty of geopolitical issues
- Developed markets' fiscal deficits restrict flexibility and may reduce growth
- Approximately 30% of employment gains made since 2008 have come from "Energy" states[2]

Opportunities Exist

Our base case continues to argue for a slow grind higher for corporate earnings and the broader economy. We believe it continues to be prudent to stick with companies that possess strong financial flexibility, those that can take market share from peers and can opportunistically flex their muscle with pricing, and companies that are critical to their customers. In addition to these structural winners, we continue to look for "self-help" stories. In sum, we do not believe that the current expansion is over, though at this point in the cycle we as investors remain extremely focused on factors that could tilt our generally constructive base case towards something more threatening.

10 Rules of Thumb For a Volatile Market

Focus on Organic Growth Opportunities

With economists calling for below-trend GDP growth (trend considered to be approximately 3% real growth) over the next year, we believe investors will place a premium on companies possessing the ability to increase their sales and earnings at rates in excess of the broader market through organic (non-acquisitive) growth. Companies in the early stage of a new product cycle or brand line extensions of popular products often offer superior opportunities for organic growth and economic resilience, in our opinion. In a suboptimal growth environment, we also recommend looking for companies that have the ability to capture an increasing share of their end markets.

Identify Long-Term Growth Trends

Shifting demographic patterns or new legislation can often lead to critical behavioral changes that influence the products and services consumers and corporations purchase. Often, these trends are less affected by economic conditions because of necessity. In many cases, companies enjoying either critical mass or "first mover" status reap the benefits of these changes and develop strong customer loyalty, which, in turn, can lead to strong recurring revenues.

Focus on Companies That Make Other Companies More Productive

With productivity gains and resulting cost savings becoming more difficult to achieve given the age of the current expansion and macroeconomic headwinds, we believe that companies will focus on those products and services offering a "value proposition" or enhanced return on investment (ROI). We have seen examples of this in a host of different areas, ranging from companies that utilize software to help streamline their customers' operations to those new media companies that can help advertisers allocate spending more efficiently.

Maintain an Emphasis on Companies Possessing Financial Flexibility

During periods of heightened uncertainty, access to additional capital might become more difficult to obtain and viewed as a sign of weakness by the investment community. We believe companies that possess the financial strength to fund internal or external growth opportunities through strong and rising free cash flow (and low debt service costs) tend to exhibit lower volatility and more stable returns over time. Metrics that take on added importance in the late stages of a credit cycle include: interest coverage, working capital efficiency and sustainable free cash flow. We believe companies that possess low debt levels as a percentage of total capital will be rewarded by investors, particularly when access to financing is perceived to be limited.

Make Sure "Perception" Can't Become Reality – Avoid Companies That Need to Roll Debt or Access the Capital Markets During Adverse Conditions

Recent market events show that companies with high leverage and/or operating in beleaguered industries needing to raise capital or roll maturing debt can suffer severe consequences in the current environment. What would normally be a regular occurrence can quickly become a source of worry, given the heightened risk aversion in certain segments of the market. Furthermore, share price weakness can raise questions about the perceived (or real) ability for a company to raise capital for growth plans and put a company into financial distress, provided they don't have the ability to shift to internal funding.

Pay Attention to the Quality of Earnings

Over time, we believe the market's performance has generally been driven by the path of corporate earnings, so having conviction in the quality of a company's earnings is critical. As market cycles progress, we have found that corporate earnings tend to settle into a pattern of modest earnings "beats." At the

[2] Source: Bureau of Labor Statistics and Fundamental Equity Advisors.

end of a cycle, however, we have found that investors tend to get complacent. Underlying earnings quality begins to deteriorate, as corporations stretch to meet earnings expectations. For a time, a corporation may be able to mask an underlying deterioration in fundamentals through financial engineering and by pointing investors toward "Adjusted Earnings" and away from GAAP earnings. The use of Adjusted Earnings has increased considerably in recent years; in its purest form, this non-GAAP measure is designed to provide clarity to investors, removing one-time items, non-cash items, and other non-core distortions. However, the definition of "Adjusted Earnings" is quite malleable and at the discretion of management; this allows the potential for exploitation, in our view. To us, a good measure of a corporation's quality of earnings is how closely its free cash flow (net income + depreciation & amortization +/- changes in working capital – capital expenditures) matches its net income.

Focus on/Scrutinize Free Cash Flow

We believe free cash flow is the clearest measure of a company's financial flexibility. Companies generating excess free cash flow may choose to reward shareholders through the payment of a dividend or a share repurchase program. Other corporations may choose to direct cash flow toward strategic acquisitions or internal growth opportunities. Investors should closely monitor corporations where significant changes in depreciation schedules can have a meaningful impact on near-term earnings. Additionally, a large increase in receivables or inventories can be an indication of potential trouble ahead.

Avoid Value Traps

In our view, investors should focus on forward earnings projections because many economically sensitive companies, particularly at or near cyclical peaks, tend to appear attractively valued based on trailing earnings. Beyond the normal economic cycle, we have seen numerous instances where a particular industry has undergone significant but often temporary changes that can have a meaningful impact on profitability (both negative and positive). These changes often prove transitory and can have a meaningful impact on what earnings multiple an investor is willing to ascribe to that company or industry. More myopically, a focus on consensus earnings estimate revisions can provide investors with some insight into near-term operating momentum. Often, particularly during a period of slowing economic growth, the first earnings shortfall may act as a harbinger of future earnings disappointments.

Merger & Acquisition (M&A) Selection Criteria Shouldn't Be Dismissed

Over shorter periods, the share price of a company can be driven by a host of nonfundamental factors, such as sentiment, technical factors, fund flows, and nonrecurring fundamental factors. Over the longer term, however, we believe there are several durable drivers of value for a company, many of which are sought out by financial and strategic buyers (leveraged buyouts and M&A). These include strong free cash flow, low leverage and ample opportunity for margin expansion. Screening for companies that have minimal leverage and free cash flow yields well in excess of prevailing borrowing costs can be a good starting place for evaluating potential investment ideas.

Focus on the Long Term and Keep Emotions in Check

Successfully negotiating difficult market environments requires a willingness to act quickly on investor misperceptions that frequently occur due to "panic selling" or "group-think." Emotionally charged markets are often driven by fear rather than the careful analysis of fundamentals. In our view, a disciplined investment process, emphasizing strong or rising free cash flow, profit margin expansion, attractive valuation, positive changing internal dynamics, incremental market share opportunities, and strong management teams, can help maintain clarity in volatile markets.

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