KARMIN CAPITAL

Bullish Backdrop into 2020

At the depths of the December 2018 stock market sell-off, many investors were understandably concerned that the bull market and economic expansion that began in 2009 were coming to an end. Going into 2019, five major risks occupied investors' minds (highlighted below). Each has seen a positive resolution, or the worst fear was not realized. Consequently, we are not surprised that U.S. and global markets have performed strongly this year after a difficult 2018. Given that market risks have materially declined, we remain optimistic about owning stocks and think that future gains are still likely to follow the trajectory of earnings growth.

RISKS TO START 2019	OUTCOMES
1. U.S.-China Trade War	1. Countries Reached Phase 1 Agreement
2. Central Banks Tightening	2. Central Banks Now Easing
3. Weak Economic Growth	3. U.S./Global Growth Held Steady
4. Poor Company Earnings	4. Earnings Surprised to Upside
5. Political/Policy Uncertainty	5. Brexit Nearing Resolution; Moderate Democrats Rising in 2020 Primary Polls

Notwithstanding the improved market backdrop, we still firmly believe that valuations matter. As we invest over the coming year, we are generally biased toward companies with reasonable valuations and robust cash flow generation as opposed to expensive firms whose valuations are predicated on extrapolating high sales, profitability and/or cash flow growth rates many years into the future. While technology firms have performed extraordinarily well over the last decade and remain core, long-term portfolio holdings for us, we think it is likely that other sectors will lead the market higher in coming years. As the growth outlook has improved in both the U.S. and abroad, companies that are more sensitive to a pick-up in economic activity are likely to outperform. Industries exposed to higher economic growth rates include banks, industrials, transports, materials, semiconductors, consumer discretionary companies and energy firms.

These are the types of industries typically associated with value investing, which has significantly underperformed growth investing over the last 10 years. In fact, since 2009, the Russell 1000 Value Index (which tracks large and mid-cap value stocks) has underperformed the Russell 1000 Growth Index by nearly 60%.[1] We doubt such underperformance repeats over the next decade, as valuations of the two indices have widely diverged. The Growth Index trades at 25x expected component earnings for next year vs. the Value Index trading at 16.3x expected earnings.[2] In addition to benefitting from rising earnings tied to an improving economy, we think value firms may also benefit from rising multiples that investors are willing to pay for those earnings. If earnings grow 5% but investors are willing to pay closer to an 18x multiple to own value firms (roughly 10% higher than the today's 16.3x multiple), then the total return over a year could approach 15%. It is hard to imagine investors paying

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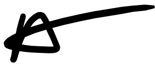
substantially higher earnings multiples for growth firms given that valuations are now the highest outside the 1999/2000 tech bubble peak (during which time investors paid upwards of 45x multiples for future earnings).[3]

The other commonality amongst the type of industries we listed above is that their businesses are primarily reliant on tangible assets (meaning actual physical goods). Over the last decade, incredible value accrued to the owners of intangible assets (like intellectual property or data). We think there is tremendous value in these intangible assets – after all the economy increasingly runs on data – but valuations currently reflect much of this. The ownership, production and/or operation of physical assets still matters. For instance, none of the data that the economy runs on could exist without telecom and fiberoptic lines, energy/electricity, semiconductor chips, data storage centers, etc. Real assets have literally and figuratively powered the growth in intangible assets, and we think this is a fact that many investors have lost sight of. As we noted in our last communication: take away your iPhone and modern life becomes more difficult; take away energy firms and modern life ceases to exist.

While predicting future returns for any asset class is usually a futile exercise, we nevertheless think that businesses operating in the tangible realm – that are typically associated with value investing – have a much lower bar for achieving meaningful future returns than many growth businesses whose assets are intangible and whose valuations are currently elevated.

2019 has been a great year for returns across all asset classes. While we doubt investable assets rise as much next year, diminished market risks, a persistent low interest rate environment and improving economic growth expectations set up a favorable investment backdrop for 2020. As always, please let us know if you would like to discuss your portfolio, the markets and/or any investment opportunities. Happy holidays!

Sincerely,



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Citations and Disclosures

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[1] Bloomberg (as of Dec. 17, 2019).
[2] Bloomberg (as of Dec. 17, 2019).
[3] Bloomberg.

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