Value Stocks Are Trading At A Record Discount To The Market: Rare Opportunities Are Available In Small Caps, Energy and Materials Stocks

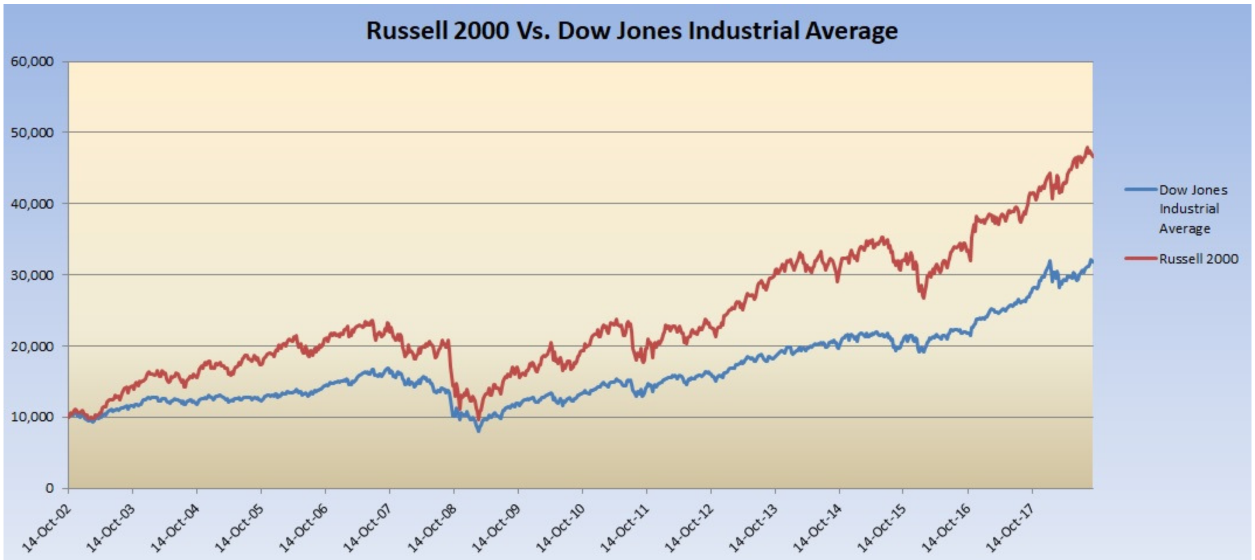
As we discussed in our May 23rd article, the global economy and certain stock market sectors have been hit hard by President Trump's trade war. At this moment, small cap U.S. stocks are in a bear market for the second time since last Fall, when every major U.S. stock market index fell into a bear market. This is also the third market "correction" since early 2018. During the 4th quarter 2018 panic it was the trade war and the government shutdown that led to selling. Nearly 9 months after that bear market started, although Large Cap U.S. stocks have held up fairly well, Small Cap stocks trade at an enormous discount to their Large Cap peers. This is a big concern to those invested in Small Cap U.S. stocks, but smaller company stocks have underperformed so much that they actually now represent a historic investment opportunity. Small Cap stocks over the long-term outperform Large Cap stocks, but the investing public currently has a perception that smaller companies will be less able to withstand the Trump administration's tariffs on U.S. companies importing products and materials from abroad.

Here is a sampling of how various Small Cap sectors have fared since just before the bear market started last year through May 31st this year:

Since 8/31/18	Russell 2000 Small Cap Index	down 15.67% (down 27.25% at the 12/24/18 low)
Since 7/10/18	Small Cap Energy Index	down 54.70%
Since 9/20/18	Small Cap Materials Index	down 28.6%
Since 8/31/18	Small Cap Healthcare Index	down 25.77%
Since 8/23/18	Small Cap Consumer Discretionary Index	down 22.36%
Since 8/21/18	Small Cap Industrials Index	down 19.00%
Since 8/31/18	Small Cap Consumer Staples Index	down 16.80%
Since 8/31/18	Small Cap Technology Index	down 15.05%
Since 10/3/18	Dow Jones Industrial Average	down 7.35%

As the table above shows, Small Cap stocks have significantly underperformed Large Cap stocks as the trade war has worsened. However, as the graph below shows, during the 17 year period beginning in October 2002 and ending September 24, 2018, Small Cap stocks significantly outperformed. The Russell 2000 Small Cap stock index averaged returns of 10.53% per year during this period versus an annualized return of 7.95% per year for the Dow Jones Industrial Average, which is made up exclusively of Large Cap stocks. To illustrate just now significant the additional 2.58% annual return is, the growth of a $10,000 investment in Small Cap stocks would have grown to $46,690, while a $10,000 investment in the Dow Jones would have grown to just $31,792. (Yahoo Finance, 2019)

All this data simply points to a basic fact – Small Caps historically outperforms Large Caps, but the recent significant underperformance points to some fantastic opportunities in Small Cap value stocks.



The 4th quarter bear market started as President Trump began ramping up tariffs against imports from China and other trading partners, but markets began to recover in January as confidence grew that the President might make a trade deal with China. However market turmoil returned in April when the President announced that not only were deal negotiations with China called off, but the President was raising tariffs on Chinese imports from 10% to 25%. Since that time Large Cap stocks have clearly outperformed Small Caps. Although certain industries are affected unevenly – take the 50% plus drop in Small Cap Energy stock prices for example – it looks like investors have clearly overreacted to the negative with Small Caps. The best guess for why investors have sold off Small Cap stocks in such extremes is the assumption that smaller companies will have a tougher time dealing with tariffs costs. Smaller companies may find mitigating measures such as layoffs, price increases to consumers or changing their supply chains to avoid tariff countries - but the Small Cap selloff looks very overdone.

Virtually any company with exposure to the import/export market is facing higher costs due to the tariffs and as a result, nearly the entire U.S. stock market is seeing reduced corporate profits. Although smaller companies may find tariff workarounds more difficult than large cap peer the divergence between Small Cap and Large Cap stock performance since last Summer is simply historic. As a value investing firm we now find ourselves in a difficult, but opportunistic situation.

Value Stocks Selling At A Record Discount Versus The Broader Market

It's true that our value focused Small Cap strategies have significantly underperformed since last summer when the trade war ramped up. However, as prices have declined we have continued to buy undervalued stocks in solid businesses and we now see a potential runway over the next few years to significantly outperform the broader markets. According to Chris Matthews of Market Watch, "there's never been a worse time in history to be a value investor". Matthews states in his June 6th, 2019 article that value stocks are "trading at the biggest discount ever, and offers the largest premium over the last 30 years". (Marketwatch, https://www.marketwatch.com/story/value-stocks-are-trading-at-the-steepest-discount-in-history)

Value investing, the investment strategy our firm has always used, was created by Benjamin Graham in the 1930s and popularized by Warren Buffett, the third richest man in the world. Value investing is essentially investing in stocks of businesses that are undervalued – or simply, the stock is selling for much less than the business is worth. Over the long-term, value investing has proven to be the best performing investing strategy, but there's a constant debate about whether value investing is better than growth investing. Growth investing is a more popular, and recently more profitable, investing strategy where a portfolio manager invests in stocks with high growth trajectories. The strategy works if the companies selected continue to grow at high rates, but since growth investing requires paying higher prices for stocks than value investing, if a company's growth slows down, the stock prices can crash. But after nearly a decade where "market leadership" has been dominated by growth companies such as Facebook, Apple, Amazon, Netflix and Google (FAANG), value investing has underperformed the broader markets over the last few years.

We think that could change and we think our portfolios are perfectly positioned to benefit if value stocks again begin to outperform growth stocks. While it's true that President Trump and his trade policies present a giant wildcard, if the trade war does end soon the stocks that have been hit hardest will likely significantly outperform growth stocks and the overall market. According to Dubravko Lakos, head of U.S. equity strategy at J.P. Morgan, "value is now trading at about seven times discount versus the market. Last time we saw it was basically year 2000 at the peak of the TMT growth bubble". What this means in plain English is that value stocks are selling for a record low valuations versus the entire stock market. J.P. Morgan uses a number of indicators including PE ratios, price-to-sales and price-to-book ratios and others to determine that value stocks have never been cheaper. (CNBC, 6/12/19 https://www.cnbc.com/2019/06/12/value-stocks-trade-at-a-record-discount-and-could-spark-summer-rally.html

Lakos refers to the year 2000 in his article and it's important to remember that at the height of the Dot Com bubble, value investing had underperformed so much that Barron's magazine published an article in 1999 titled, "What's Wrong Warren?" - questioning whether value guru Warren Buffett had lost his "touch" (Barrons, https://www.barrons.com/articles/SB945992010127068546). However, from 2000 through 2003 when previously loved growth stocks got hammered, Buffett outperformed the S&P 500 cumulatively by over 56%. Other famed value investors had similar results like Century Management (outperformed the S&P 500 by 105.12% from '99 through '03) and Schneider Capital Management (outperformed the S&P 500 by 169.79% from '99 through '03). (gurufocus.com)

Specific Stock Buying Opportunities In Sectors Hit Hardest By Tariffs

Within the Small Cap space, as shown in the data table on page 1 of this article, certain sectors have suffered far worse than others as the trade war has gone on. One sector stands out above all the rest as far as poor recent performance is concerned – Small Cap Energy. According to S&P, the Small Cap

Energy Index as of June 13th, 2019 had dropped 52% in the previous year. In fact, the index has dropped 84.93% since hitting an all-time high on June 27, 2014. What happened after that of course was the 2014-2015 oil crash that turned out to be the worst drop ever in the price of oil. Is the sector broken? Are the energy businesses in the sector really doing so bad that an 85% drop in value over 5 years is warranted? (Seeking Alpha, June 2019) The answer to both questions is a resounding no. It's true that the record drop in oil prices caused quite a few bankruptcies in the Energy sector. But as oil has rebounded from $26 a barrel in January 2016 many energy businesses have begun to rebound - but their stock prices have not. However even offshore oil drillers are now finally seeing their profitability and revenues begin to climb again.

The Energy sector has also significantly changed since the 2014-2015 oil crash. Since that time, high cost operators and oil producers have gone out of business, leaving the energy field more populated with stronger businesses better prepared to deal with an extended oil price downturn. The production dynamics of the Energy sector have changed dramatically as well. In 2014 Saudi Arabia and Russia were the world's largest oil producers – but now that mantle goes the United States as U.S. producers continue to hit new record highs each month in oil production. This has caused a shift in oil production methods as well. Offshore oil was once king, but now the shale industry is the dominant producer, so the dynamics have shifted more to onshore production. Oil services companies, not the drillers, have adapted to these changes or they've died.

What's left after the 85% drop in oil company stock prices is an industry that has improving fundamentals led by a group of companies that has learned to adapt to the new energy environment. The market however, has completely ignored all of this recent good news and instead has sold small cap energy stocks down to their all-time lows. We now see profitable energy and oil services companies literally selling for pennies on the dollar.

In our Fundamental Value, Value Stock Score® and Global Stock Score equity strategies we found some cheap energy stocks from 2014 through early 2016. Then again during the 4th quarter of 2018, we found quite a few more as the multi-decade low stock prices left some very good businesses selling at major discounts. We found great stock picks in areas hit hardest by market sellers recently - within the S&P 500 Energy Sector subsectors such as:

- Oil & Gas Equipment Services, - 44.7% return last 12 months
- Oil & Gas Refining and Marketing, - 32.2% return last 12 months
- Oil & Gas Drilling, -22.4% return last 12 months
- Oil & Gas Exploration and Production, 18.1% return last 12 months (Marketwatch, June 12th, 2019, https://www.marketwatch.com/story/investors-patience-with-oil-services-stocks-could-be-richly-rewarded-2019-05-29/print)

It's in these "oil services" sectors that the most extreme recent stock price drops have occurred. While the S&P Large Cap Energy Index has dropped 12% overall in the last year, the Small Cap Energy Index has dropped over 50%. These huge drops deserved more inspection. We found that many oil services companies profits have suffered because as the multi-year oil price decline has continued, larger companies are cutting exploration expenses. These small cap oil services companies are the customers of those large oil drillers so when the large oil companies reduce drilling plans, it trickles (or pours) through the industry. However, now that oil prices have risen due to decreased OPEC+ production, increased demand and oil production implosions in Iran, Venezuela and other oil producing nations, oil services companies are seeing increased profits, revenue and demand. Although trade uncertainty and tariffs and retaliatory tariffs are affecting profitability in some corners, the future looks bright for this subsector. A patient investor who purchases stock in the most conservatively managed companies in this arena can likely sit on their stock purchases for several years. Charles Lemonides, CIO of ValueWorks believes offshore driller Transocean - which we also own - may see its stock price increase from 600% to 800% "two to five years down the road" (Marketwatch, https://www.marketwatch.com/story/investors-patience-with-oil-services-stocks-could-be-richly-rewarded-2019-05-29/print). Investopedia author Alan Farley says that the VanEck Vectors Oil Services ETF (OIH) testing 18 year lows, dropping 76% since it's high in 2014 (Investopedia, https://www.investopedia.com/oil-services-stocks-could-bottom-out-after-downtrend-4690189). It's in this ash pile we think we've found some diamonds to hold for the long-term.

Riding Out The Trade War With A Portfolio Of Strong Companies...Bought At Cheap Prices

Wall Street analysts, talking heads and gurus offer advice on "positioning" more often than a yoga instructor. A constant flow of advice to avoid portfolio "collapse" that is focused on short-term movements rather than long-term success floods airwaves and tv channels. Experts will say "get defensive", avoid companies with China exposure, focus on sectors that have done well lately. For the most part an approach of constantly shifting to avoid being uncomfortable for short periods will simply lead to horrible long-term performance.

News-based portfolio management doesn't work. However, buying companies with strong long-term growth potential at cheap prices will offer excellent long-term returns. If one buys companies that can withstand a constant barrage of change and can do so when the stock price is disconnected from the business' real value, that person needs to do little selling over a period of several years.

If the trade war gets worse and tariffs increase, we will likely see a long-term "market crash" and potentially a recession. Planning around or doing guesswork to avoid this is folly though, because just as likely is a scenario where the President comes to a deal, declares victory and some or all of the tariffs disappear. There is no playbook for this kind of uncertainty and in American history we've never really seen such an unpredictable actor wield so much power over the flows of the global economy.

According to JP Morgan, a full blown trade war might cost $9 per share in earnings from the S&P 500, which was estimated to earn a total of $167 a share in earnings this year (Barrons, https://www.barrons.com/articles/trade-war-stock-picks-51558136501). An earnings decline like this or worse could cause yet another bear market, but we feel our portfolio is made up of companies that are financially healthy enough to bear the brunt of an event like this. But like all bear markets, the next one will end and stocks will recover. What's worse than the relatively short-term damage to stock markets, is the real long-term damage to the U.S. and our trading partner relationships that the trade war is doing.

Even if a trade deal comes, it could be that tariffs might not totally go away overnight. We could ratchet down tariffs with China for example, but we still have tariffs against other countries on steel and other metals, with Canada, Mexico and the EU. The trading relationships with these nations has devolved under the current administration and it could take years until all tariffs are removed and we return to the free trade environment that has led to the current U.S. economic growth engine. When the first tech bubble burst in 1999 it was the old world companies that continued to carry the stock market. It was the "boring", but profitable companies that were selling for undervalued prices that outperformed while the popular tech stocks of the today crashed and the underlying businesses disappeared. This is different from that era, companies like Facebook, Amazon, Netflix and Google are dominant and profitable, but their stock prices are still amazingly inflated. We think there's a chance that value stocks could outperform over the next few years similarly to the post dot com burst period simply because those stocks are so cheap, it could take years and 3 figure gains before they're fairly valued again.