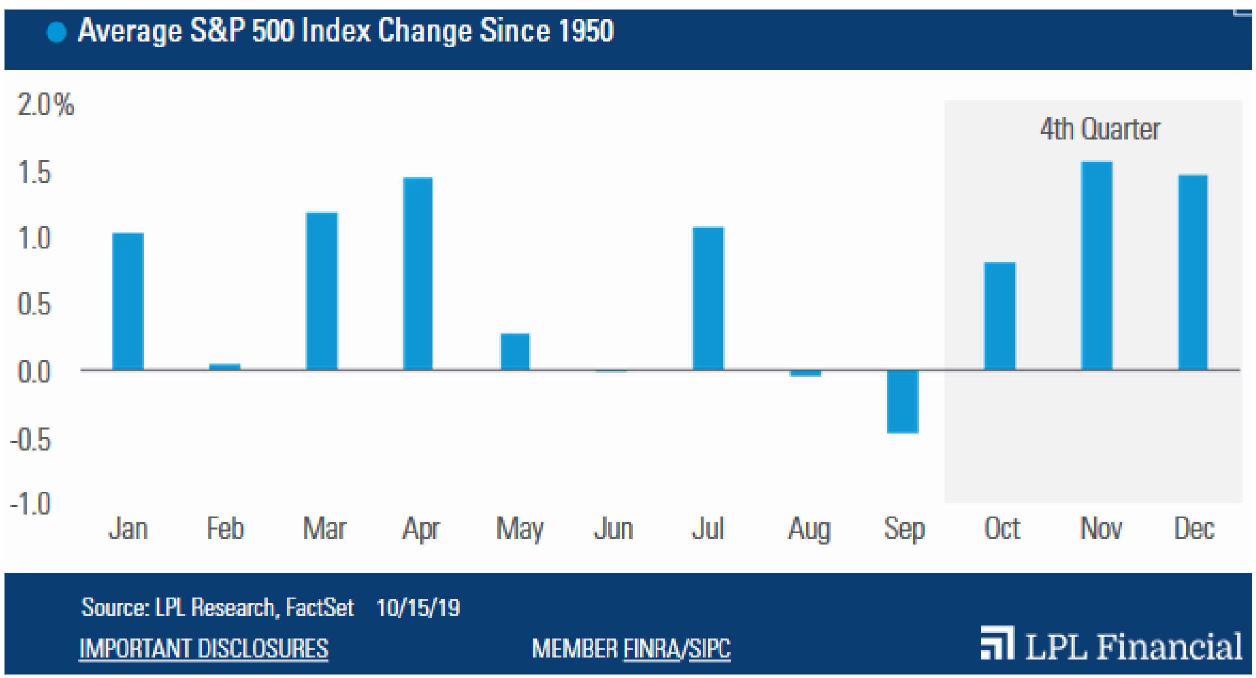
OBSERVATIONS - November 6, 2019

Financial Markets Review

It's probably a little too soon to announce that the coast is all clear, but that shouldn't stop us from celebrating the S&P 500, DJIA, NASDAQ and Russell Mid-Cap setting all-time highs this past week. Small cap stocks, as measured by the Russell 2000, remain roughly 10% below their all-time that was set back in September 2018.

For the past couple of months, we've noted how the S&P 500 has moved up and down rather dramatically but has essentially gone nowhere over the past 20 months. Now, we can finally say we've gone somewhere! The S&P 500 is now trading roughly 6% above its January 2018 high, 3% above its May 2019 high and 1% above its July 2019 high. It's not much, but it's something! If nothing else, it's always a welcome sight to see the market break out to new highs.

All these records being set come at a great time in the year. We've now entered the couple of months where seasonality trends and FOMO could take this market to another level. Last year aside, the fourth quarter tends to be the strongest quarter during a calendar year. In fact, since 1950, according to LPL Financial, two of the best months for the S&P 500 have been November and December.



Couple the seasonality trade with an equity market that has already advanced more than 20% year-to-date and the "catch-up" or FOMO trade is all this market likely needs to advance significantly higher. Ryan Detrick, with LPL Financial, recently compiled the historical statistics in the table below. If history rhymes, the S&P 500 could be in for quite the finish to an already great year.

S&P 500 Returns Final Two Months Of The Year If Up >20% At The End Of October					
Date	Price	YTD	November	December	Final Two Months
10/29/54	31.68	27.7%	8.1%	5.1%	13.6%
10/31/58	51.33	28.4%	2.2%	5.2%	7.6%
10/31/75	89.04	29.9%	2.5%	(1.2%)	1.3%
10/31/89	340.36	22.6%	1.7%	2.1%	3.8%
10/31/95	581.50	26.6%	4.1%	1.7%	5.9%
10/31/97	914.62	23.5%	4.5%	1.6%	6.1%
10/31/13	1,756.54	23.2%	2.8%	2.4%	5.2%
		Average	3.7%	2.4%	6.2%
		Median	2.8%	2.1%	5.9%
		Higher	7	6	7
		Count	7	7	7

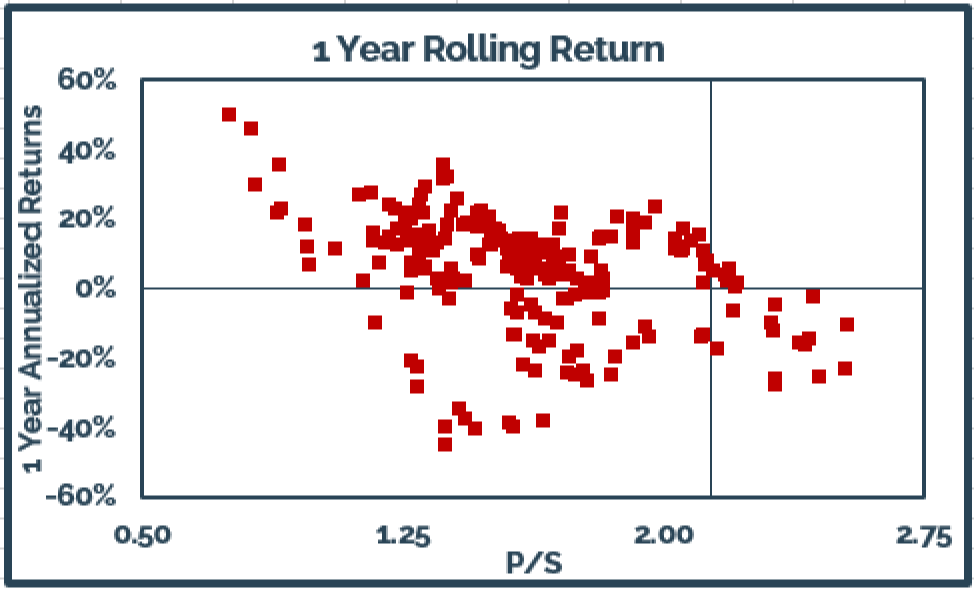
Source: Ryan Detrick, LPL Financial

Strategy and Valuations

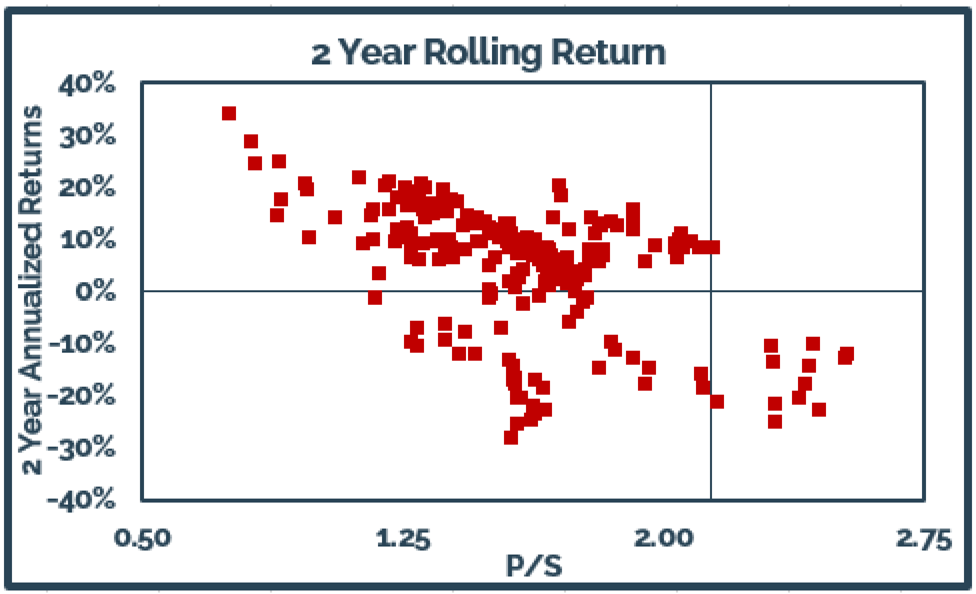
Seasonality and FOMO are often great trading opportunities. This is because fundamentals and valuations don't really matter, but rather momentum is the name of the game. It is this type of environment where active traders do very well. It is also this type of environment that can frustrate those investment managers who covet and build their investment process around the fundamentals and valuations of companies. During these times, it is imperative to stick with your investment discipline and not let the emotion of a market "getting away" change your investment strategy.

As you are aware, we are not "traders". We are an investment manager who invests in companies based on their fundamental growth and valuations. Over the past few months, we've talked a little bit about the decelerating fundamental picture, whether it be on the global and domestic macro or at the company level. What we haven't discussed a lot recently is market valuation.

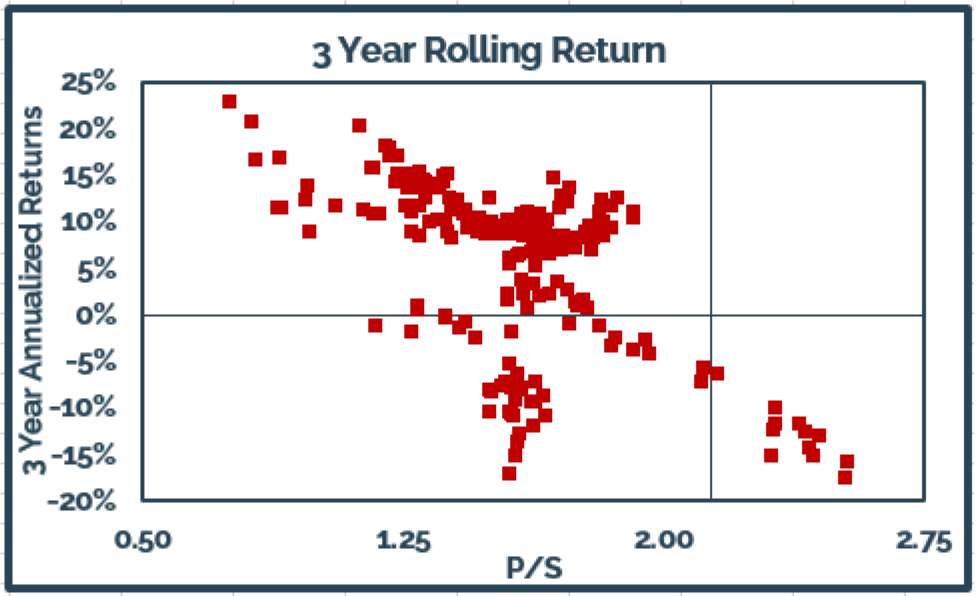
One of the valuation metrics we use in our quantitative model is price-to-sales (P/S). The last time we discussed the P/S ratio in any depth was in late-2017 and mid-2018. At that time, the S&P 500 was trading with a P/S ratio north of 2.0 for the first time since the Tech Bubble in the late 1990s and early 2000s. After doing a little research, it became apparent that there was a strong negative correlation between the P/S ratio and future returns. This shouldn't and didn't come as a shock, but rather reinforced the idea that price and valuation matter. Future returns are a function of the price you pay today. The graphs below show the annualized 1, 2 and 3-year returns for a given P/S ratio. This data was gathered using monthly data points on the S&P 500 going back for the past 20 years.



Source: Factset



Source: Factset



Source: Factset

The vertical axis is the P/S ratio today. What should stand out are the negative returns for the S&P 500 when the P/S ratio is at current levels or higher. There are a handful of positive 1-year returns, a single positive 2-year return and no positive 3-year returns. Granted, this time could be very different, but it still points to the importance of being cognizant of the price you pay for an asset.

Again, this doesn't mean the market can't move higher in the short-term. As we just mentioned, history points to a high probability of the market moving higher through year-end. In fact, the P/S ratio is at the same level today as it was when we first wrote about it exactly two years ago. From November 2017 through January 2018, the S&P 500 rose over 6%, which was a great time to be a momentum trader. However, as an investor it was a very difficult time to put money to work during those three months. But if you remained patient, you were ultimately rewarded with opportunities amidst the ensuing volatility.

Tandem Strategy Update

The biggest news to share regarding our core holdings is the liquidation of CVS Health (CVS). We've spent a good bit of time over the past couple of years writing about CVS, whether it be from a valuation, fundamental, technical point of view or to highlight the headline du jour – Amazon's disruption, death of the PBM or the Aetna acquisition. From the date of our first purchase, a little over two years ago, to today, CVS has consistently passed through our quantitative model. On a valuation level, CVS has always been ranked undervalued since it became a core holding of ours. However, CVS no longer met our fundamental criteria when the Board of Directors decided not to raise their dividend on October 3rd. The decision to keep the quarterly dividend at $0.50/share was just enough to cause the company to no longer consistently grow their dividend. Therefore, as part of our strict sell discipline, we are required to liquidate the position from our strategies regardless of the "cheap" valuation.

It pains me to say that CVS was not our finest investment. The stock is down 5% since our first purchase at the strategy level in August 2017 and underperformed the S&P 500 by 35% over that time. It's always good to review what went right, wrong and could be done better when making any investment. In the case of CVS, we learned a lot, and hopefully have implemented safeguards into our discipline that better recognize potential value traps.

-Billy Little, CFA

"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it." ~ Ralph Waldo Emerson