February 2018 E-Digest

TEALWOOD
ASSET MANAGEMENT

> *"If you can keep your head when all about you others are losing theirs…"*
>
> \- Rudyard Kipling

Q: What does a Rational Investor do when the market does something that does not make sense?
A: The thing that makes sense.

The media-fed narrative around the latest market turbulence contributes little to making sense out of this rapid, steep sell-off. That narrative has two (primary) versions: 1) the good news from Friday's employment report portends further interest rate increases and the market is discounting the impact of higher rates, and 2) short-term price corrections are a recurring phenomenon and need not be correlated to fundamental data; random valuation corrections occur with regular irregularity.

All that said, what does the market "know" now that it did not know Friday morning? From our perspective, the data and the information set have not changed meaningfully, which are:

- The economy is stable and is growing;
- Earnings are growing;
- Valuations are mostly rich, with the top quartile of price-to-earnings ratios for the S&P 500 Index being flat-out expensive.

So, if we are to do "the thing that makes sense," what is that?

1. Do not change your strategy because others are behaving tactically.
2. Pursue a data-driven, fact-based strategy. The growing economy and growing earnings are the signals countering the noise. Remain focused on the opportunity, not the turbulence.
3. Know that our security selection embeds risk management. We stay away from flat-out expensive (and therefore riskier) businesses and/or that are fundamentally underachieving. Focus on overachieving business fundamentals and fair values.
4. "Keep your head when all about you others are losing theirs."

We see most of this sell-off as being exaggerated by structural changes in the marketplace where futures trading, high frequency trading, leveraged directional ETFs and ETNs, derivatives, and index investing amplify volatility. There has been a flood of short-term tactical momentum-chasing money that has pushed many valuations ahead of what we would consider a reasonable price. Despite these extrinsic factors, we believe that concentrating on intrinsic business value wins out.

Earnings & Valuations

The consensus earnings estimate for the S&P 500 Index is now $151 for 2018. In 2017, from a valuation perspective, this Index traded in a multiple range of about 17 to 21. If the $151 in earnings were to be achieved (a probable, not certain, event), and if the S&P were to trade at 19X (reasonably probable, not certain), that would project to an Index of 2869; which, from this morning's opening quote of 2615, would represent a potential return of 10%. Keep in mind the qualifications and caveats noted in the previous sentence - we work with probabilities, not certainties.

Yesterday's sell-off hit the most expensive stocks the hardest. The 20% of the S&P that declined the most (-5.5% for the day) had an average trailing price-to-earnings ratio of 36.6. The 20% that declined the least (-1.8% for the day) were among the least expensive stocks in the Index.

Stay in the game. We do not see this moment as the inflection point at which you change your strategy. Be a Rational Investor. Focus on Quality at a Reasonable Price. Be prepared for 2018 to be a productive year for equity investors.

Data sources: Capital IQ 2/6/18