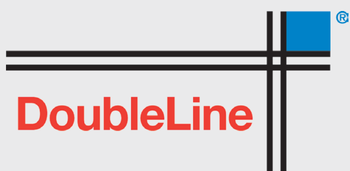
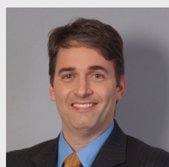


Portfolio Managers' Commentary

Emidio Checcone | **Brian Ear** | Fourth Quarter 2020



Emidio Checcone, CFA
Portfolio Manager,
Equities

Mr. Checcone joined DoubleLine in 2014. He is the Portfolio Manager of the Equity Value strategy. Prior to DoubleLine, Mr. Checcone spent six years at Huber Capital Management, where he was a Principal and Portfolio Manager. Prior to that, he worked at PRIMECAP Management Co. for six years, where he was a Principal and Financial Analyst. Mr. Checcone holds a B.A. in Social Studies from Harvard College and a J.D.-MBA from Harvard Law School and the Harvard Graduate School of Business Administration. He is a CFA charterholder.

Brian Ear, CFA
Portfolio Manager
Equities

Mr. Ear joined DoubleLine in 2016 as an Equity Analyst and is now a Portfolio Manager. Prior to DoubleLine, he spent two years at Compass North Advisors as a Consultant and six years at Palmyra Capital Advisors LLC, where he was a Principal and Portfolio Manager. Prior to that, Mr. Ear worked for five years at Hotchkis & Wiley Capital Management as an Equity Analyst. He holds a B.S. in Economics from the Wharton School of the University of Pennsylvania. Mr. Ear is a CFA charterholder and a licensed CPA (inactive).

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to heaven, we were all going direct the other way – in short, the period was so far like the present period, that some of its noisiest authorities insisted on its being received, for good or for evil, in the superlative degree of comparison only."

- Charles Dickens, "A Tale of Two Cities"

"But human experience is usually paradoxical, that means incongruous with the phrases of current talk or even current philosophy"

- George Eliot, "Daniel Deronda"

Charles Dickens began his famous novel "A Tale of Two Cities" with the ponderous yet profound first sentence encapsulating the great contradictions arising in a late-18th century Europe witnessing the death of the feudalist Ancien Régime and the emergence of the industrialist modern period. His tale of two cities references the surprising collapse of the French monarchy and resurrection of the social order in Paris in a less-repressive, more-democratic form while serving as a warning to the unconcerned denizens of London of the fragility of the status quo in light of the increasingly troubling consequences of neglecting the plight of the poor and oppressed for too long. Dickens recognized, as did George Eliot, observing in her final novel, "Daniel Deronda," less than two decades later, that we run great risk by disregarding the lessons of our lengthy human experience. This sage insight would seem equally important in our own times, particularly following a year that presented its own set of rather stark contradictions.

Indeed, 2020 was nothing if not a tale of two markets. We witnessed one of the fastest stock market collapses in the first quarter, as the S&P 500 Index and other U.S. equity indexes – seemingly tired and vulnerable after recording the longest bull run in history – dropped dramatically as the pandemic hit our shores and government officials moved to shut down much of the economy. To wit, the S&P 500 fell 34% from peak to trough. Then, we saw a startling recovery as the federal government stepped in and flooded the economy with fiscal and monetary stimulus on an unprecedented scale. In response, the S&P 500 rallied a remarkable 68% off the March trough, reaching successive new highs even as the lockdowns continued and posting a gain of 18.4% for the full year.

Value stocks again underperformed growth shares, with the Russell 1000 Value Index (RLV) lagging its growth counterpart, the Russell 1000 Growth Index (RLG), by more than 35% for the year, pushing the value-to-growth discount to a new record. Because the lockdowns prompted work-from-home contingencies for roughly half of the workforce, many technology companies saw their prospects actually improve during the pandemic, driving a remarkably fast recovery in growth stocks that started very early in the second quarter. However, value stocks did stage somewhat of a comeback in the fourth quarter on the November news that Pfizer and BioNtech, and Moderna had developed and won approval for two COVID-19 vaccines that tested close to 95% effective, lifting hopes that the economy might reopen in the middle of 2021. With improved optimism for an economic recovery, the RLV index soared 16.3% during the quarter, outpacing the RLG's return of 11.4%.

We ended 2020 with a seemingly never-greater disconnect between the financial markets and the underlying economic ones (e.g., markets for labor, consumer goods, industrial inputs, etc.), prompting famed investor and self-described market historian Jeremy Grantham to observe that the stock market's valuation lies within the top 10% of its historical range while the economy is in the bottom 10% – and perhaps bottom 1% – of its historical range. The stunning increase in wealth among the top 1%, a function of financial markets rebounding on government aid, even as food lines lengthened across the country for those whose state and federal support checks were running out, provided a sobering reminder of this disconnect. This wealth increase likely is a driving force behind the rising social unrest and still greater political polarization we are witnessing. Despite the rising hope surrounding the advent of efficacious coronavirus vaccines and the justified prospective planning for a reopening of the economy, there remain multiple reasons to be cautious about how quickly we can return to a semblance of normalcy.

And yet, it would seem that most market participants are throwing caution to the wind, if equity valuations are examined. In regard to most traditional valuation measures, the S&P 500 is trading nearly as expensively as it did during the previous all-time high during the technology bubble of the late 1990s. *(Figure 1)*

	EV/ EBITDA	P/E LTM	P/E FY1	P/E FY2	P/B	P/Sales
Current	18.0x	27.9x	27.4x	22.4x	4.1x	2.8x
Peak	18.2x	31.3x	28.4x	24.1x	5.4x	2.9x
Average	11.1x	18.7x	17.7x	15.5x	3.0x	1.7x

Figure 1
Source: FactSet Research. Valuations are from 1996 to 2020.

Because the market ascent over the past decade or longer has been predominantly led by growth stocks, the share of total market capitalization of these growth names has expanded even as the multiples for such shares have become even more elevated, pulling up the overall valuation of the broader market. At present, growth stocks trade at record valuations by many measures. On a price-to-book value basis, the top half of the S&P 500 companies trades at 12.4x, about 4.5 multiples higher than it did during the prior peak that occurred amid the technology bubble. On a price-to-earnings (trailing) basis, the top half of the S&P 500 companies trades at 44.0x, exceeding the prior peak of 40.6x also seen during that 1990s tech bubble. As we have noted previously, whereas the rise in growth stock prices relative to value shares in prior years was accompanied by relatively stronger earnings and cash flow growth prospects, the outperformance in 2020 has been driven much more by differential multiple expansion than any disparate expectations over the future performance of underlying fundamentals. We believe that the average market participant is overextrapolating the advantage growth names have enjoyed in an environment of lockdowns too far into a future in which the pandemic will be behind us. Such recency bias – a normal but irrational tendency to assign too much weight to particularly negative recent events – might explain the disconnect between the relative value of growth stocks from value shares on the one hand and the long-term fundamentals of each on the other.

As many experienced market observers have noted, there also have been growing signs of irrational behavior and excessive risk taking by market participants. In 2020, investors funded 248 special purpose acquisition companies (SPACs), which are so-called blank-check entities or shell companies into which investors commit capital ahead of yet-to-be-determined acquisitions, as opposed to traditional investment in a going concern with a history of financial performance and observable assets that can be studied and understood by equity holders. Relatedly, one should understand that by going public through a SPAC, managers circumvent the more-rigorous audit and filing requirements that are part of the traditional initial public offering process, making a SPAC generally riskier than a traditional IPO. Despite these elevated risks, investor appetite for SPACs has hit levels beyond exuberance, with the number formed in 2020 three times higher than any prior year over the last 15; the funds raised just in the last year exceeded the total of the preceding decade.

We have also witnessed other market oddities in 2020. There was the spike in Hertz* shares, driven by retail investors. And despite the salient fact that the company was in bankruptcy proceedings, the share increase was so pronounced that lawyers incredibly suggested that an equity raise could be a part of the workout plan. There was the sharp increase in Eastman Kodak* stock on the news that the company would assist in the production of COVID-19 treatments, even though management had already stated that it'd be giving away those chemicals at cost. Perhaps driven by overconfident retail investors, there were more than three times as many companies with a market cap over $250 million that tripled in value in 2020 than had been observed during any year over the previous decade. Meanwhile, Tesla* stock increased more than seven-fold during 2020, making the company more valuable

* DoubleLine Equities have not held Tesla, Kodak Eastman, or Hertz within the last year.

than the nine largest global auto manufacturers combined, even though its annual unit sales constitute only about 1% of the vehicles sold by those 10 automakers collectively. We view this disconnect between price and underlying fundamentals as a sign of a potential bubble in growth assets, so we would approach growth stocks with great caution in the present environment.

> **"While it has been the best of times for quite some time for growth investors, it has been the worst of times for what seems like forever for value investors."**

While it has been the best of times for quite some time for growth investors, it has been the worst of times for what seems like forever for value investors. The so-called value spread, which is the valuation discount of value stocks versus their growth counterparts, was already at record levels at the end of 2019. That the RLG outperformed the RLV by 35.7% in 2020 has only pushed that value spread to new extreme levels. On a price-to-book value basis, the bottom half of S&P 500 companies now trades at a 10.8 multiple point discount to the top half; this differential exceeds the historical average by more than two standard deviations and is also much greater than the 4.7 point discount experienced during the height of the tech bubble. *(Figure 2)*

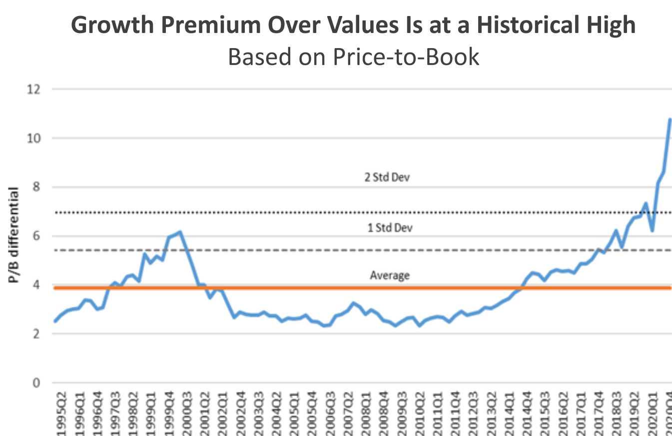


Figure 2

Source: FactSet Research as of December 31, 2020.

Note: Data represents weighted harmonic average P/B of S&P 500 constituents over time.

On a trailing price-to-earnings basis, the bottom half of the S&P 500 companies now trades at a 30.0 multiple point discount to the top half, also more than two standard deviations above the historical average and greater than the discount experienced during the height of the tech bubble. *(Figure 3)*

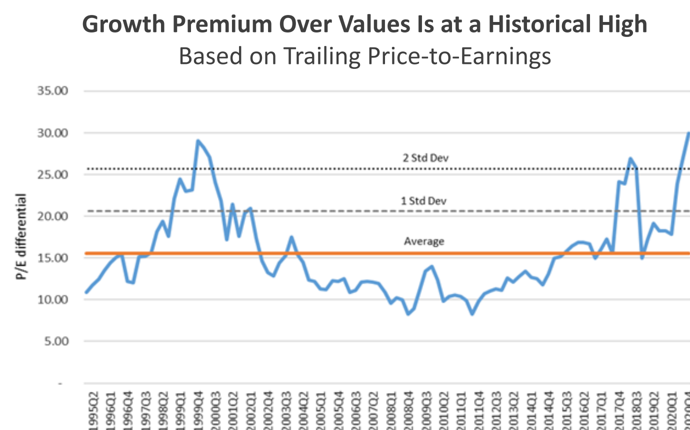


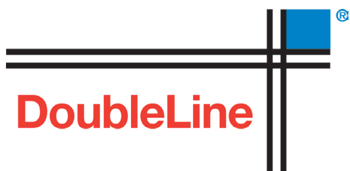
Figure 3

Source: FactSet Research as of December 31, 2020.

Note: Data represents weighted harmonic average trailing P/E (excluding unusual items) of S&P 500 constituents over time.

We have previously noted that consensus expectations for earnings growth are actually higher for value companies than for growth peers in 2021 and in 2022 (i.e., RLV component company growth of 27.5% in 2021 and 18.0% in 2022 versus RLG component company growth of 18.4% in 2021 and 14.7% in 2022). Moreover, through-the-cycle profit margins and return on assets (ROA) for value and growth companies have remained fairly stable through time (i.e., value stocks have shown a stable discount over the last half-century of 14% in terms of gross profit margin and 5% in terms of ROA versus their growth counterparts). This suggests that the vastly widened valuation discount for value stocks we observed exiting 2020 is explained less by fundamentals and more by the ongoing euphoria over growth stories.

We think the growth-to-value rotation seen in the fourth quarter could extend into 2021 and beyond for multiple reasons. First, we believe the vaccines clear a path for the economy to fully reopen, and this should disproportionately advantage value stocks. While more-favorable secular tailwinds have advantaged growth stocks over the last several years, the expected cyclical upswing this year and next fueled by the economic reopening will see higher earnings growth, as reflected in current consensus estimates,



and likely greater positive earnings surprises among value shares. Undoubtedly, restarting an economy – much less one as fragile as the current one – is not analogous to flipping on a light switch. It likely will take a while for activity to rebound fully as the task of vaccinating populations amid a current case-demic is certainly not a trivial one, and vaccinated people might still maintain some level of social distancing and/or choose to cautiously spend to rebuild savings. Also, the lockdowns undoubtedly caused a great deal of damage to the financial positions of small businesses and local governments. The sober reality is that the economy continues to be reliant on fiscal and monetary stimulus as well as other government actions such as forbearance and deferrals. Furthermore, the recovery might be rather uneven, given the potentially permanent damage done to some businesses and due to potentially lasting changes in consumer behavior wrought during the pandemic. Yet, even considering these difficulties, we would expect economic activity to improve meaningfully from the end of 2020, boosting the prospects of value companies on a relative basis versus their growth counterparts since the former were more adversely impacted during the pandemic.

Second, with the recent elections, the Democrats control the White House and both houses of Congress for the first time since 2009. In the near term, the focus will include resolving the COVID-19 crisis and supporting the fragile economy. However, the Democrats will seek to deploy much-larger amounts of stimulus toward these goals. Specifically, they seek a multitrillion-dollar fiscal stimulus, in addition to the $900 billion recently approved, and one that likely includes assistance for state and local governments, infrastructure spending, additional unemployment insurance and direct support for vaccine distribution. Such a large stimulus should provide a temporary boost to GDP, mitigating the risk of a double-dip recession, but it would also drive the budget deficit much higher, creating adverse economic consequences longer term. Moreover, the Democratic agenda includes corporate and individual tax increases, and heightened regulatory oversight, which combined could pose a headwind to corporate profitability and economic growth down the road. So far, the market has taken the changed political landscape in stride, likely under the assumption that the Democrats will have great difficulties making any sweeping policy changes with only slim control via Vice President Kamala Harris' tie-breaking vote in the U.S. Senate. As we have noted, however, the risks associated with unconstrained government spending create the potential for higher inflation and interest rates that could adversely impact a high-multiple equity market banking on low rates forever. In such an environment, lower-multiple value stocks might carry lower risks.

Third, the Federal Reserve has indicated it will be patient about withdrawing monetary accommodations as the economy strengthens, allowing inflation to rise. For the moment, monetary policy remains loose while credit, operating through a banking system more regulated since the Global Financial Crisis, remains healthy. Despite unemployment elevated by the pandemic, credit overall has deteriorated only modestly largely due to government support. The banking system continues to function properly as banks remain sufficiently capitalized and able to provide credit to healthy businesses. Meanwhile, the Fed and U.S. Treasury provided access to funding for those businesses impacted most by the pandemic, ensuring that credit continued to flow even to some of the most-vulnerable industries. As a result, the tail risks of a major collapse in the financial system were sharply reduced. Given recent commentary from its leadership, we expect the Fed to remain supportive of credit and allow these loose monetary policies to persist for a while longer even in the face of rising inflation. As such, the prospects of lower near-term rates, a steepening yield curve and higher inflation – if driven by an improving economy – would be favorable for the earnings prospects of cyclical value companies.

"We believe that aggregate U.S. equity valuations are significantly elevated even as the economy remains very weak, and such a mismatch between prices and fundamentals demands caution."

Finally, value stocks have been underowned by long-only fund managers. According to a Bank of America study of stock ownership data, growth stocks are overowned by many active managers while value stocks are widely neglected. Long-only mutual fund positioning in growth sectors is above benchmark weights (i.e., positive active weights) while positions in value sectors are below those weights (i.e., negative active weights). Continued relative outperformance by value stocks, which started episodically in the fourth quarter and continued at the start of 2021, could prompt fund managers to rebalance their portfolios by increasing their value exposures.

In summary, we believe that aggregate U.S. equity valuations are significantly elevated even as the economy remains very weak, and such a mismatch between prices and fundamentals demands caution. Yet we also recognize that the elevated (and perhaps bubbly) valuation of the broader equity market represents the best of times in growth and the worst of times in value, as seen in the epic valuation spread between growth and value shares. Given the stark valuation difference, we believe that a rotation to value stocks from growth stocks will be rewarded as the better earnings prospects and superior valuation setup for the former names become more apparent. Separately, as noted in the past, we also expect that active management will show its importance in the present investing environment as the differences in relative company positioning begin to emerge through the crisis and into the changed, post-COVID-19 world. We will continue to seek sound, long-term investment ideas and strike reasonable balances within our portfolio among those investment ideas in an attempt to offer safety in uncertain times. In addition, we will look for holdings that could represent compelling long-term value once a broader recovery is underway. Our differentiated fundamental value investment philosophy allows us to capture both of these opportunity scenarios in our ongoing effort to seek out solid relative returns

We thank you for your continued interest in DoubleLine Equity. ■

Select Definitions

Price-to-Book (P/B) Ratio – Used by companies to compare a firm's market capitalization to its book value. It's calculated by dividing the company's stock price per share by its book value per share (BVPS). An asset's book value is equal to its carrying value on the balance sheet, and companies calculate it netting the asset against its accumulated depreciation.

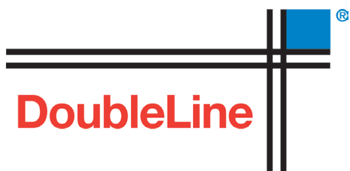
Price-to-Earnings (P/E) Ratio – This ratio for valuing a company measures current share price relative to earnings per share (EPS). The P/E ratio is also sometimes known as the "price multiple" or the "earnings multiple." A high P/E ratio could mean that a company's stock is overvalued, or investors are expecting high growth rates in the future.

Return on Assets (ROA) – Indicator of how profitable a company is relative to its total assets. ROA gives a manager, investor or analyst an idea how efficient a company's management is at using its assets to generate earnings. ROA is displayed as a percentage.

Russell 1000 Growth (RLG) Index – This index measures the performance of the large-cap value segment of the U.S. equity universe. It includes Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000 Value (RLV) Index – This index measures the performance of the large-cap value segment of the U.S. equity universe. It includes Russell 1000 Index companies with lower price-to-book ratios and lower expected growth values.

S&P 500 Index – This unmanaged capitalization-weighted index of the stocks of the 500 largest publicly traded U.S. companies is designed to measure performance of the broad domestic economy through changes in the aggregate market value of the 500 stocks, which represent all major industries.



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