Portfolio Managers' Commentary

Emidio Checcone & **Brian Ear** | First Quarter 2021

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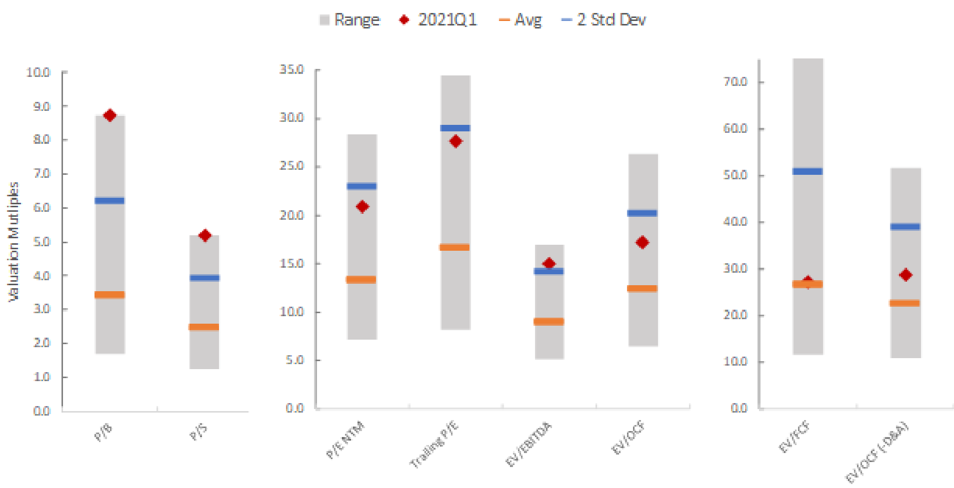
In the first quarter of 2021, U.S. equity markets continued their ascent to new highs as the rapid rollout of COVID-19 vaccines facilitated an increase in economic activity and a more optimistic corporate earnings outlook. The recent rise in the market was primarily fueled by a strong rally in value stocks, supporting our previously articulated view that the historically wide valuation discount of value stocks relative to growth stocks (i.e., the value spread) would prove unsustainable, especially given the expected improvement in value stock fundamentals in an economic recovery. During the quarter, the Russell 1000 Value Index (RLV) returned 11.3%, the Russell 1000 Growth Index (RLG) returned 0.9%, and the S&P 500 Index gained 6.2% .

Even with the recent move, the value spread remains very elevated due to the extended duration of value stock underperformance, which goes back to 2007, across a variety of valuation measures. (Figure 1) We are likely still in the early innings of this rotation into value stocks. History might serve as a useful guide in this regard: Value stocks have led the market coming out of each of the 14 recessions since 1929, with such outperformance, more often than not, lasting more than one year. Considering the severe underperformance by value since 2007, the value rotation could prove to be more significant in magnitude and duration during this economic cycle.

Growth Premium Over Value Is Near a Historic High Across Most Valuation Multiples Except EV/FCF Ratio



Source: FactSet, DoubleLine

It is important to understand that value investing — purchasing securities of companies at a discount to their intrinsic value — continues to work but has been masked for the last several years by ever-rising multiples among growth stocks and continually declining multiples for value stocks. In effect, the average stock market investor has paid higher and higher premiums for exposure to the former while demanding a wider and wider discount to invest in the latter. As we detailed in a recently published DoubleLine whitepaper ("Value Investing Is Dead? No, Long Live Value!"), the reasons given for the ever-widening value spread, resulting from these opposing moves in valuation multiples, do not appear to hold water and probably constitute fallacious "new era" thinking.

Based on our analysis, this valuation differential cannot be explained by faulty valuation metrics, since problematic book value is not emphasized outside of the academic community. Nor does it appear to be a function of our digitizing economy and rise of high-growth, high-multiple technology companies. Indeed, the relative profitability of growth stocks versus value stocks, as measured by metrics such as operating profit margin or return on assets, has not deviated materially from historical averages. Interest rates also do not appear to be a robust explanatory factor, as most studies have concluded that interest rates are not a statistically significant factor and, where significance is found, they are at best a weak driver of the value spread. All of this suggests that the persistent widening of the value spread for more than a decade now does not appear to be based upon any deteriorating fundamentals impacting value stocks nor due to any cessation in the underlying effectiveness of value investing as a strategy.

We recognize that in 2020 earnings for value stocks were hit much harder by the pandemic. Earnings for companies within the RLV fell by about 27%, compared to a modest increase of nearly 1% for firms in the RLG. However, with earnings for many cyclical value companies improving in the fourth quarter of 2020 and expected to rebound sharply in 2021, the brunt of the drop in earnings seems to be driven more by cyclical headwinds rather than a more permanent impairment in business fundamentals for value companies. Moreover, the anticipated economic recovery should usher in higher earnings for value stocks than growth stocks during this year and next. In 2021, companies within the RLV are expected to grow earnings on average by 32% year-over-year (YoY) compared to 20% YoY growth for companies in the RLG. In 2022, RLV earnings are expected to surpass pre-pandemic levels, and companies in the value index are expected to again outgrow their growth stock counterparts — which would make value stocks the new growth stocks during this reflationary period.

Given this glaring disconnect between the historically wide valuation spread and the rapidly improving underlying fundamentals of value stocks, we would expect value shares to rerate relative to growth stocks. Combined with attractive near-term earnings growth expectations, such a rerating should lead to continued relative price outperformance for value over growth. As we have counseled previously, investors should be positioned within equities with adequate exposure to value in order to profit from this sustained rotation into value names.

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Our positioning is based upon our cautiously constructive view on the ongoing economic recovery made possible by the advent of COVID-19 vaccines and related treatment improvements, which have reduced the case counts, hospitalizations and deaths associated with this tragic pandemic. Although there is the possibility of a reopening that occurs only with fits and starts as well as several other key macroeconomic risks, we see a continued recovery in economic and business activity as the key driver of improved earnings growth for equities generally and, critically, for disproportionately better earnings performance among value stocks. Essentially, we anticipate a positive chain of events supporting the equity market in general and value stocks in particular. Those events include the unwinding of lockdowns; the government's continued fiscal and monetary support driving an anticipated recovery in consumer spending, business activity and investment; and a normalization of inflation and yields. As a result, that normalization should drive a rise in earnings and accelerate the flow of funds into those names whose prospects have moved from extremely dire last year to increasingly constructive this year and next.

Since the news of efficacious vaccines and therapeutic options in the fall of last year, the global economic outlook has been improving as many states and nations have begun to reopen their economies at least partially. While such reopening progress has been highly uneven, with false starts along the way, the arrow continues to point upward as more and more vaccinations occur. Moreover, this recovery should strengthen further given the apparent pent-up demand among consumers who are long past tired living under the lockdown restrictions as well as the need to address supply chain disruptions and other input constraints caused by the pandemic across a variety of areas. Such imbalances will take time to resolve and likely will drive near-term jumps in economic activity.

That the U.S. government has recently elected to inject additional sizable fiscal stimulus into the economy, while maintaining highly accommodative monetary policies, means there is an enormous amount of liquidity to drive the acceleration in demand. As a result of the historic easing, the Federal Reserve's balance sheet has grown to $7.4 trillion, including over $4 trillion spent on fixed income securities since March 2020. By year-end 2021, the balance sheet could approach $9 trillion as the Fed has committed to purchasing $120 billion per month of U.S. Treasuries and mortgage-backed securities. Meanwhile, the multiple rounds of record stimulus have reached consumers, allowing them to continue making needed purchases even as the shutdown has put many out of work. Additionally, the stimulus checks received have allowed many individuals to repair their personal balance sheets, which creates a favorable setup for consumer spending as the lockdown orders are lifted, first partially and then completely.

We expect that consumer spending will continue to rebound even as unemployment remains meaningfully above pre-pandemic levels. This is atypical, since normally personal savings decline during a recession due to job losses. However, in this downturn, transfer payments such as extended and supplemental unemployment along with stimulus checks have provided consumers with a substantial pile of savings. According to The Economist, consumers, stuck at home and unable to spend as much on entertainment such as restaurants or movie theaters, have accumulated over $1.6 trillion in excess savings in the past year, while a J.P. Morgan study found that bank balances for the poorest Americans were about 40% higher than the prior year. Goldman Sachs estimates this excess savings could add 2% to GDP growth in the year after a full reopening. Meanwhile, high earners who have been able to retain their job during the pandemic have suppressed spending on discretionary activities such as travel and entertainment due to social distancing restrictions. The lifting of these restrictions could unleash some of that withheld spending. Importantly, more fiscal transfers are on the way with the recent approval of President Joe Biden's $1.9 trillion stimulus package, potentially adding to the anticipated consumer spending spree.

Meanwhile, we anticipate that capital spending and business sentiment will continue to rebound. We have already seen supply constraints in areas such as semiconductors and building materials that are being addressed with additional capital expenditure commitments. Encouraged by the continued support from both Fed Chairman Jerome H. Powell and Treasury Secretary Janet Yellen, who have both consistently voiced support for additional stimulus, CEOs should continue to bolster the economic recovery via corporate investments. Moreover, President Biden and congressional Democrats' proposal for a multitrillion-dollar infrastructure investment program, if passed, should provide an additional uplift to GDP, although the program would likely take time to be implemented.

Interest rates have been rising along with inflation expectations that come with an economic recovery. The economic boom should provide a particularly healthy tailwind for cyclical companies and financials. Rising input costs actually create an opportunity for many companies to seek price increases, which can boost rather than compress margins for those with higher-quality operations. Meanwhile, rising prices also prompt consumers to spend rather than wait for the next round of price declines; hence, if the consumer has used the stimulus to repair personal balance sheets, then a sustained level of moderate inflation can actually be healthy. Of course, all of this assumes that inflation and interest rates do not rise too much too quickly, as such an environment — last witnessed in the 1970s — was not healthy for equity markets. However, beyond the temporary spikes in many prices that are caused by base effects or short-term, pandemic-caused, supply chain disruptions, which we think will be too short-lived to impact equities on a sustained basis, our current expectation remains one calling for inflation and rates of the benign variety.

The economic recovery should translate into better overall corporate earnings, particularly for those companies that saw the most-challenging environments last year. This is already starting to be incorporated into sell-side earnings estimates, but we believe that there is more likely to be additional increases. Usually, analysts initially assign overly optimistic expectations for upcoming quarterly earnings and then reduce them over time. However, in the current environment, which is so unorthodox and unpredictable, we are seeing the opposite phenomenon whereby the analysts are cautiously raising estimates on a lagged basis. We haven't seen this behavior since 2010 coming out of the Great Financial Crisis. According to FactSet, first quarter 2021 earnings per share (EPS) for the S&P 500 was revised up by 6% since the end of last year, contrasting with the normal pattern over the last 10 years of bottom-up EPS estimates for the S&P 500 being revised down by 4.2% on average in the three months leading up to a quarterly reporting season. The same pattern is occurring for sell-side analysts' full-year earnings estimates, as the 2021 bottom-up EPS estimate for the S&P 500 has increased by 5.0% during the first quarter of this year. The revisions have been particularly strong for value sectors as energy, materials and financials were the top three sectors with the strongest expected 2021 earnings growth. If those sectors, given their disproportionate exposure to the economic recovery, also see the largest and most widespread positive earnings surprises, as we expect, then earnings should strongly support the continued rotation into value stocks.

Certainly, the excess liquidity delivered by supportive government fiscal and monetary policy has flowed into stocks. In contrast with the past, equity fund flows have been positive and strong during the first quarter of this year, further pushing up valuation multiples. A healthy share of those funds have recently found their way into value stocks and value funds, so the rotation into value stocks appears to be driven at least in part by those positive liquidity flows. As the value rotation continues to gather steam, the reallocation of capital from growth stocks will supply additional support.

Because this recovery should most directly boost the prospects and stock prices of those (largely value) companies most closely tied to the economic rebound, we continue to recommend positioning for the value rotation. We would note that such positioning also accounts for one key risk to the overall U.S. equity market, which is elevated valuation. That valuation level is above 24-year averages, no matter which valuation metric is employed. (Figure 2) Because value stocks continue to carry valuation multiples that are lower than those of growth shares or the overall market, despite carrying attractive earnings growth and positive surprise potential over the next two to three years, this relative value of value stocks is another important support for the rotation into value, as well as a partial mitigant to elevated U.S. equity valuation.

S&P 500	EV/ EBITDA	P/E LTM*	P/E FY1	P/E FY2	P/B	P/Sales
Current	18.7x	28.2x	22.6x	19.6x	4.2x	3.0x
Peak	18.7x	31.3x	28.4x	24.1x	5.4x	3.0x
Average	11.2x	18.8x	17.8x	15.6x	3.1x	1.7x

Source: FactSet Research. Valuations are from January 31, 1996 to March 31, 2021.
* Last Twelve Months

	EPS Growth			P/E			PEG		
	2021	2022	2023	2021	2022	2023	2021	2022	2023
R1000 Value	33.1%	15.5%	9.9%	19.0	16.5	15.0	0.58	1.07	1.52
R1000 Growth	19.8%	13.7%	11.0%	31.8	27.9	25.2	1.60	2.03	2.29
Delta	13.2%	1.7%	-1.1%	-12.7	-11.5	-10.2	-1.03	-0.97	-0.77

Source: FactSet, DoubleLine
Estimated figures are provided for illustrative purposes only and are not a prediction of future performance. Estimates depend on, among other factors, future operating results, interest rates, economic and market conditions all of which may differ from the assumptions on which these estimates are based.

We continue to view the many examples of excessive froth in the market with concern but do not yet see evidence of widespread systemic risks that could jeopardize either the economic recovery or the sustained rotation into value stocks. Examples of this froth include the explosion of special purpose acquisition companies (SPACs), also referred to as blank-check companies. The surge in SPAC issuance that began in late 2020 has accelerated in early 2021, with 298 new SPACs just in the first quarter raising about $100 billion, more than the total raised in all of 2020, and comprising about two-thirds of all capital raised through U.S. listings. We see SPACs as riskier than traditional IPOs, with inferior performance relative to traditional IPOs, so their proliferation should be viewed as a sign of market excess and, thus, a risk when disappointments proliferate.

There are other signs of potential froth in the financial markets, such as the recent GameStop retail investor frenzy that created massive swings and extremely elevated valuation levels in that company's stock, which we view as unhealthy. With the rise in retail trading activity and the advent of technologies supporting large-scale investor chatrooms, there are increased risks that a particular stock or set of stocks can have prices dramatically detach from underlying fundamentals. This might also have occurred in the case of Archegos, where the ability to dramatically boost a set of stocks to high levels was driven not by employing technologies to gather tens of billions into anonymous and poorly regulated retail investor chatrooms but by employing large amounts of leverage and exploiting the anonymity of weak disclosure rules around family offices and nonstandard derivative contracts (e.g., contracts for differences) to drive stocks in short periods of time apparently above levels justified by underlying fundamentals. Should these events become more widespread, then the U.S. stock market, with an elevated valuation multiple, will be more susceptible to a meaningful pullback.

This excess froth is without a doubt being caused by the historically large quantum of liquidity that the government has deployed to keep the economy afloat during the pandemic-prompted lockdowns. This is another example of unintended consequences at work, and it should be monitored carefully, because cheap money invariably leads to excessive risk-taking, including imprudent levels of leverage. While regulators have constrained leverage in the banking system by requiring banks to retain excess capital, the excessive leverage appears to be creeping up in parts of the market among nonbank financial companies. Beyond the Archegos example, we have seen permissive lending standards leading to massive write-downs and executive terminations related to Greensill Capital, another company built on excessive debt that underwent a spectacular collapse. We also worry about the rise of more subtle but perhaps more pervasive risk being driven by the continued search for yield found in the growth of unconventional credit products by nonbanking actors such as Golub Capital and Owl Rock Capital, which have issued asset-backed securitization (ABS) financing backed by the recurring subscription revenue of software companies with little to no profits. While recognizing that these might be examples of true financial innovation, we also would point out that these novel debt instruments would appear to entail greater risks than traditional ABS financings. If the risks associated with higher leverage and more-creative financing operations do come home to roost, then there is great potential to see systemic, adverse impacts for the wider financial system.

The other potential risks related to the historical surplus of liquidity could be an overheating economy, runaway inflation or a rapid jump in interest rates caused by a loss of confidence in the Fed's balance sheet and the U.S. dollar. As noted, we believe these risks remain low in the immediate future. However, it must be pointed out that the emergence of uncontrolled inflation or fears over our rapidly rising indebtedness, compounded by a loss in the credibility of the Fed, could cause a general loss of investor confidence, hurt valuation multiples and hasten a meaningful correction in the equity markets.

For now, we expect the economic recovery to lead to stronger earnings, particularly for value stocks relative to growth stocks. In addition, the reward-to-risk ratio for value stocks remains compelling relative to growth stocks as valuation spreads remain high even with the recent value outperformance. Meanwhile, fund managers are still crowded in growth stocks and are underweight in value stocks. All of this lends support to our expectation of a continued value rotation.

As always, we will continue to seek sound, long-term investment ideas and aim to strike reasonable balances within our portfolio among those investment ideas offering safety in uncertain times and those holdings representing compelling long-term value once a broader recovery is underway. Our differentiated fundamental value investment philosophy allows us to pursue both of these opportunity scenarios in our ongoing effort to target solid relative returns.

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

Select Definitions

Basis Points (BPS) – Basis points (or basis point (bp)) refer to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% or 0.0001, and is used to denote the percentage change in a financial instrument. The relationship between percentage changes and basis points can be summarized as: 1% change = 100 basis points; 0.01% = 1 basis point.

Book Value – Equal to the cost of carrying an asset on a company's balance sheet, and firms calculate it netting the asset against its accumulated depreciation. As a result, book value can also be thought of as the net asset value (NAV) of a company, calculated as its total assets minus intangible assets (patents, goodwill) and liabilities. For the initial outlay of an investment, book value might be net or gross of expenses such as trading costs, sales taxes, service charges and so on.

Comps – Short for "comparable company analysis," which is a technique used to assign a value to a business based on the valuation metrics of a peer or peers.

Delta – Ratio that compares the change in the price of an asset, usually marketable securities, to the corresponding change in the price of its derivative. For example, if a stock option has a delta value of 0.65, this means that if the underlying stock increases in price by $1 per share, the option on it will rise by $0.65 per share, all else being equal.

Earnings Per Share (EPS) – Calculated as a company's profit divided by the outstanding shares of its common stock. The resulting number serves as an indicator of a company's profitability.

Enterprise Value (EV) – Measure of a company's total value, often used as a more-comprehensive alternative to equity market capitalization. EV includes in its calculation the market capitalization of a company but also short- and long-term debt as well as any cash on the company's balance sheet. EV is a popular metric used to value a company for a potential takeover.

Enterprise Value (EV)-to-Earnings Before Interest Taxes Depreciation and Amortization (EBITDA) Ratio – The enterprise multiple, also known as the EV multiple, is a ratio used to determine the value of a company. The enterprise multiple, which is the enterprise value divided by EBITDA, looks at a company the way a potential acquirer would by considering the company's debt.

Enterprise Value-to-Free Cash Flow (EV/FCF) Ratio – Compares the total valuation of the company with its ability to generate cash flow.

Enterprise Value-to-Operating Cash Flow (EV/OCF) Ratio – Company's enterprise value divided by the company's operating cash Flow.

Enterprise Value-to-Operating Cash Flow Minus Depreciation and Amortization (EV/OCF (-D&A)) Ratio – Company's enterprise value divided by the company's operating cash flow less depreciation and amortization.

Free Cash Flow (FCF) – Cash a company produces through its operations after subtracting any outlays of cash for investment in fixed assets like property, plant and equipment. In other words, FCF is the cash left over after a company has paid its operating expenses and capital expenditures.

Global Industry Classification Standard (GICS) – Hierarchical industry classification system, created by Morgan Stanley Capital International and S&P Dow Jones Indices in 1999, comprising four tiers going from broadest to narrowest to classify companies by industry: sectors, industry groups, industries and subindustries. The 11 GICS sectors are: energy, materials, industrials, consumer discretionary, consumer staples, healthcare, financials, information technology, real estate, communication services and utilities.

Growth Stock – Any share in a company that is anticipated to grow at a rate significantly above the average growth for the market. These stocks generally do not pay dividends. This is because the issuers of growth stocks are usually companies that want to reinvest any earnings they accrue in order to accelerate growth in the short term. When investors invest in growth stocks, they anticipate that they will earn money through capital gains when they eventually sell their shares in the future.

Operating Cash Flow (OCF) – Measure of the amount of cash generated by a company's normal business operations. OCF indicates whether a company can generate sufficient positive cash flow to maintain and grow its operations, otherwise, it might require external financing for capital expansion.

Price/Earnings-to-Growth (PEG) Ratio – A stock's price-to-earnings (P/E) ratio divided by the growth rate of its earnings for a specified time period. The PEG ratio is used to determine a stock's value while also factoring in the company's expected earnings growth, and it is thought to provide a more complete picture than the more standard P/E ratio.

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) Next 12 Months (NTM) Ratio – Forward price-to-earnings (forward P/E) is a version of the price-to-earnings (P/E) ratio that uses forecasted earnings for the P/E calculation.

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.

Price-to-Sales (P/S) Ratio – Valuation ratio that compares a company's stock price to its revenues. It is an indicator of the value that financial markets have placed on each dollar of a company's sales or revenues. The P/S ratio can be calculated either by dividing the company's market capitalization by its total sales over a designated period (usually 12 months) or on a per-share basis by dividing the stock price by sales per share. The P/S ratio is also known as a "sales multiple" or "revenue multiple."

Prime – Classification of borrowers, rates or holdings in the lending market that are considered to be of high quality. This classification often refers to loans made to high-quality "prime" borrowers that are offered "prime" or relatively low interest rates.

Russell 1000 Growth (RLG) Index – This index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values. Growth stocks are shares in a company that are anticipated to grow at a rate significantly above the average growth for the market.

Russell 1000 Index – This index typically comprises approximately 92% of the total market capitalization of all listed stocks in the U.S. equity market and is considered a bellwether index for large-cap investing.

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. Value stocks are shares of a company that appear to trade at a lower price relative to the company's fundamentals.

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.

Standard Deviation – Measure of the variation or dispersion of a set of data from its mean or expected/budgeted value. A low standard deviation indicates that the data points tend to be very close to the mean, whereas a high standard deviation indicates that the data is spread out over a large range of values. A measure of an investment's volatility.

Trailing Price-to-Earnings (P/E) Ratio – Relative valuation multiple that is based on the last 12 months of actual earnings. It is calculated by taking the current stock price and dividing it by the trailing earnings per share (EPS) for the past 12 months.

Value Stock – Shares of a company that appear to trade at a lower price relative to its fundamentals, such as dividends, earnings or sales, making it appealing to value investors.

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