DoubleLine®

Portfolio Managers' Commentary

Emidio Checcone | **Brian Ear** | Third 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. Previous to that, he worked at PRIMECAP Management Company for six years, where he was a Principal and Financial Analyst. Mr. Checcone holds a BA in Social Studies from Harvard College and a JD-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. Previous to that, Mr. Ear worked for five years at Hotchkis and Wiley Capital Management as an Equity Analyst. He holds a BS in Economics from the Wharton School of the University of Pennsylvania. Mr. Ear is a CFA® charterholder and a licensed CPA (inactive).

"Bäume wachsen nicht in den Himmel."

- Old German proverb

"Multa renascentur quae iam cecidere,
cadentque quae nunc sunt in honore…"

- Ars Poetica, Horace

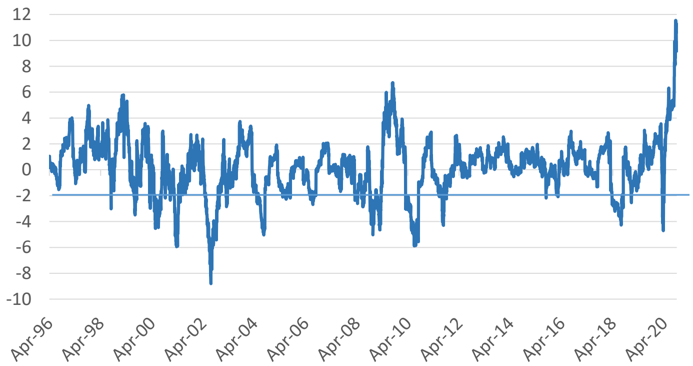
During the third quarter of 2020, historic monetary and fiscal stimulus continued to propel the U.S. equity market, pushing the S&P 500 Index to a record high in early September, notwithstanding the prospects for a full economic recovery remain very uncertain and highly challenged. Even against a still weak economic backdrop, the S&P 500 rose 8.9% to a new peak in early September before pulling back slightly. The Russell 1000 Growth Index soared 13.2%, far outpacing the Russell 1000 Value Index's return of 5.6%.

From a trough sell-off in late March, the stock market rebound has been mostly led by large-cap growth stocks, which perhaps should not be very surprising. These businesses have shown resilient or even improving business fundamentals despite the pandemic-induced recession, and they have delivered solid earnings reports and attractive market returns as a result. Meanwhile, value stocks and smaller cap names, which are more dependent on a re-acceleration in earnings during economic recoveries, have not yet seen sufficient investor confidence in a cyclical upswing to participate to the same extent in the equity market's rebound. Hence, the market conditions that have supported and sustained the unprecedented relative outperformance of growth stocks during the last decade or more — low interest rates; scarcity of growth; ongoing tech disruption; the rise of environmental, social and governance (ESG) investing; relative balance sheet strength and earnings resiliency of growth companies, et. al. — remained in place during the third quarter.

The relative outperformance has stretched the relative valuation of growth stocks to unprecedented extremes over their value counterparts. Indeed, value stocks today trade at a steeper discount to growth stocks than they did during the late stages of the tech bubble in late 1999 and early 2000. On a price-to-book valuation basis, the bottom half of the S&P 500's constituent companies now trades at a 9.0x multiple-point discount to the top half, much greater than even the discount experienced during the height of the tech bubble (4.7x). The remarkable differential currently observed is more than two standard deviations greater than the historical average. Based on consensus-estimated 2021 price-to-earnings multiples, the Russell 1000 Growth Index traded at about 29x at the end of the quarter, almost twice the multiple of the Russell 1000 Value Index (about 16x). Growth's valuation premium over value has reached one of the highest levels on record.

More concerning, this recent surge in the growth premium has not been driven by sturdy distinguishing characteristics of such stocks. Specifically, while the rise in growth company share prices had previously been accompanied by strong earnings growth and continued posting of attractive returns on equity, it is important to note that the recent move has been driven much more by mere multiple expansion. In fact, during the last six months, this growth company multiple expansion was so large that it increased the overall S&P 500 earnings multiple by more than 9 multiple turns (e.g., from 16x price-earnings ratio six months ago to 25x as of Sept. 30), the largest such expansion in postwar history.

S&P 500 FY1 P/E 6-Month Change



Source: FactSet Research as of September 30, 2020

One can debate whether such a dramatic multiple expansion is related to rising speculation and animal spirits amid easy money, defensive positioning in proven large-cap technology winners or the mathematical relationship of higher-valuation multiples to longer-duration earnings during ultralow rates. Valuations have increased substantially for some companies with limited operating and profit history, as was the case in recent initial public offering and special purpose acquisition company deals involving early stage high fliers or the apparent proliferation of retail investor participation in highly speculative momentum stocks — including those randomly pulled out of a hat (or was it a bag?) by blogging star and investing neophyte David Portnoy. Yet valuation multiples and analyst price targets of proven technology winners, like Amazon and Microsoft, have continued to push higher on more institutional investor bets regarding company earnings and lower-for-longer rates. Indeed, analysts can justify higher valuation targets when the assumed interest rates input into their discounted cash flow models are lowered for the next decade amid the rate regime of an interventionist Federal Reserve. Yet the important observation remains: The cost incurred by investors for those incremental growth companies' earnings, however resilient, have never come at higher valuations.

Obviously, it is the crowding into growth stocks — which necessarily entails further neglect of value names — that is driving the dramatic valuation dispersions in the equity market. According to Bank of America's "BofA's Picks for Quality Value Stocks" report, published Sept. 29, 2020, which analyzes stock ownership data, long-only equity managers have concentrated positions in growth sectors like technology and internet services while maintaining underweight positions in value sectors such as financials and industrials. While this portfolio allocation strategy has worked recently, just as it has for most of the last decade or more of growth's epic run, the reality is that this relative outperformance cannot continue indefinitely. "Trees do not grow to the sky," as the Germans like to say. Rather, they are typically felled by lightning or other threats or, alternatively, halted by old age.

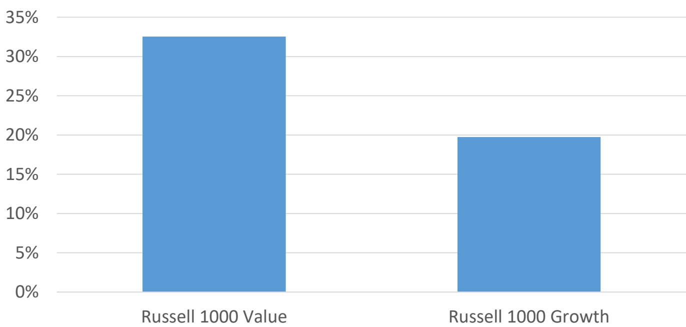
The giant sequoias of the market — the well-known large-cap growth names — face many challenges even as their nose-bleed valuations would imply the opposite. Not only do they require much larger incremental addressable markets to move the needle on what are much larger operations — the problematic law of large numbers — they also face greater government scrutiny in terms of antitrust inquiry and regulatory oversight of their use of customer data. There is growing (albeit still low) risk that these dominant technology platform oligopolies will eventually be broken up or, more likely, hindered by regulation and taxation.

"Like the redwood forests near Silicon Valley, these technology giants might indeed stand tall for many years to come, but their stock prices simply cannot continue to be driven by the sort of multiple re-ratings or earnings surprises that we have seen in recent quarters."

Given their size and power, we do not expect competition or government action to take down these fantastic businesses anytime soon; however, we think that their strength and resilience is so well known that there is little room for them to grow sufficiently faster than market expectation to be a source of alpha (an investment strategy's ability to beat the market), and so we would expect their valuations to recede in the future or their stock prices to run the risk of correction going forward. This is true not only of the so-called FANGMAN (Facebook, Amazon, Netflix, Google, Microsoft, Apple and NVIDIA) names, but especially of other high-flying technology companies sporting high-altitude valuations like Zoom and Tesla. Like the redwood forests near Silicon Valley, these technology giants might indeed stand tall for many years to come, but their stock prices simply cannot continue to be driven by the sort of multiple re-ratings or positive earnings surprises that we have seen in recent quarters. Trees don't grow to the sky.

This observation, we believe, potentially sets the stage for a meaningful rotation out of richly priced growth and into reasonably priced value. Indeed, September marked a modest rotation into value stocks that could be attributed to rising valuation concerns surrounding growth stocks, coupled with abating fears about more cyclically sensitive value names. We believe that a shift to value will become more durable than the tentative, ephemeral moves of the last 10 years when the market can reliably discount a broad economic recovery and concomitant widespread cyclical rebound in earnings. Historically, value stocks have outperformed growth stocks when the business cycle turns up. As noted in the Bank of America report, value stocks have outperformed growth stocks in 15 of 17 prior corporate profit recovery periods, measured trough to peak from 1944 to 2018. Moreover, value stocks have outperformed the broader S&P 500 for at least a quarter, and usually for far longer, following the trough of every recession or depression since 1929. While recognizing that a sustained economic recovery is far from assured at this point in the current pandemic and recession, we nonetheless see ahead of us an emerging opportunity to position one's portfolio for the expected rising relative attractiveness of value stocks over their growth counterparts.

2021 Expected Earnings Growth



Source: FactSet Research as of September 30, 2020

It is widely understood that the competitive positioning of many growth companies has dramatically improved during the crisis as the forced work-from-home environment has boosted the business of technology and internet companies at the expense of more-traditional businesses. For example, usage of Zoom and Microsoft's remote-work software has skyrocketed even as the operations of airlines and nonessential retailers – located at the epicenter of the pandemic crisis – have been severely disrupted. However, the reality is that the recent earnings declines for a large number of value companies are properly viewed as being in a cyclical downturn rather than in secular decline. This means that the pressures of the business downturn, however severe, should abate as the economy demonstrates a durable recovery. Consensus expectations are for S&P 500 earnings to rebound significantly in 2021, with value sectors anticipated to contribute most to the overall earnings growth projected for next year. In fact, the Russell 1000 Value Index earnings are forecasted to grow at a notably faster pace than that for the Russell 1000 Growth Index in 2021. If these earnings forecasts are correct, or even understate the relative size of future earnings rebounds between growth and value stocks, then we would expect any rotation into value, likely occurring in anticipation of such attractive earnings, to prove durable. Future earnings still matter to equity prices.

"Value sectors are anticipated to contribute most to the overall earnings growth projected for next year. In fact, the Russell 1000 Value Index earnings are forecasted to grow at a notably faster pace than that for the Russell 1000 Growth Index in 2021."

Separately, the macro environment might soon turn more favorable for value stocks. While academic research shows at best only a weak correlation between interest rates and relative performance of value versus growth, there appears a stronger connection between central banks' balance sheets and the relative fortunes of value and growth investment. Specifically, value stocks have tended to outperform in periods of shrinking central bank balance sheets. Therefore, it will become significant if quantitative easing has peaked and the economic recovery continues to gather strength. While we might not be out of the woods yet with regard to risks of a double-dip recession, we can say that as the economy recovers, the Federal Reserve balance sheet shrinks and corporate earnings improve, the valuation gap between value and growth stocks should narrow to normal levels from current extremes.

Recognizing that value investor underperformance often comes from being too early, market participants will not want to miss the great rotation that is potentially imminently before us. Indeed, famed investor Benjamin Graham included in the preface to his revered book, "Security Analysis," the immortal quote by the Roman poet Horace, "Many shall be restored that are now fallen, and many shall fall that are now in honor," to caution investors of the dramatic reversals of fortune that can occur in this world, including the unforgiving, mean-reverting rotations within capital markets.

How are we positioned given this potential for a great rotation? We are continuing gradually to shift our portfolio holdings from higher-multiple defensive names with more-reliable growth and margin profiles to lower-priced value stocks that are expected to show outsized earnings growth as the economy strengthens. We are carefully monitoring the economy and changes in corporate earnings prospects to determine the rate at which we should manage this transition.

"The market likely will need to anticipate the advent of a recovery not reliant upon government support in order to justify further gains, especially in those value names that are more sensitive to business cycles."

The future of the economy and corporate earnings results is uncertain. First, it goes without saying that we are not through the pandemic, which caused the economic crisis in the first place. Without the advent of vaccines or therapies, or the development of hard-to-gauge herd immunity, a full recovery will be highly challenged. At the moment, the economy continues to benefit from past fiscal and monetary stimulus, and other government actions such as forbearance and deferrals. This support has boosted the personal savings rate and has provided an added income buffer for those who are unemployed. Because the benefit from the fiscal and monetary stimulus, which has been greater than expected, will largely be temporary, the market likely will need to anticipate the advent of a recovery not reliant upon government support in order to justify further gains, especially in those value names that are more sensitive to business cycles.

Of course, the economy, which remains mired in a deep recession even after the anticipated third quarter bounce, does not appear ready to be taken off life support for a host of reasons. First, meaningful gains in employment will likely be a challenge, as certain industries, such as travel and leisure, struggle to resume normal activity without an effective treatment or herd immunity. Second, state and local governments, which employ about 20 million people, or about 13% of the total U.S. workforce, are facing mounting fiscal pressures. Budget shortfalls are expected to approach $1 trillion, according to Barron's, and without federal aid, governments might be forced to cut expenses by laying off workers. Third, the benefits from past stimulus activity seem to be waning, causing a stall in hiring. Meanwhile, within the most-vulnerable industries, layoffs have started to increase again, while business bankruptcies have been on the rise. With the pace of economic activity appearing to slow, there seems to be a greater need for further stimulus at this stage of the recovery.

Fourth, hopes for additional stimulus continue to be dashed as negotiations have become increasingly politicized. There appears to be a deep divide between the Democrats and Republicans regarding the size of a new package and how it should be deployed. Also, with major market indexes rebounding so thoroughly and employment trends improving from their recent nadir, urgency has diminished in Congress to pass additional stimulus. Furthermore, the upcoming presidential election has added partisan calculations to the stimulus negotiations, amplifying the risk that further stimulus will come too late or in insufficient amounts, triggering a major slowdown in the economy and a correction in the equity markets.

Lastly, the federal deficit is expected to reach a record high as a percentage of GDP over the next couple of years, which could have long-term negative ramifications for economic growth, interest rates and possibly inflation depending on how future deficits are funded. Prior to the pandemic, the U.S. economy had struggled to achieve targeted levels of growth due to unfavorable demographics and adverse debt load. It would not seem likely that such challenges to secular economic growth will be lessened in the post-pandemic years ahead, even before we consider the complicated question of how our society has been permanently changed by COVID-19.

"We will continue to seek sound, long-term investment ideas and strike reasonable balances within our portfolio among those investments aiming for safety in uncertain times and those holdings that represent compelling long-term value once a broader recovery is underway."

Given these elevated uncertainties, we remain cautious and believe it is prudent to maintain a defensive posture with continued exposure to high-quality companies with more-resilient balance sheets and more-reliable earnings growth profiles. Meanwhile, we continue gradually adding to our weightings in more-cyclical stocks that are riskier in the current environment but also more attractively priced relative to longer-term earnings prospects. This reflects our view that while value stocks are generally more vulnerable to economic weakness, especially if the current recovery proves uneven, growth stocks are not without risks – especially after the recent dramatic outperformance period in which their valuations have risen so much. As the relative attractiveness of value stocks' risk-reward profile increases in the days and weeks ahead, we expect to adjust this balance in our portfolio weightings. In short, we will continue to seek sound, long-term investment ideas and strike reasonable balances within our portfolio among those investments aiming for safety in uncertain times and those holdings that represent compelling long-term value once a broader recovery is underway.

More fundamentally, we will continue to search, as always, for companies with compelling products and services, leadership positions in their markets and prudent management teams. These are the businesses most likely to gain share, achieve above-consensus growth, post strong or even expanding margins, and generate attractive returns over the long term. We would expect that holding a collection of such businesses will allow portfolios comprising them to post attractive risk-adjusted rewards over time. As we have previously noted, it is our differentiated, fundamentals-focused, value-oriented investment philosophy that informs our equity research and portfolio management process, and furthers our efforts to achieve solid relative, risk-adjusted investment returns.

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

Select Definitions

CRSP U.S. Total Market Index – This index, managed by the Center for Research in Security Prices, comprises nearly 4,000 constituents across mega, large, small and micro capitalizations, representing nearly 100% of the U.S. investable equity market.

Gross Domestic Product (GDP) – Total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period. As a broad measure of overall domestic production, GDP functions as a comprehensive scorecard of a given country's economic health.

Nasdaq 100 Index – This index comprises the 100 largest U.S. and non-U.S. non-financial securities based on market capitalization listed on the Nasdaq stock exchange. The index reflects companies across major industry groups including computer hardware and software, telecommunications, biotechnology and retail/wholesale trade.

Russell 1000® Growth 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® 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 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.

Vanguard Total Stock Market Index – This index tracks the investment results of the CRSP U.S. Total Market Index, comprising approximately 100% of the investable U.S. stock market. Vanguard index companies, which represent a cross-section of market capitalizations, primarily trade on the New York Stock Exchange and Nasdaq stock exchange.

Important Information Regarding This Material

Issue selection processes and tools illustrated throughout this presentation are samples and may be modified periodically. Such tools are not the only tools used by the investment teams, are extremely sophisticated, may not always produce the intended results and are not intended for use by non-professionals.

DoubleLine has no obligation to provide revised assessments in the event of changed circumstances. While we have gathered this information from sources believed to be reliable, DoubleLine cannot guarantee the accuracy of the information provided. Securities discussed are not recommendations and are presented as examples of issue selection or portfolio management processes. They have been picked for comparison or illustration purposes only. No security presented within is either offered for sale or purchase. DoubleLine reserves the right to change its investment perspective and outlook without notice as market conditions dictate or as additional information becomes available. This material may include statements that constitute "forward-looking statements" under the U.S. securities laws. Forward-looking statements include, among other things, projections, estimates, and information about possible or future results related to a client's account, or market or regulatory developments.

Important Information Regarding Risk Factors

Investment strategies may not achieve the desired results due to implementation lag, other timing factors, portfolio management decision-making, economic or market conditions or other unanticipated factors. The views and forecasts expressed in this material are as of the date indicated, are subject to change without notice, may not come to pass and do not represent a recommendation or offer of any particular security, strategy, or investment. All investments involve risks. Please request a copy of DoubleLine's Form ADV Part 2A to review the material risks involved in DoubleLine's strategies. Past performance is no guarantee of future results.

Important Information Regarding DoubleLine

In preparing the client reports (and in managing the portfolios), DoubleLine and its vendors price separate account portfolio securities using various sources, including independent pricing services and fair value processes such as benchmarking.

To receive a copy of DoubleLine's current Form ADV (which contains important additional disclosure information, including risk disclosures), a copy of DoubleLine's proxy voting policies and procedures, or to obtain additional information on DoubleLine's proxy voting decisions, please contact DoubleLine's Client Services.

Important Information Regarding DoubleLine's Investment Style

DoubleLine seeks to maximize investment results consistent with our interpretation of client guidelines and investment mandate. While DoubleLine seeks to maximize returns for our clients consistent with guidelines, DoubleLine cannot guarantee that DoubleLine will outperform a client's specified benchmark or the market or that DoubleLine's risk management techniques will successfully mitigate losses. Additionally, the nature of portfolio diversification implies that certain holdings and sectors in a client's portfolio may be rising in price while others are falling or that some issues and sectors are outperforming while others are underperforming. Such out or underperformance can be the result of many factors, such as, but not limited to, duration/interest rate exposure, yield curve exposure, bond sector exposure, or news or rumors specific to a single name.

DoubleLine is an active manager and will adjust the composition of clients' portfolios consistent with our investment team's judgment concerning market conditions and any particular sector or security. The construction of DoubleLine portfolios may differ substantially from the construction of any of a variety of market indices. As such, a DoubleLine portfolio has the potential to underperform or outperform a bond market index. Since markets can remain inefficiently priced for long periods, DoubleLine's performance is properly assessed over a full multi-year market cycle.

Important Information Regarding Client Responsibilities

Clients are requested to carefully review all portfolio holdings and strategies, including by comparison of the custodial statement to any statements received from DoubleLine. Clients should promptly inform DoubleLine of any potential or perceived policy or guideline inconsistencies. In particular, DoubleLine understands that guideline enabling language is subject to interpretation and DoubleLine strongly encourages clients to express any contrasting interpretation as soon as practical. Clients are also requested to notify DoubleLine of any updates to client's information, such as, but not limited to, adding affiliates (including broker dealer affiliates), issuing additional securities, name changes, mergers or other alterations to Client's legal structure.