Win or Lose, It's Always About Fundamentals

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For nearly a decade, central banks' efforts to stabilize risk assets through balance sheet expansion provided the liquidity leading to broad, robust U.S. equity returns. Central banks' policies were further supported by an unprecedented move of capital into passive investment vehicles over the past few years. Unfortunately, these actions have distorted price discovery and artificially suppressed risk leading to a less efficient public equity market. Despite the recent trend, fundamentals remain the prime determinant of valuation over meaningful time periods.

Fundamentals, Valuations, and Distortion

In spite of the equity market inefficiencies of late, the long-term performance of an individual company continues to be predicated upon the fundamentals of the underlying business. While the direction and magnitude of performance may fluctuate on a month to month or quarter to quarter basis, between 80% - 90% of ten year returns are explained by fundamentals.

Valuation is all that matters in the long-term

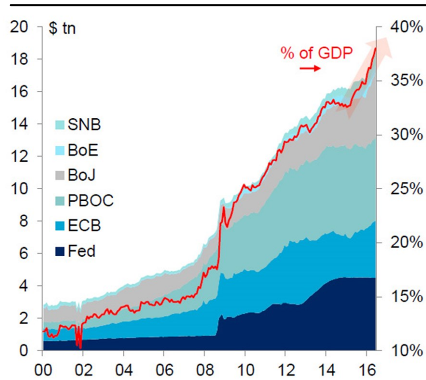
Normalized P/E's predictive power on S&P 500 returns

Source S&P, BofA Merrill Lynch US Equity & US Quant Strategy

While the long term importance of fundamentals is not disputed, asset prices today are grossly distorted due to atypical liquidity. Key contributors to the inefficiency include:

- Expanded central bank balance sheets: The aggregate balance sheet of large central banks today approaches 40% of GDP. Through 1Q17, central banks purchased $1 trillion of financial assets on a YTD basis providing record levels of liquidity.[1]

Aggregate balance sheet of large central banks, $tn & % of GDP



Source: Citi Research, Haver.

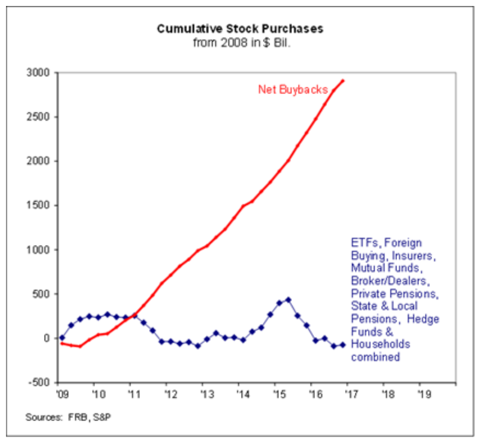
[1] http://www.zerohedge.com/news/2017-04-21/why-nothing-matters-central-banks-have-bought-record-1-trillion-assets-2017

- Flows to Passive Investments: Unprecedented flow to passive vehicles has further skewed asset prices. Approximately $1 trillion moved from active to passive globally in 2016 compared to $1 trillion between 2001 and 2015.[2] More, when active dollars are a source of funding for passive strategies, the market replaces lower beta investments with strategies that have a beta of 1.

- Stock's Inclusion in Passive Vehicle: Recently, one of the most consistent predictors of a company's stock price is the number of passive vehicles in which it is included. Stocks in the top quartile of passive ownership outperformed by 50bps on average per quarter over the past 20 quarters. In contrast, stocks with the least passive ownership underperformed by 100 basis points on average per quarter for the past 20 quarters.[3]

- Interest Rates: Given the persistence of low interest rates, prudent businesses are issuing record levels of debt, delivering cash to their balance sheet, and in turn repurchasing stock. Stock repurchases are the single largest net buyers of US equities today dwarfing the aggregate of mutual funds, ETFs, pensions, foreign investors, retail, insurers, and hedge funds.[4]

Cumulative Stock Purchases from 2008 in $ Bil.



Conclusion and Approach

The risk of moving away from fundamentals as the main decision driver is multifaceted. If the availability of inexpensive credit dissipates, one of the largest buoys of asset prices, stock repurchases, erodes. Further, as central banks begin shrinking their balance sheets a reduction of liquidity follows. Finally, if the record shift to passive investments wanes, indices will lose their indiscriminate bid and a divergence will emerge between fundamentally sound companies and those propped by flow.

Short term liquidity and flow have contributed to return levels unsustainable over extended periods of time. The liquidity provided by central banks has accelerated passive flows and fostered markets that disregard fundamentals. The inefficiencies created by monetary policy or investment vehicle choice are benign to the long term value recognized by the market. We are staunch in our support that fundamentals improve the efficiency of an investor's portfolio over time. Particularly within the context of the current economic environment, we anticipate that high active share, concentrated, high conviction, fundamental and valuation based portfolios will outperform both their peer group and indices over time.

[2] https://www.realvision.com/channel/realvision/videos/000e8bb7d4c84206b7eddcdd6a1725de
[3] Furey Research Partners, High Passive Ownership Stocks Outperform & Low Ones U/P, Hurting Active MGMT
[4] Chart prepared by New Albion Partners, LLC