BOWLING
PORTFOLIO MANAGEMENT LLC

"Price is what you pay, value is what you get" – Warren Buffet

We normally begin the letter by summarizing the financial markets and move on to discussing topics that we know our clients are seeing in the media. However we are going to spend this entire newsletter instead discussing the elephant in the room; we are value investors and value investing is out of favor. Significantly. So we are swimming upstream, flying into a headwind, etc. It's not the first time this has happened and it will also not be the last. This is cyclical, not structural, and it will change as it always has in the past. "This time is different" never is. Value investing has outperformed growth investing over the long term in every academic study we have seen. The value investor is the tortoise to the growth investor's hare. We know who eventually wins.

As a testimony to just how aberrational and abnormal this growth dominated market has truly become, we would point out that just three stocks (Amazon, Netflix, and Microsoft) together this year are responsible for 71 percent of the S&P 500 returns and for 78 percent of Nasdaq 100 returns. When just three more (Apple, Facebook and Alphabet) are included, these six (six!) stocks make up 98 percent of S&P 500 returns and 105 percent of Nasdaq 100 returns. Truly astonishing.

The chart below shows the astounding outperformance of growth stocks versus value stocks over the last 6 quarters.

Russell 1000 Growth Index Return since 1/1/17	Russell 1000 Value Index Return	Difference
39.66%	11.74%	**27.92%**

The 6 consecutive quarters of outperformance by growth stocks vs. value stocks is unprecedented in modern history, and the differential you see in the chart above was surpassed only during the 6 quarters in the 1999/2000 period when the NASDAQ was going wild (and only by a whisker). These things always revert, and giving money to a value manager like Bowling would have been a great move in 2000. We feel the exact same way today.

The Russell 1000 Growth index returned 5.76% for the second quarter of 2018 versus 1.18% for the Russell 1000 Value index. This was the 6th straight quarter of outperformance by growth stocks, and the 11th out of the last 14. Over this 6-quarter period, the Russell 1000 Growth index has outperformed the Russell 1000 Value index by an astounding 27.9% (39.6% cumulative return for growth stocks versus 11.7% for value)! To put this in historical perspective, this is the first time in at least 38 years that we have seen 6 consecutive quarters of outperformance by growth stocks in the large cap universe!

Russell began tracking the growth and value subsectors of the Russell 1000 in 1979, and until now the longest such streak of outperformance by growth stocks was the 5-quarter period ending in March of 1999 (which ultimately led to growth stocks outperforming in 9 out of 10 quarters through June of 2000). As we all know, this synchronized period of outperformance in large cap growth stocks did not end well for people holding those types of stocks, and value stocks went on to outperform growth stocks by 63% over the subsequent 9 months beginning in July of 2000. We do want to clarify that stock market valuations overall are nowhere near where they were in 2000 (the Russell 1000's current P/E ratio is about half of what it was in 2000). We are simply saying that at some point there has to be a reversion which will favor value stocks (and managers like Bowling).

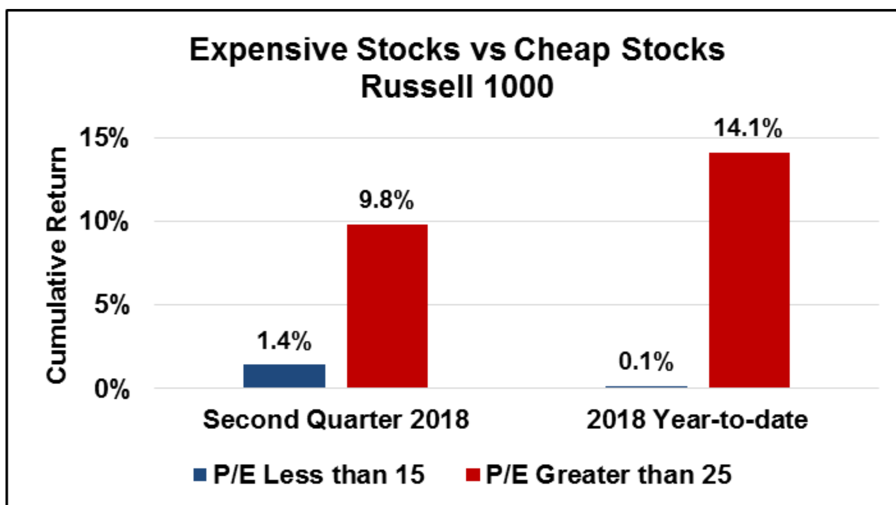
The second quarter, while positive in nominal terms, was a difficult quarter for us relative to the broad market indexes. Bowling utilizes a quantitative investment process that emphasizes a value foundation, while also requiring the stocks selected to have metrics like dividend growth rates, return on equity, and earnings quality to be higher than the market averages. These things have all been academically proven to provide superior investment results over time, and it also seems intuitive that a portfolio with these types of metrics would tend to outperform over the long run (and since inception of our stock portfolios this has in-fact been the case). However, we are currently in an environment where the market is favoring expensive, low quality stocks with low return on equity (among other factors we look at). This is temporary and will pass, but doesn't make the current period any less painful. We will spend the bulk of this newsletter diving deeper into the current market environment, and providing historical data which will explain why the best plan of action is simply to stay the course.

In a nutshell, the strategy that is working right now in the stock market is buying low quality, expensive stocks that have appreciated rapidly over the past year. In fact, the top 10 performers in the Russell 1000 year-to-date are currently trading at an average forward P/E ratio of 60, compared to an average of 16.4 for the index overall. This is not what Bowling does and will never be what we do, simply because we know from decades of experience that this is a losing strategy in the long run. In fact, buying an investment simply because it has recently gone up in value can be a dangerous proposition. Earlier this year Bitcoin had an enormous amount of price momentum and seemed like an easy way to make quick money, until it wasn't and dropped 70% in less than 6 months. In the late 1990's technology stocks were expensive and had an enormous amount of price momentum, until they didn't and the NASDAQ ultimately dropped 78%. We are never going to play this game of musical chairs by chasing performance in expensive stocks.

One of Bowling's key tenets is a belief in a value approach that selects stocks that are trading at a discount to the overall market based on fundamentals such as price-earnings ratios and price-cash-flow ratios. The reason for this belief is simple: since Russell began tracking data in 1979, stocks that trade cheaply relative to these metrics (Russell 1000 Value) have outperformed stocks that are expensive relative to these metrics (Russell 1000 Growth) by a whopping 1,605%!

The reason for this persistent outperformance of inexpensive stocks really comes down to human emotion. Investors tend to overestimate the long term growth of companies that are currently doing very well (thus bidding up their stock prices to unreasonably high levels), and on the flip side tend to underestimate the long-term value of companies that may have just temporarily hit a weak period with regards to sales and earnings (thus depressing their stock prices). While this so-called "value approach" to stock selection has worked out well for our investors over the course of our firm, we have occasionally hit periods where this type of strategy temporarily goes out of favor.

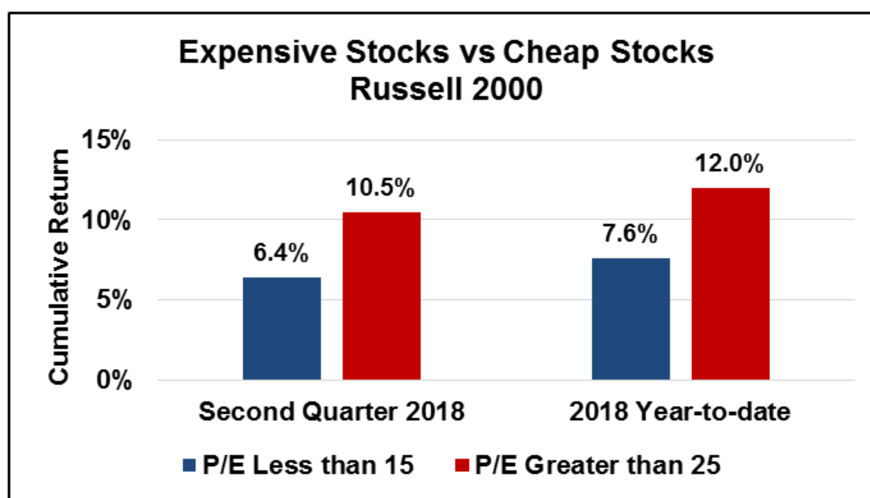
To put the current period in perspective, consider the following chart which shows the performance of the Russell 1000 constituents broken down by forward price/earnings ratio:



Source: Thomson Reuters

The current forward P/E ratio of the Russell 1000 is 16.6. As you can see in the chart above, over the last 6 months stocks that have traded at a P/E ratio greater than 25 (which would be 50% higher than the Russell 1000 average) have significantly outperformed stocks trading at a P/E ratio below 15 (which would represent a 10% discount to the market average). In fact, year-to-date the expensive stocks have returned 14.1% compared to just 0.1% for the cheap stocks. For comparison, the forward P/E ratio of our Large Cap Equity portfolio is 11.9, well below the Russell 1000 average.

Within the Russell 2000 small cap universe an identical trend has emerged, with the Russell 2000 Growth index also outperforming the Russell 2000 Value index for the 6th consecutive quarter, an event that has not occurred in at least 38 years! You are reading that correctly, in both the Russell 1000 (large cap) and Russell 2000 (small cap) universes, we have just seen an event that has not ever happened before! Never! The following chart shows the performance of expensive stocks compared to cheap stocks in the Russell 2000 small cap universe.

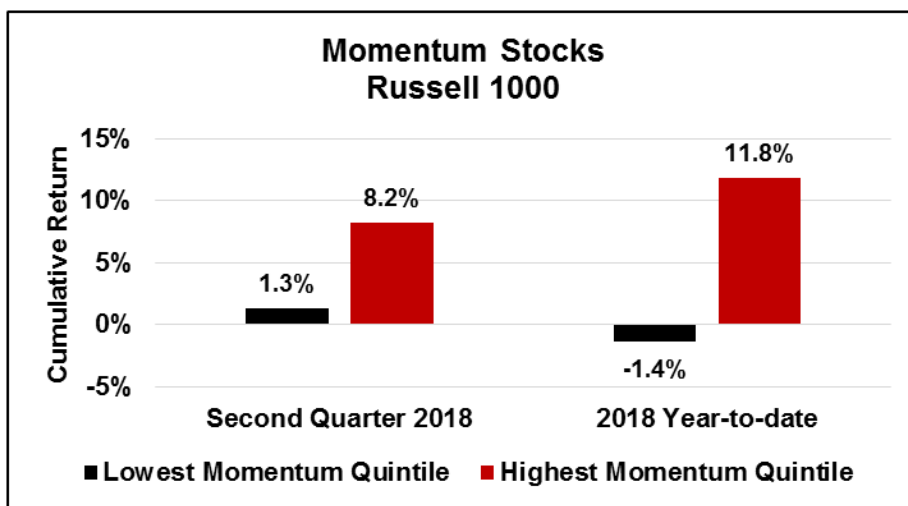


Source: Thomson Reuters

As with large caps, having a strategy based on buying cheap stocks has hurt us thus far in 2018 in our small cap portfolios (Bowling's Small Cap Equity portfolio has a forward P/E ratio of 12.6 compared to 23.5 for the Russell 2000). So as a manager who has always believed in a value foundation to our stock selection process, Bowling is left with two options. One option would be to abandon everything we have learned in our decades of stock market experience, start buying expensive stocks, and hope that things really are different this time. The other option, which is the one we choose, is to stay disciplined, continue to focus on stock market valuations, and wait for the superior fundamentals of our portfolio to play out.

Momentum Keeping on Keeping On

The current environment of expensive stocks outperforming has coincided with momentum-based investment strategies also having their day in the sun. Saying a stock has momentum is simply another way of saying that it has recently appreciated in value (stock price has gone up). The chart below shows how Russell 1000 stocks with the highest 12-month price momentum (labelled Highest Momentum Quintile below) have fared this year compared with stocks that have the lowest 12-month price momentum (labelled Lowest Momentum Quintile below).



Source: Thomson Reuters

As an investment manager, it's not difficult to see what's working right now in the stock markets. Simply buying expensive stocks that have done well over the previous 12 months would have been a winning strategy this year. Stocks with the highest amount of momentum within the Russell 1000 have returned 11.8% year-to-date versus -1.4% for stocks with the lowest amount of momentum. The problem, from our perspective, is that we know from decades of experience that simply buying stocks with the strongest price momentum is not a recipe for long term outperformance. In fact, ignoring valuations and buying an investment simply based on strong price momentum can be hazardous to an investor's portfolio, as we have seen so many times in the past (i.e., tech stocks in the late 90's, real estate in the mid 2000's, gold in 2009, Bitcoin earlier this year.)

Equal Weight vs Market Weight S&P 500

One other area that has hurt our performance recently, although not to the degree that the outperformance of expensive stocks has, is our average company size versus the index. The S&P 500 and Russell 1000 are market cap weighted indexes. This means that if you invested $500 in an S&P 500 index fund, you would not be investing $1 in each of the 500 constituents of the index. Instead, the amount that would be invested in each company would be proportional to the size of each company's value in the stock market (market capitalization). Within the S&P 500, half of the total market cap is in the top 51 companies, leaving the other 449 under-represented. By comparison, the bottom 51 companies only make up 1.52% of the index. The problem with this approach is that over the long haul, the smallest companies in the index have tended to outperform the larger companies in the index by a fair margin.

Since 1990 a portfolio that equally weighted each company in the S&P 500 index would have returned 1,947%, versus 1,310% for the market-weighted S&P 500 index. Over the last 18 months, however, this relationship is upside down with the equal-weight index underperforming by more than 4%. Bowling's process does not discriminate based on company size and our portfolio generally has more representation (on a percentage basis) in the smaller companies in the index than the major market indexes. The Russell 1000 has approximately 50% of its weighting in the top 67 companies and 50% in the other 933. Our Large Cap portfolio, however, has only 33% of it's weighting in the top 67 companies and 67% in the other 933.

A final factor that has negatively impacted our portfolios, and really goes hand in hand with the outperformance of growth and value stocks, is the fact that low quality stocks have outperformed significantly thus far in 2018. Quality ratings are determined by things like financial strength, debt level, earnings history, and industry stability. Bowling's portfolios emphasize quality. However according to Ford Equity Research, companies in their highest quintile of quality ratings have underperformed companies in their lowest quintile of quality ratings by a whopping 9.9% through the first 6 months of the year.

While we recognize that the relative underperformance of late is frustrating, we simply can't begin gambling our clients' well-earned money on expensive, low quality stocks just because they happen to be going up in value. It's not in our DNA, it's not what our clients expect of us, and it's something that we will never do. We have history on our side with our value approach and appreciate your patience while the fundamentals of our portfolio play out.

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