MORNINGSTAR Managed Portfolios

Investment Insights

Our Perspective: Is the Stock Market Rebound Overdone?

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Introduction

We've heard questions from many clients about why the market is doing so well right now given how bad the economy is, and whether we will see the lows of March retested.

They're good questions, but they might not have clear-cut answers for those who want certainty. We'll discuss three points imbedded in the questions.

Key Takeaways

- Markets are unpredictable, especially in the short term. This means we should be prepared to see many different outcomes, including what we've seen in recent months.
- Markets predict the economy, not the other way around. Don't expect the economy to improve because the stock market has risen.
- What is a market? An index's performance can hide the idiosyncrasies of underlying sectors and types of stocks.
- In our view, stocks that have fallen more or recovered less often have greater potential for future gains.

Point 1: Markets Are Unpredictable in the Short Term

This point is perhaps obvious, yet there seems to be no end to the appetite for predictions from investment managers. It's not just investing—anyone who watches sports on television fully knows that a) the unpredictable seems to happen a lot, b) humans' ability to predict any short-term outcome is very limited, and c) we still love to hear and make predictions.

In the short-term, one should be prepared for a wide range of outcomes in markets. Yet, we are often surprised at what markets do. Being surprised implies a level of confidence in our expectation that is probably misplaced. So, not only are markets unpredictable in the short term, we are also overconfident in our or others' ability to predict.

With investments, we try to keep a humble confidence about the long-term path of markets. History has shown time and again that market declines are eventually repaired by rebounds and that the general direction of stocks in aggregate is up, as long as their underlying companies are profitable and managements continue to allocate capital so that its growth compounds. The path however is far from smooth and even.

We do find that market prices will depart from market fundamentals, or the aggregate cash flows produced by companies. When prices are below what we think a stock or market is worth, all else equal, we'll typically find that to be an attractive investment. This doesn't require accurate short-term predictions.

Point 2: Markets Predict the Economy

Bill Miller, the famous value investor who founded Legg Mason Capital Management and later Miller Value Partners, observed that markets predict the economy rather than the economy predicting markets. Economic data is historical—it's backward-looking—while markets are forward-looking. This explains why markets typically rebound before a recession is over, but it certainly doesn't mean markets are always right.

Is it true today—have markets correctly seen that the economic impact from COVID-19 will be less than thought in March? We just don't know.

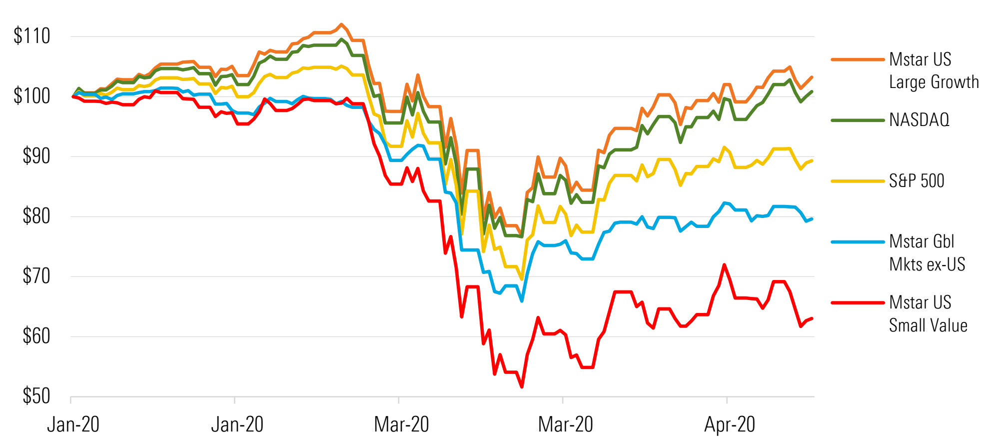
We do believe, however, that buying assets when they're attractively priced is usually well-rewarded. Also, doing so removes the need to be right about predictions. Even if markets test new lows, we think they'll eventually recover and assets bought at attractive prices will do well—regardless of whether they were bought at the most attractive price or not.

Point 3: A Market Is More Than an Index

The idea of "the market" is a tricky one, and what we say about a market can depend on how it's defined. So it's important to understand what's within an index before you talk about it—or invest in it.

Exhibit 1 illustrates how the headline performance number for an index that's meant to represent U.S. stocks, like the S&P 500, doesn't tell the full story about the investable universe. Small-cap value stocks

Exhibit 1 YTD Returns Have Diverged for U.S. Large Growth, Small Value



Source: Morningstar Direct. Data as of 05/15/2020. See Disclosures for index descriptions.

have lagged large-cap growth stocks by a wide margin year to date, and the S&P 500 has well outpaced international stocks, represented by the Morningstar Global Markets ex-US Index.

Also, the S&P 500 itself is an agglomeration of other markets, one that changes over time. The composition of the S&P 500 has become increasingly dominated by stocks that are doing well in the current environment because they benefit from work-from-home consumers or are internet-related, have strong balance sheets, benefit from globally diversified revenues, or their businesses are defensive by nature (meaning demand for their products is less dependent on the strength of the economy).

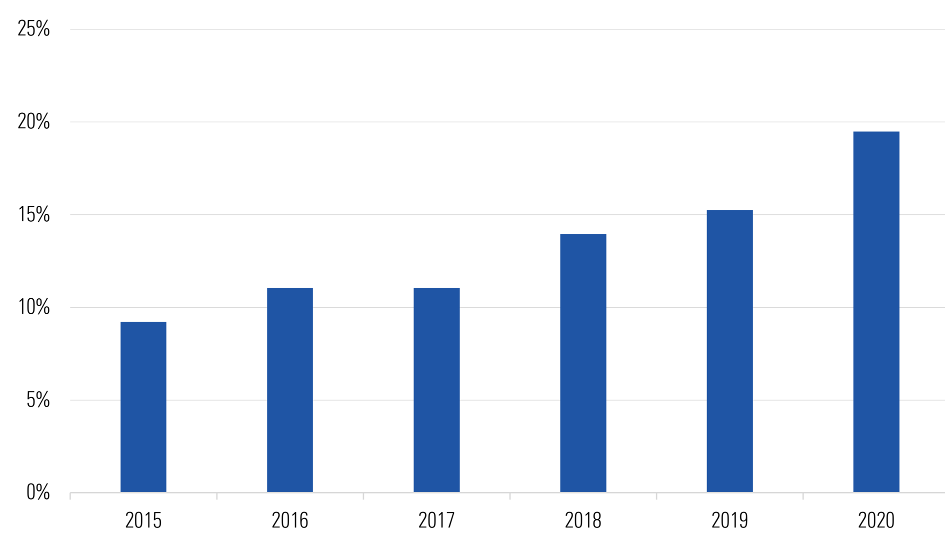
Most other stocks are down, some by a lot. So, while it feels like some parts of the market are doing too well currently, other parts are pricing in some negative outcomes like energy companies and banks, and outright disaster for airlines, hotels, and cruise lines.

The Flaw of Averages

This is another example of the flaw of averages. When you add market-cap weighting—or the fact that larger companies make up more of the total worth of a market—it's the flaw of averages on steroids.

The flaw of averages is illustrated by the man who sticks his feet in the freezer and his head in the oven so he can feel comfortable, on average. To give you a sense of the "the oven" in the U.S. stock market, Exhibit 2 shows the weighting in the S&P 500 of five big tech stocks: Facebook, Amazon, Microsoft, Apple, and Google or Alphabet. We think all these firms benefit from the positives being rewarded by today's markets mentioned earlier—internet-based and global businesses that are benefitting from the work-from-home environment, and they all have strong balance sheets. Even though they're technology stocks, not defensives, investors aren't treating them as cyclical stocks.

Exhibit 2 Tech Giants' Share of S&P 500 Is Approaching 20%



Source: Morningstar Direct. Combined share of Facebook Inc., Amazon.com, Microsoft Corp. Apple Inc., and "Google" (GOOGL & GOOG, class A and C shares for Alphabet Inc.) in the S&P 500 as of 03/31 for each year shown.

What Does This Mean for Portfolios?

While we will never have a satisfactory answer to the question of what is driving the market, we do think one can respond to the prices and opportunities presented.

The market is facing a wide range of possible economic outcomes with more uncertainty than usual. In the wisdom of the crowd model, the crowd's accuracy is driven by the difference of guesses and the accuracy of the individuals' guesses. We don’t see anything to suggest a greater diversity among guessers, and most investors would say their guesses have a wider range than normal, so the average accuracy may be much lower than normal.

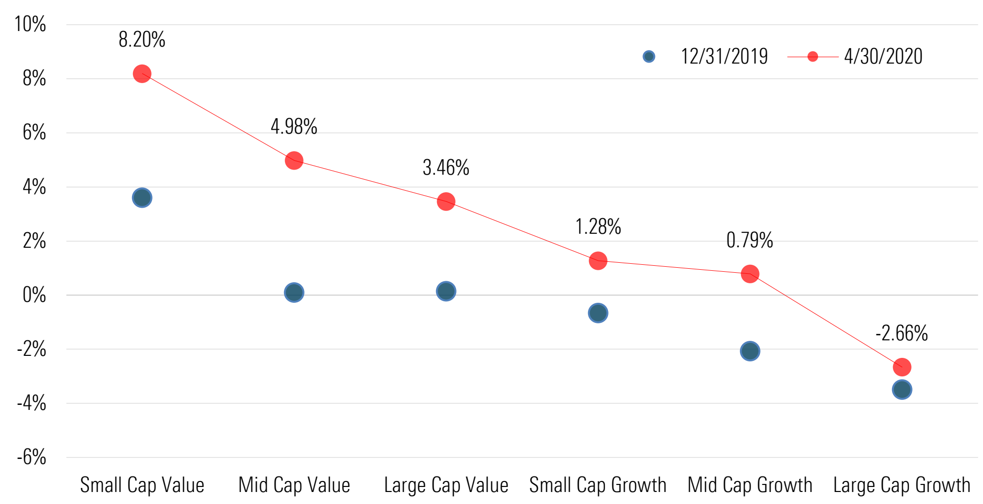
This means the market’s accuracy may be hindered and, using the wisdom of the crowds metaphor, it may have lost a few IQ points. We think it also could mean investment opportunity for investors willing to be different from the crowd.

For those businesses that are at higher stock prices than they were at the end of January 2020, one has to wonder whether this environment should call for higher valuations. Mark us as skeptical, but there are still select opportunities.

We find those opportunities through our valuation-driven investment approach. Our valuation research leads to calculations of the returns we think an asset class will experience over each of the next 10 years, averaged and adjusted for inflation.

As shown in Exhibit 3, U.S. small-cap value stocks are poised for much higher returns—according to our valuation-based, forward-looking return estimates—than U.S. large-cap growth stocks.

Exhibit 3 Our Estimates Show Far Better Expected Returns From Small Value Than Large Growth



Source: Morningstar Investment Management. For illustrative purposes only. Expected return estimates are forecasts based on our research and beliefs and do not guarantee future results; they estimate annual inflation-adjusted performance over the next full market cycle (about five to 10 years). Data as of 03/31/2020.

We chose to show these valuation-implied return forecasts for U.S. small value versus U.S. large growth to stick with the theme above. We're also seeing similar gaps between U.S. and international stocks and among sectors, with the energy and financials sectors being priced for the best returns, according to our calculations.

In our opinion, market timing is not possible, however prospectively, we think the returns for value, international, and energy stocks in U.S. dollars at current prices look attractive for a long-term U.S. investor.

Disclosures

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The indexes noted are unmanaged and cannot be directly invested in. Individual index performance is provided as a reference only. Since indexes and/or composition levels may change over time, actual return and risk characteristics may be higher or lower than those presented. Although index performance data is gathered from reliable sources, Morningstar Investment Management cannot guarantee its accuracy, completeness or reliability.

Index Descriptions
Morningstar US Large Growth TR USD - The index measures the performance of US large-cap stocks that are expected to grow at a faster pace than the rest of the market as measured by forward earnings, historical earnings, book value, cash flow and sales.

NASDAQ Composite – The index measures the performance of all domestic and international based common type stocks listed on the NASDAQ Stock Market. It includes common stocks, ordinary shares, ADRs, shares of beneficial interest or limited partnership interests and tracking stocks. The index is market capitalization-weighted.

S&P 500 TR USD - The index measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid 1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

Morningstar Global Markets ex-US GR USD - The index measures the performance of the stocks located in the developed and emerging countries across the world (excluding the United States) as defined by Morningstar. Stocks in the index are weighted by their float capital, which removes corporate cross ownership, government holdings and other locked-in shares. This index does not incorporate Environmental, Social, or Governance (ESG) criteria.

Morningstar US Small Value TR USD - The index provides a comprehensive depiction of the performance and fundamental characteristics of the Small Value segment of U.S. equity markets.

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Drawing on our core capabilities in asset allocation, investment selection, and portfolio construction, Morningstar's Investment Management group provides a global point of view and local market experience. Our investment professionals, located around the world, are guided by core principles focused on long-term investment results and helping end investors reach their financial goals. Built around world-class investment strategies and harnessing the global resources of Morningstar, Inc., our investment offerings support financial advisors, institutions, and the investors they serve.

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