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Maclura Investments Mid-Quarter Update

The Business of the American People is Alive and Well

Clay Brethour, CFA

“It is probable that a press which maintains an intimate touch with the business currents of the nation is likely to be more reliable than it would be if it were a stranger to these influences. After all, the chief business of the American people is business. They are profoundly concerned with buying, selling, investing and prospering in the world.” President Calvin Coolidge in his Presidential address to the American Society of Newspaper Editors on January 17, 1925.

Calvin Coolidge, the 13th President of the United States, was known for being brief with his words and a commonsense, sensible statemen when governing. Those traits seem void in the current environment from both parties as this divided nation heads towards an election this November. But his quote above came to mind as I contemplated the status of the US economy portrayed by corporate America through their financial results and commentary, versus what has been portrayed through the media, and I see the rigid dichotomy between the two.

On the one hand, the press has been overly negative on the status of the economy, continuously highlighting the impact from the mandatory shutdown of the economy in March and the resulting dire aftermath. After listening to countless company management conference calls and reviewing second quarter financial results of hundreds of companies, I conclude a much different picture than is being portrayed by the media. The pandemic has acted as a catalyst to accelerate the adoption of new technologies and operating models that would have otherwise taken years to be incorporated into businesses.

Typically, with abrupt changes in the economy, analysts tend to overestimate changes within their financial projections for the companies they follow, and the recent quarter results were no exception. Factset, a global provider of integrated financial information, reported that since it began tracking its actual versus estimated quarterly financial results metric in 2008, the recent quarter has been the highest percentage of companies beating Earnings Per Share (EPS) projections at approximately 83%. Additionally, 64% reported better revenues than expected.

As shown in the table below, the returns quarter-to-date have been positive across all market cap benchmarks for both growth and value stocks. From a general market perspective, the Morningstar US Market Index was up 9.17% quarter-to-date and 5.78% year-to-date. Investors need to be cognizant that benchmarks are good indicators of directional movements of the markets they represent, but the weighting within the benchmarks can skew the returns significantly. For instance, in the Morningstar Large Growth benchmark, five stocks represent nearly 25% of the benchmark. The S&P 500 ten biggest firms now comprise of approximately 29% of the index, the highest percentage in the past 40 years. It is the opinion of Maclura Investments that this level of concentration is not prudent portfolio management for individual investors wishing to build and preserve wealth. Regardless of value or growth biases, the market has had overall positive returns across the board for most equity investors during the quarter to date.

							2020			
	Morningstar Index Market Returns	2015	2016	2017	2018	2019	1st Qtr.	2nd Qtr.	3rd Qtr as of 8/15	YTD as of 8/15
Growth	U.S. Growth	5.54%	3.16%	29.52%	0.78%	35.90%	-11.50%	29.86%	8.84%	25.08%
	Large Growth	7.71%	1.79%	31.15%	2.94%	33.81%	-11.51%	26.60%	11.92%	22.43%
	Mid Growth	-0.71%	6.46%	25.67%	-3.16%	36.01%	-17.00%	34.66%	7.84%	20.53%
	Small Growth	-0.18%	9.61%	23.77%	-5.67%	27.60%	-21.45%	32.84%	8.06%	12.76%
Value	U.S. Value	-2.16%	20.79%	14.23%	-7.51%	25.09%	-28.43%	13.82%	6.53%	-13.21%
	Large Value	-1.43%	18.91%	15.09%	-5.90%	25.70%	-25.10%	12.45%	5.53%	-13.25%
	Mid Value	-2.57%	25.21%	13.02%	-10.63%	24.81%	-35.52%	18.78%	8.57%	-16.85%
	Small Value	-8.65%	27.96%	8.40%	-16.61%	19.96%	-39.68%	21.85%	9.96%	-19.18%

The evolution of business operations has been fast moving over the past several months due to the Covid-19 pandemic. Healthcare has seen a significant uptick in "virtual care". Unitedhealth Group (UNH) facilitated more than 4 million digital care visits at peak care system closures earlier this year in April. This is nearly 30 times the number of visits the company enabled in January. Remote monitoring of patients will continue to be a driver within healthcare for companies such as Dexcom (DXCM), through its continuous glucose monitoring technology, or Abbott (ABT), which recently received approval of Gallant systems, its next-generation heart rhythm devices that feature Bluetooth connectivity for continuous remote monitoring.

Social distancing is even making its way into the consumer space as companies figure out how to distribute their products to consumers while prioritizing health, safety, and hygiene with contactless solutions. Coca-Cola (KO) announced last month the introduction of touchless freestyle machines in the United States which allow consumers to choose and pour drinks from their phones without the need to create an account or download an app. One of the best performing consumer stocks quarter-to-date is Tesla (TSLA) as it posted its fourth consecutive quarter of profit, making it eligible for inclusion into the S&P 500.

The skeptical investors would point to Tesla's profit in the most recent quarter being helped by the sale of $428 million in emissions credits to other automakers who needed them to meet regulatory standards than actually from selling vehicles as being less than optimal, but CEO Elon Musk has nonetheless managed to change the automotive industry from being about hardware to now being about software, and others will follow. On Tesla's recent conference call, management discussed the monetizing of its installed base through its over-the-air software update ability, with the largest opportunity in the near-term being Full Self Driving technology. Tesla will be giving consumers the ability to upgrade their vehicles through an app, whether it is to increase the driving range of the vehicle, acceleration boost, or gaming software to play while the vehicle is driving itself, the business model changes from a one-time monetary event between the company and the consumer, to future commerce enticements of high margin nature. We believe other auto manufacturers will follow.

While investing at current levels in Tesla is not for the faint of heart, there are other avenues to gain exposure to this trend, such as a semiconductor company historically focused on smartphones, Skyworks (SWKS). Through its advanced wireless technology, it is enabling new usage cases not only in automotive, but also industrial, aerospace, and defense in the expanding, connected economy.

While most consumers think of electric cars as the way of the future, and we would agree, hydrogen is likely to be the future choice for commercial and public transportation. In July, Air Products & Chemicals (APD) announced an agreement to build a world-scale green ammonia production facility, powered by renewable electricity, for export to global hydrogen markets. The significance of this announcement is the use of the word "green." Throughout the whole process of making and distributing the hydrogen, it will be carbon-free in a product that can easily and commercially be shipped around the world with available technology and available ships. It will still take a decade or more before this has a significant impact, but this technology is coming. Energy companies are under enormous pressure by the investment community to cater to the environmental, social, and corporate governances' standards that are driving capital allocations, and we would expect to continue to see technological advancements to help "clean" the industry while the world continues to have an abundant supply of energy.

These are just a sample of the innovative trends flourishing in the economy, and as watcher of the market for nearly three decades, these are truly exciting times to be an investor. At Maclura Investments, we take a long-term approach to investing and seek to identify investment opportunities that have secular tailwinds to provide growth regardless of the condition of the overall economy. While valuations may seem stretched at current levels (forward price to earnings (PE) multiple of 22x for the S&P 500), when compared to historical averages, with the current low interest rates, we would disagree and continue to believe that selective investments in equities will provide the greatest return long-term from current levels. As of August 15th, the US 10-year treasury was yielding 0.68%, hardly an acceptable return to build wealth. If an investor would apply the same valuation technique to the US Treasury by using the PE multiple, the PE would be 147x. (the inverse of the PE multiple is the return on invested capital, so the calculation of the US treasury PE multiple would be 1/.0068 = 147x).

Of course, PE multiples aren't commonly used to evaluate the attractiveness of fixed income investments, but it's a simplistic way to illustrate the lack of alternatives to equity investments, which we believe has resulted in the resumption of the 10-year bull market. If the 10-year treasury yield returned to a pre-2009 level of 3 to 5% (an equivalent PE multiple of 33x to 20x), then fixed income would become an attractive alternative to the current equity market and PE multiples would likely experience downward pressure. From the message communicated from the Federal Reserve, the likelihood of rates returning to that level in the foreseeable future is slim.

President Coolidge's advice to President-elect Hebert Hoover in 1929 seems applicable to today's investor, "If you see ten troubles coming down the road, you can be sure that nine of them will run into a ditch before they reach you." We continue to advise investors to look beyond the short-sightedness and biases of the news cycle and remain focused on the long-term opportunities abounding in the market today.