Perkins
—JANUS HENDERSON—

CIO OUTLOOK

UNCOMMON VALUE℠

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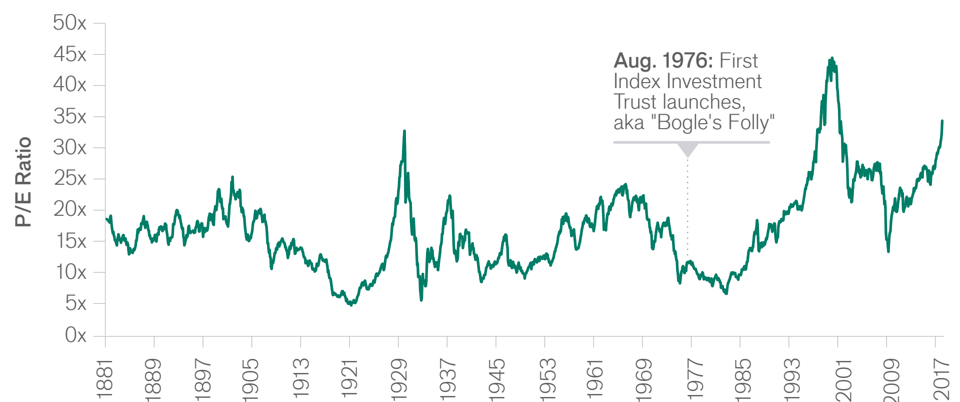
OFF THE BEATEN PATH

"I wish I knew where I was going to die, and then I'd never go there." Charlie Munger, vice chairman of Berkshire Hathaway and Warren Buffett's longtime business partner, has through the years used this notion to describe an approach to problem solving which he refers to as inverting or addressing backward. That is to say, instead of asking how to create X, turn the question around and study how to create non-X.[1] Munger suggests that inverting in this manner is particularly useful when approaching hard problems.

Let's give it a try. Often investors ask themselves, "How can I achieve great returns?" That's a hard problem, so instead invert and ask, "How can I achieve non-great returns?" Or, if you prefer, "How can I achieve disastrous returns?" There are of course a variety of ways to achieve non-great returns. Purchasing stock of a company with an excessively leveraged balance sheet just prior to encountering operating difficulties is one example. Buying a firm facing escalating industry pressures but having no competitive moat to support it is another.

A third method of achieving non-great returns is particularly relevant today: overpaying for an asset. Both logic and experience are clear on this point. Pay too rich a valuation and returns will ultimately suffer. Investors would do well to recognize that global stocks are expensive, and that the U.S. market, in particular, is the second- or third-most expensive in its long history. Therefore, not only is the forward return outlook modest, but the downside risk should the market revert to merely average historical valuation has rarely been greater. Amid the bullish excitement, many investors are seemingly forgetting to ask themselves, "How can I achieve disastrous returns?" and are simply buying the extremely expensive U.S. market via passive index funds and ETFs, which will by design capture 100% of any downside that materializes in the years ahead (along with 100% of the upside), not accounting for fees. Significant drawdowns – and the damage they inflict on portfolios, spending/retirement plans, etc. – could be considered the financial equivalent of Munger's "death," and investors should carefully focus on never going there.

U.S. CYCLICALLY ADJUSTED PRICE-TO-EARNINGS (P/E) RATIO



Source: http://www.econ.yale.edu/~shiller/data.htm, Vanguard. As of 01/31/2018.
Notes: The cyclically adjusted P/E ratio is defined as price divided by the average of 10 years of earnings, adjusted for inflation. Data shown are for the S&P 500® Index.

1. https://www.biznews.com/thought-leaders/1986/06/13/charlie-mungers-speech-to-the-harvard-school-june-1986/

> "In navigating today's great bull market, we believe that the further a stock is from the optimistic headlines, the better."

Still, the exercise of considering what one shouldn't do leaves one wanting more. A particular area of current interest at Perkins is off-the-beaten-path-type securities. We believe that less mainstream holdings may be less exposed to the general bullishness we observe, and crucially less exposed to a reversal in the level of bullishness. Our research efforts are increasingly focused on stocks with minimal Wall Street/sell-side analyst coverage, management teams which are not overly promotional, and niche businesses with secular business drivers. As an example, while the Las Vegas casino may be well known and "mainstream," perhaps the Korean counterpart is more obscure, and therefore potentially the better bargain. Instead of the well-known, diversified chemical company benefiting from current/cyclical dynamics, consider the niche operator benefiting from structural trends, and so on. In navigating today's great bull market, we believe that the further a stock is from the optimistic headlines, the better.

Extending this idea to portfolio construction, we favor an eclectic mix of holdings. Yes, there will be favorite sectors (consumer staples) and individual holdings which should be bought with conviction. However, in such an expensive and seemingly uncertain market environment, remember to diversify. A healthy mix of different drivers of alpha has the potential to strengthen portfolios. A well-constructed portfolio should be able to withstand a variety of news headlines and potential economic outcomes, and not just the positive ones. Ultimately, as the market and many of its individual stock components become increasingly unattractive from a reward-to-risk standpoint, we want the portfolios we manage to be less like the market.

Looking back, the beginning of index fund investing was timed quite well. When Jack Bogle launched the First Index Investment Trust (now the Vanguard 500 Index Fund) in August 1976, the cyclically adjusted P/E ratio was 11.6x. While the market's valuation low wasn't put in until 1982, Bogle initially "bought" well below the then long-term average 15.1x, thus aiding his forward returns potential. Fast-forward to today and buyers of the original passive index fund are paying 34x, which, as shown in the chart, is historically expensive.

We believe that today's index fund buyers are, in a way, ignoring Munger's sage advice about inverting when trying to solve the hard problems as they forget to analyze what actions might lead to non-great returns. Instead, we suggest looking off the beaten path for stock ideas and building eclectic portfolios. Careful consideration of downside risk, along with attempting to position portfolios to reduce drawdown capture to well below 100%, are of paramount importance today.

Thank you for your investment with Perkins Investment Management.

Gregory Kolb
Chief Investment Officer,
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When valuations fall and market and economic conditions change it is possible for both actively and passively managed investments to lose value.

No investment strategy can ensure a profit or eliminate the risk of loss.

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Foreign securities are subject to additional risks including currency fluctuations, political and economic uncertainty, increased volatility, lower liquidity and differing financial and information reporting standards, all of which are magnified in emerging markets.

The consumer staples industries can be significantly affected by demographics and product trends, competitive pricing, food fads, marketing campaigns, environmental factors, and government regulation, the performance of the overall economy, interest rates, and consumer confidence.

Alpha compares risk-adjusted performance relative to an index. Positive alpha means outperformance on a risk-adjusted basis. **S&P 500® Index** reflects U.S. large-cap equity performance and represents broad U.S. equity market performance.

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