Perkins
—JANUS HENDERSON—

UNCOMMON VALUE℠

CIO OUTLOOK

Gregory Kolb, CFA
Chief Investment Officer,
Portfolio Manager

THE ZIGZAG PORTFOLIO

On a recent visit to the Chicago Botanic Garden – a highlight of our city – my oldest daughter and I spent some time enjoying the Japanese garden islands. Connecting two of them is the Zigzag Bridge, which, as the name suggests, is a bridge constructed in that odd pattern. A plaque at the base notes that humans can elude evil spirits by crossing a zigzag bridge because those spirits move only in a straight line. This is an ancient myth which, subject to interpretation, may hold useful wisdom. My take? "Straight line" portfolios that effectively assume the bull market of the past eight years will continue unimpeded are vulnerable to volatility and losses, which we can think of as evil spirits. Investors would do well to doubt the current positive trend and instead hold "zigzag" portfolios with the potential to traverse whatever comes next in the stock market.

The experience of the past 20 years shows clearly enough the dangers of "straight line" extrapolation *in both directions*. Remember those so-called new era tech, media and telecom stocks that led the market higher in the late 1990s? Or the gloom and doom surrounding the economy, housing and financial markets generally in 2008-2009? In both cases, the trend eventually changed. Investors who were unprepared likely suffered substantial losses and missed out on extraordinary gains. Calling tops and bottoms is of course highly speculative and subject to too many variables to form the basis of a serious investing strategy. However, current high valuations (with the inflation-adjusted U.S. Shiller price-to-earnings ratio at 30x) and earnings (with companies recently reporting new highs across the U.S., Europe and Japan), coupled with exceptionally accommodative central banks (globally) and years of market gains (also globally), suggest a degree of optimism in stock prices which is rare and unlikely to get much better, at least in a material and lasting way. Conversely, these circumstances also indicate the potential for significant drawdowns, which can be very damaging for savers/investors.

STRAIGHT LINE ASSUMPTIONS GONE WRONG
MSCI WORLD INDEX (7/31/1997-7/31/2017)

Source: Bloomberg

"A zigzag portfolio holds a well-balanced mix of stocks with many different drivers of alpha as an attempt to perform well, even if the trend changes."

A zigzag portfolio holds a well-balanced mix of stocks with many different drivers of alpha as an attempt to perform well, even if the trend changes. By consistently performing reasonably well – and avoiding the big drawdowns – the zigzag approach aims to come out ahead over time. The zigzag investor contemplates potentially meaningful changes on the horizon, and holds positions which may outperform in those possible scenarios. This is in contrast to the straight line approach, which bets more narrowly on recent winners, assuming rather naively that recent past will prove prologue. The zigzag investor asks: might the Bank of Japan reach the limits of its government bond buying program now that it holds in excess of 40% of that market, and if so, what are the ramifications? The straight line investor simply bets on more bond buying.

At Perkins, while we focus primarily on individual stocks, we believe it is important to pay careful attention to the big picture. Sometimes that is where the most important risks lurk. Key considerations at the macro level today include trade-offs between relatively expensive "stable" companies and cheaper "cyclical" firms, potentially changing central bank behavior in the capital markets, the ability of China to continue with its asset- and debt-intensive growth model, and whether President Donald Trump and the U.S. Congress will enact corporate tax cut and/or growth-inducing legislation.

We are also considering whether what has been will continue to be at the company and industry level. For example, much is changing in the consumer retail ecosystem and, while many related stocks are currently down-and-out, they may be value traps rather than true bargains. Similarly in media, technological change is having a big impact on many players and previously very profitable business models are experiencing significant threats. More generally, as we vet individual securities, we are especially attracted to strong balance sheets, entrenched competitive advantage, and reasonable – if not outright cheap – valuations in what we believe is a high-price/high-risk stock market environment. We also increasingly prize stocks that are off the beaten path and are thus somewhat less exposed to passive investment flows, which may not always continue to be significantly positive, as they have been recently.

The Chicago Botanic Garden's website notes a zigzag bridge also has a practical purpose: to slow your progress, encouraging you to enjoy the beauty around you. This notion seems especially relevant as summer draws to a close. Carefully consider the path forward for your investment portfolio so that you may reach your financial destination. And enjoy the richness of the remaining summer season.

Gregory Kolb
Chief Investment Officer,
Portfolio Manager

Investing involves risk, including the possible loss of principal and fluctuation of value.

There is no assurance that the investment process will consistently lead to successful investing. No investment strategy can ensure a profit or eliminate the risk of loss.

There is no assurance the stated objective(s) will be met.

A client commitment is not a guarantee that a stated objective will be met.

The views presented are as of the date published. They are for information purposes only and should not be used or construed as an offer to sell, a solicitation of an offer to buy, or a recommendation to buy, sell or hold any security, investment strategy or market sector. No forecasts can be guaranteed. Opinions and examples are meant as an illustration of broader themes, are not an indication of trading intent, and are subject to change at any time due to changes in market or economic conditions. There is no guarantee that the information supplied is accurate, complete, or timely, nor are there any warranties with regards to the results obtained from its use. It is not intended to indicate or imply that any illustration/example mentioned is now or was ever held in any portfolio. Past performance is no guarantee of future results. Investing involves risk, including the possible loss of principal and fluctuation of value.

MSCI World Index℠ reflects the equity market performance of global developed markets.

Alpha compares risk-adjusted performance relative to an index. Positive alpha means outperformance on a risk-adjusted basis.

Perkins Investment Management LLC is a subsidiary of Janus Henderson Group plc and serves as the sub-adviser on certain products.

C-0817-12114 08-30-18 188-15-32352 08-17