The Essex Exchange

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ESSEX INVESTMENT MANAGEMENT COMPANY, LLC

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Observations on a Long Bull Run

By: Robert J. Uek, Co-Chief Executive Officer & Senior Portfolio Manager

The third quarter of 2018 has witnessed the achievement of a number of meaningful milestones in our economy and the capital markets. In late August, the current bull market in US stocks officially became the longest on record at 3,543 days without a market correction greater than 20%. Further, the US economic recovery is approaching the longest on record, surpassed only by the expansion in the 1990s. Also during the quarter, we lapped the 10-year anniversary of the bankruptcy of Lehman Brothers, a key event in the significant sell-off in the stock market and near-collapse of the US financial system. Clearly the past decade has been an eventful and profitable period for those invested in stocks, particularly growth stocks. While these achievements are remarkable and could hardly have been envisioned when we were staring into a financial abyss a decade ago, the questions today are how much longer can we go on and how much better can things get. Of course, the answers to these questions are always unknowable in advance but there are a number of variables and metrics to consider.

Although we are in midst of the longest bull market, that doesn't necessarily mean we are at the end (but surely one would think we are closer to the end than we are the beginning). The duration of this current bull market might be historic, but the magnitude of the rise off the bottom is not a record. Since the bull market began on March 9, 2009 through the end of the third quarter of 2018, the S&P 500 Index has increased 330.7%, which is an annualized return of 16.5%. Bull markets in the past have risen as much as 418% (November 1990 to March 2000) and on an annualized basis, have generated annual returns as high as 26.7% (August 1982 to August 1987). Nor are we at market extremes in terms of valuation, according to Thomson Reuters I/B/E/S estimates, the S&P 500 Index currently trades at 18.9 times trailing earnings, which is above the long term average but well below market extremes. When taken in context with today's interest rates, the price-earnings ratio of the market appears well within historical norms. We take the greatest confidence in the fact that this current bull market has solid economic underpinnings. This market appreciation is not merely being driven by multiple expansion but is buttressed by healthy economic growth and improvement in the underlying corporate earnings. Typical economic expansions tend to end with excesses/imbalances and higher inflation rates, neither of which seems to be an imminent problem.

For many, this unique and extended run in both the economy and stock market seemingly has been unappreciated: cash levels remain high and money continues to flow out of active equity mutual funds. One of our favorite quotes is from legendary investor John Templeton: "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria". It doesn't feel like we are in the euphoria stage yet. As mentioned previously, market valuations are not overly expensive, market flows into equities have not been excessive, and, although there has been a pickup in the number of initial public offerings in 2018, the post-listing performance of these IPOs has been lackluster (the Renaissance US IPO Index has lagged the broader S&P 500 Index for both the past quarter and year to date).

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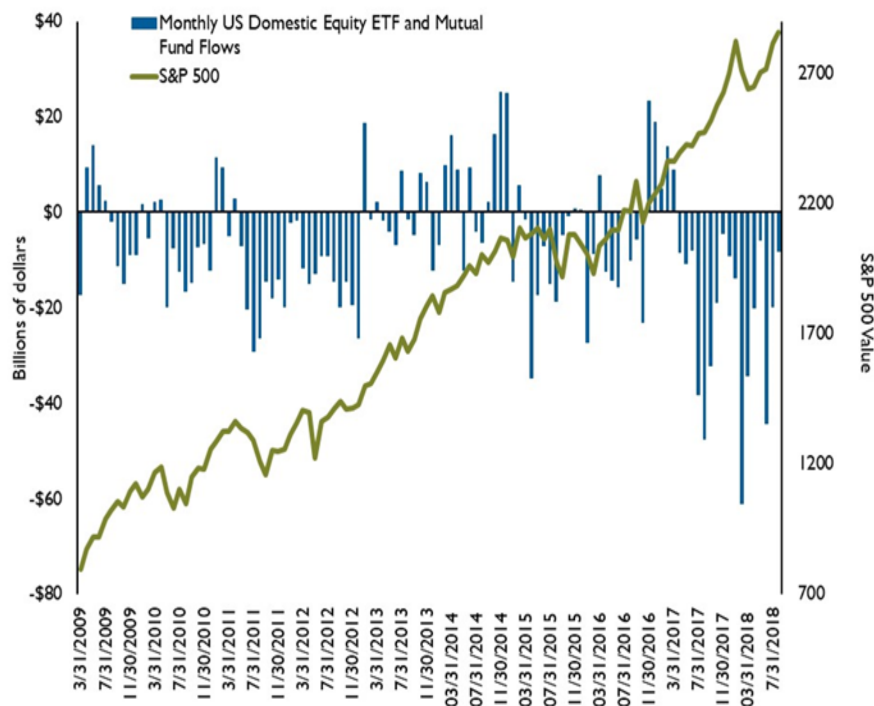

Source: FactSet and ICI Research

Sure, there have been pockets of hype over the past year, most notably in the bitcoin and cryptocurrencies at the end of last year and certain marijuana related stocks in the past couple of months, but overall, the stock market seems more rational than euphoric. Beyond stocks, we do observe some levels of frothiness in private equity (with PE firms announcing hundreds of billions of dollars of new funds this year alone) and in student lending and corporate debt levels. Further, the recent announcement from Softbank and its intention to raise $100 billion funds (targeting tech investments) every two years is worrisome from a "too few dollars chasing too few opportunities" perspective. We continue to monitor these areas closely.

The economic and stock market gains in the US are not being enjoyed globally. Through the end of the third quarter, the US stock market is one of the strongest in the world while most other major stock markets around the globe are in negative territory. Just a couple of years ago, many market observers (us included) were sanguine about the synchronized global economic recovery. At that time, the US, Japan, Europe and emerging markets all seemed to have recovered from the global financial crisis, many of the troubled banks had been recapitalized, and the vast majority of central banks were extremely accommodative. The outlook for healthy, balanced global growth was robust. Fast forward to today and the US looks like an island of economic strength and stability while growth in Asia and Europe has stalled out. Indeed, recent economic data in the US suggests an *accelerating* economy. But we ask ourselves if this de-coupling of economic growth and stock market performance can continue especially after considering that some 40% of revenues of companies in the S&P 500 is generated overseas.

The performance of emerging markets has been particularly poor of late. The MSCI Emerging Markets Index (consisting of stocks in 24 emerging markets, but the great majority of the Index is comprised of stocks from China, South Korea, Taiwan, India and Brazil) is down nearly 10% for the first three quarters of 2018. The sharp divergence in the performance of the US stock markets and Emerging markets is mainly caused by a fear of tariffs and trade wars and the potentially negative impact on the emerging economies like China that are highly dependent on exports to the US and other developed countries.

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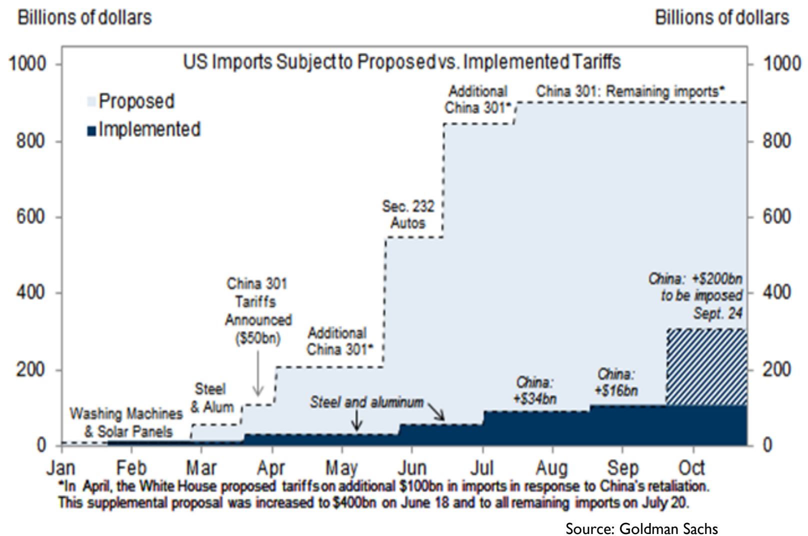
Trade barriers have been shown to cause slower growth and higher rates of inflation. Over the past 40 years, the rise of the emerging economies based on free trade and free flow of capital has had a major impact on global economic growth and inflationary (or lack thereof) trends. Any major change to trade policy that could upset this dynamic is an important development to monitor and one that could represent a major paradigm shift in the global competitiveness of economies.



Source: Goldman Sachs

One of the added challenges for an investor today is where to invest if one wants to take a defensive posture. Traditionally, when concerned about a weakening economy or stock market correction, an investor would turn to consumer staples and utility stocks. Today, we would argue that might not be the appropriate defensive game plan as many of the stalwarts in these industries are facing considerable risks that make their value proposition less certain than in the past. Within consumer staples, the rise of social media influencers and the lowering of the barriers to entry have allowed start-up companies to take market share from the behemoths. The traditional playbook of a Proctor & Gamble or Colgate has been to raise prices on products annually, tout "product innovation" to justify these price bumps, and then support the effort with massive advertising spend. But the rise of social media has given a voice to smaller companies offsetting the need to spend tens of millions of dollars on traditional advertising and allowing these start-ups to gain relevance today in a way that was not possible in the past. Cheaper and more powerful technology, as well as outsourced manufacturing and distribution through Amazon has further leveled the playing field for the smaller upstarts. This fragmentation of the market is great news for consumers who have more options at better price points, but it is a nightmare for the big consumer staples companies. Similarly, in the Utility sector, the traditional business models are being disrupted by the rise of renewable energy, the buildout of smaller, locally-based distributed energy facilities and increased concerns about the environmental impact of traditional utility infrastructure. Year to date, Consumer Staples has been the worst performing sector of the S&P 500 Index while the Utilities Index has a total return nearly 75% worse than the broader index.

Sometimes the best defense is a good offense. We continue to find attractively valued growth opportunities across a number of themes with strong secular tailwinds. For example, gene editing technology is allowing new drug development resulting in much more effective, highly targeted cures for difficult to treat diseases. Advances in battery technologies are leading to the development of cheaper and better performing electric vehicles. The on-shoring of manufacturing combined with low unemployment is requiring significant investments in factory automation and logistics. The rising challenge of water scarcity and crumbling infrastructure is being solved by new technological developments in water and wastewater treatment. Rapid advancements in computer power and artificial intelligence are opening new opportunities in data analysis positively affecting the product innovation and profitability of many companies and industries. In short, the economy remains robust, innovation is accelerating, and we are cautiously optimistic that we will be able to continue to find dynamic growth opportunities despite the age of the current bull.

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Essex Strategies

The Essex Micro Cap Growth, Small Growth and SMID Cap Growth strategies each share a common investment philosophy and process. Our team in Evanston is focused exclusively on managing long-only small growth strategies and has worked together for more than 15 years.

Micro Cap Growth: We look for under-followed, under-owned, under-appreciated companies & industries in early stages of acceleration.

Small Growth: The process focuses on identifying companies in an inefficient sector of the market at an inflection point where their growth rate is improving.

Small/Mid (SMID) Cap Growth: Our approach is to execute a systematic, fundamental process to find companies whose future growth prospects are not fully reflected in the price of the stock.

Global Environmental Opportunities Strategy (GEOS) operates at the nexus of environment and finance, investing in companies that enable greater natural resource and energy efficiency. GEOS is a listed-equity, global, all-cap strategy investing across nine environmental technology themes in long-only fashion with about 40 holdings. GEOS is clean technology and energy infrastructure-focused, with companies that exhibit generally-high growth rates.

Essex Research Strategy is co-managed by a team of investment professionals seeking growth equity opportunities across an all-cap universe. By employing fundamental top down economic and sector analysis with bottom-up stock picking skills, the strategy provides the investment team a wide framework in which to identify growth candidates regardless of market capitalization restraint. Individual client portfolios are offered in two profiles: aggressive growth or growth and income.

Essex Evolution Long Only is an aggressive all-cap strategy which primarily aims to uncover small and mid-sized companies that exhibit the potential for meaningful growth over time. Seeks to maximize returns by utilizing both fundamental and technical analysis with an emphasis on thematic investing and tactical market positioning. The Strategy is concentrated within 40-70 names and is sector agnostic.

Essex Evolution Long/Short strategy is an aggressive All-Cap equity strategy that aims to maximize returns by utilizing both fundamental and technical analysis with an emphasis on thematic investing and tactical market positioning. Specifically, we aim to understand key themes within dynamic sectors to capture the growth in those trends and utilize short positions to both hedge portfolio risk and exploit specific stock mispricing's.

Essex Global Life Sciences seeks capital appreciation by investing in both long and short positions of medical and life science companies. These companies are focused in the areas of drug discovery and distribution, the production of devices and instrumentation, delivery of health care services, and the development and implementation of medical information technology. Essex Global Life Sciences seeks to isolate the early signs of improving/deteriorating financial estimates and business conditions through a combination of fundamental research and overall industry expertise.

Growth Equity is an All-Cap strategy designed to provide investors with exposure to growth companies in a market capitalization range of $100 million and up. The strategy is a concentrated portfolio of 50-70 companies diversified across domestic industry sectors that show accelerating earnings and sustainable revenue growth. Individual client portfolios are offered in two profiles: aggressive growth or growth and income.

Please refer to our firm's website at www.essexinvest.com for more information about Essex and the strategies we manage.

ESSEX INVESTMENT MANAGEMENT COMPANY, LLC

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