Economic and Market Newsletter
Autumn 2018

HALLMARK CAPITAL MANAGEMENT, INC.
Integrity
Professionalism
Responsiveness

Hallmark Capital Management, Inc.
1195 Hamburg Turnpike
Wayne, New Jersey 07470
973-808-4144
www.hallcapmgt.com

LOGIC VS. EMOTIONS

Traditional economic theories were based on the premise that people made financial decisions only after they logically and rationally analyzed every piece of relevant information. This only served to prove that most economists lived in a world totally separate from the rest of humanity. In real life, if we all stopped to do a thorough analysis of the costs and benefits of every purchase, commerce would come to a grinding halt. Just sorting through the various plans and options of a new smartphone could be a complete showstopper all by itself! To get through the day, each of us has a list of mental shortcuts that allow us to navigate the choices in our financial lives. Studies done in the field of behavioral economics show that human emotions affect these decision-making shortcuts far more than we realize. In many cases, logic comes into play only as the means of rationalizing the decisions that were already made by our emotions. Sadly, even those with high native intelligence are not immune. In fact, evidence shows that smarter people tend to be swayed more by their emotions than the average because they are so much better at constructing rationalizations. This could be one of the reasons why so many investors, who should have known better, were swindled by Bernie Madoff.

On Wall Street, market observers have long noted the role that emotions play in driving stock prices. The first lesson most investors learn is the old saw that market cycles are propelled by the dual forces of greed and fear. While this saying incorporates a great deal of truth, it is also an oversimplification. Psychologists have found that other influences, including boredom, frustration, hope or envy also can be just as powerful as fear or greed when making investment decisions. Beyond emotions, studies in the field of behavioral finance have found that certain biases affect the way our minds process information. For example, recent events and experiences are more vivid and more strongly influence decisions than occurrences from long ago. Broader, but more superficial, information carries more weight than do details. People tend to react too slowly to changing conditions, anchoring their outlooks until their prior perceptions are overtaken by events. Most significantly, when investing, people tend to focus more on the outcomes of their choices, rather than the risks that were taken to achieve the results. The result of this mixture of emotions and biases is the tendency to make less than optimal investment decisions.

Some steps are available to help reduce these harmful effects, but they are limited. Patience, diligence and willpower simply cannot overcome the result of millions of years of evolution. Perhaps the most important tool to help counter the long list of human weaknesses is utilizing disciplined investment strategies. Certainly, those of us who work at Hallmark rely heavily on a framework of rule-based structures for determining the asset mix between stocks, bonds and cash, as well as a methodology for selecting stocks that is based upon solid fundamental principles.

FIGHTING COGNITIVE DISSONANCE

If the purpose of using an investment discipline is to help temper one's biases and emotions, then using them will likely cause a level of discomfort. If they are to work, at some point, the rules should force us to make decisions that are contrary to what we would really rather do. For example, diversification is a common sense idea to reduce investment risk that is almost universally accepted as a wise strategy. Yet, spreading investment dollars across a wider field also increases the chances of including the worst performing asset class in the portfolio. While most investors intellectually know the advantages of diversification, it feels unnatural to maintain a losing investment simply because it lowers the level of risk in the portfolio. The hardest part of using a disciplined approach is sticking with it, even when it is uncomfortable.

VALUE MANAGERS FEELING UNCOMFORTABLE

A key portion of our discipline here at Hallmark is incorporating each stock's Price/Earnings ratio into our screening mechanism. We look at a stock's business history and the expected rate of earnings growth, but all else being equal, our screen will favor a stock with a low P/E over one with a high P/E. We do this because stock-market data over many decades indicates that both the expected returns and the level of risk tend to be more favorable in portfolios constructed with low P/E stocks. After all, a disciplined investment approach should be based on criteria that have a history of adding value over a reasonable time horizon.

We certainly understand the attraction of growth investing. Who doesn't want to own companies increasing their earnings as fast as possible? Conceptually, it makes perfect sense to pay higher multiples of earnings for companies with solid balance sheets and bright futures. In practice, there have been problems with this approach, however. Firms earning above-average rates of return tend to attract competitors who want a "piece of the action." The subsequent fight for market share tends to cut into the leader's growth rate and hurt profitability. As firms continue to succeed, investors tend to become overly optimistic in their forecasts, leading them to push valuations up too far. When growth inevitably slows, the stocks can drop very far, very fast.

So far, 2018 is proving to be the exception that proves the rule. As we noted in our last client letter, highly valued growth stocks have led the markets by a large amount this year. The performance gap between growth and value widened even further in the third quarter. In fact, since the stock market bottomed at the end of the Financial Crisis, stocks of high P/E growth companies have had the longest winning streak against value stocks in the past century. Many traditional deep-value money managers that solely focus on deeply discounted valuations have lagged the broad market averages badly for a decade.

Fortunately, Hallmark uses a blended approach that takes both growth and value into account, so our record through the past decade has managed to keep pace with the broader averages. This year, however, the value component has been more of a negative factor than in the prior few years. Fortunately, our equity holdings are up this year, but not up as much as the broad market. A handful of disappointing selections set us back as well, making it harder to close the gap with the broad market. While a few quarters of underperformance normally would not rattle us too badly, we are analyzing the decade-long struggles of the value style very carefully.

DOES VALUE NO LONGER FIT?

Perhaps no other method of stock market investing has had the amount of exposure and notoriety as has the value style, backed up by years of outperformance and academic research. The most widely known investor today, Warren Buffett, has always been an adherent of a value-oriented approach. Value investing is not easy, however. It would be wonderful if all one had to do was buy inexpensive stocks and wait a short time for the market to re-price them to full value. Sadly, even well-chosen value stocks can languish for an extended period before their worth is recognized by other investors. In fact, academic studies have shown that a majority of the stocks in the value camp will underperform the market beyond most investors' conventional time horizons. The superior long-term results from the value style are derived from the smaller subset of companies whose stocks generate outsized returns. The resulting long periods of disappointing results may be one of the reasons behind the ultimate success of the value style, since so many investors do not have the tolerance to stay the course. Unfortunately, the value universe also includes many stocks that only appear to be cheap. What appear to be bargains, in reality, may be vastly overpriced, if the underlying companies are suffering from real problems. These types of stocks are referred to as "value traps" and most value managers have been caught by them, no matter how hard they try to avoid it.

Despite its long history of success, value's current reversal of fortune has led to a vigorous debate among investment professionals about the reasons. Is the shortfall just an anomaly that will naturally reverse itself, if given enough time … or has something fundamentally changed in the financial markets? Some argue that value style investing became overly popular, so its prior advantages were arbitraged away. Another theory is that the boom-and-bust cycles that used to drive the U.S. economy are no longer as frequent or severe, making P/E ratios less likely to revert toward the long-term averages. A third hypothesis is that technology changed the competitive environment for businesses, where the advantages of scale create a "winner-take-all" economy. Some analysts believe the trading structure of the stock market has been fundamentally altered by computer-generated orders. It is estimated that only about ten percent of all trading in stocks is set by actual human beings, the rest is done by machine. Bearish analysts believe that growth's outperformance is a signal that a recession is on the horizon. If investors believe we are near peak earnings, then they will assign a lower P/E ratio to economically sensitive stocks. Only those companies viewed as recession-resistant will be rewarded with higher valuations.

THE SCARCITY OF GROWTH

If we can add in our own two cents, we believe value's struggles are due to the tepid pace of this economic expansion. In a normal recovery, the economy initially rebounds robustly and the pace tends to be proportionally stronger after a deep recession. Typically then, a vast number of companies can post several quarters of very high earnings growth after the recession lows. At least for some period in a bull market, both growth and value stocks are usually able to show comparable rates of earnings improvements. This recovery has been so lackluster, however, that the more economically sensitive industrial and basic goods companies were unable to generate the typical strong earnings lift off the bottom. Slow economic growth led to years of low inflation and a long-term decline in bond yields, hurting finance and commodity companies that make up a large portion of the value universe. Growth became scarce and, like all desirable things in short supply, the price of growth went up. Investors have been willing to pay an ever-larger premium for the small group of companies that have been able to provide the kind of steady, high growth that they crave.

As a result, the relative valuation between growth and value stocks has widened to almost unheard of levels. In the U.S., the price-to-earnings gap between value and growth stocks over the past fifteen years has only been higher four percent of the time, according to data compiled by J. P. Morgan. Similar trends are also visible around the world. According to figures compiled by Sanford C. Bernstein, on a P/E basis the value gap globally between growth and value is at the 1st percentile within its historic range.

By now, value should be cheap enough to attract the attention of the investment community. Despite the wide disparity, this has yet to occur. If the comparative discount, by itself, will not be enough to turn the tide, it may take a stronger economy to serve as catalyst. As it turns out, the economic data has been getting stronger of late.

ECONOMY NEEDS TO AVOID A TRADE WAR

Real GDP growth is running near a five-year high, the unemployment rate is back to generational lows and wage gains are finally showing an improvement. Normally, business confidence would be buoyed by this kind of economic momentum, but the picture is more nuanced. The latest ***Beige Book*** from the Federal Reserve showed that several regions were reporting that rising uncertainties in the business community were affecting capital spending and expansion plans. The increasingly strident rhetoric about tariffs and trade, along with higher interest rates and rising oil prices have been enough to sap some of the enthusiasm necessary to sustain higher business investment. At this point, the uncertainty over trade has caused only postponements, with very few projects scaled back or eliminated. Perhaps the recent trade agreement with Mexico and Canada will begin to alleviate some of the stress.

WE STILL BELIEVE VALUE HAS A PLACE

While we will never be deep value managers, we still believe valuation is an important consideration when selecting stocks. This is not a decision we make lightly, however, we realize that investment tools can lose their effectiveness over time. When more and more of the trading on Wall Street is eventually directed by computer programs, then it is possible that the investment opportunities that arise from the anomalies created by human emotions and biases will gradually disappear. Until machine learning fully takes hold, however, the programs will still be written by human beings and the inherit foibles of our species will be included in the lines of code. In addition, the long-term efficacy of incorporating valuation into investment decisions goes well beyond the U.S. stock market. Value has proven an effective long-term tool in foreign stock markets, equity ETF selection, commodities, and real estate as well. Lastly, but perhaps more importantly, we believe that common sense reinforces the evidence that constructing a portfolio of above-average companies that are growing their earnings, yet sell at a reasonable multiple of earnings, will generate above-average risk-adjusted returns. We will always look for ways to refine and enhance our methods, but we believe the underlying fundamental strategy is sound.

Hallmark Capital Management, Inc. (Hallmark) is an investment adviser registered with the U.S. Securities and Exchange Commission. Registration with the SEC does not imply that Hallmark or any individual providing investment advisory services on behalf of Hallmark possess a certain level of skill or training. This Economic & Market Newsletter and its contents are for informational and educational purposes only. Any opinions, recommendations or indications of past performance contained in this letter may be subject to risks and uncertainties beyond the control of Hallmark and are no guarantee of future returns. Hallmark does not guarantee or certify the accuracy, completeness or timeliness of the information presented in this letter. In consideration of the investment objectives of any individual client, Hallmark may take actions that are inconsistent with the opinions and recommendations contained in this letter.

Not FDIC Insured	May Lose Value	No Bank Guarantee