QUO VADIS CAPITAL
Private Wealth Management

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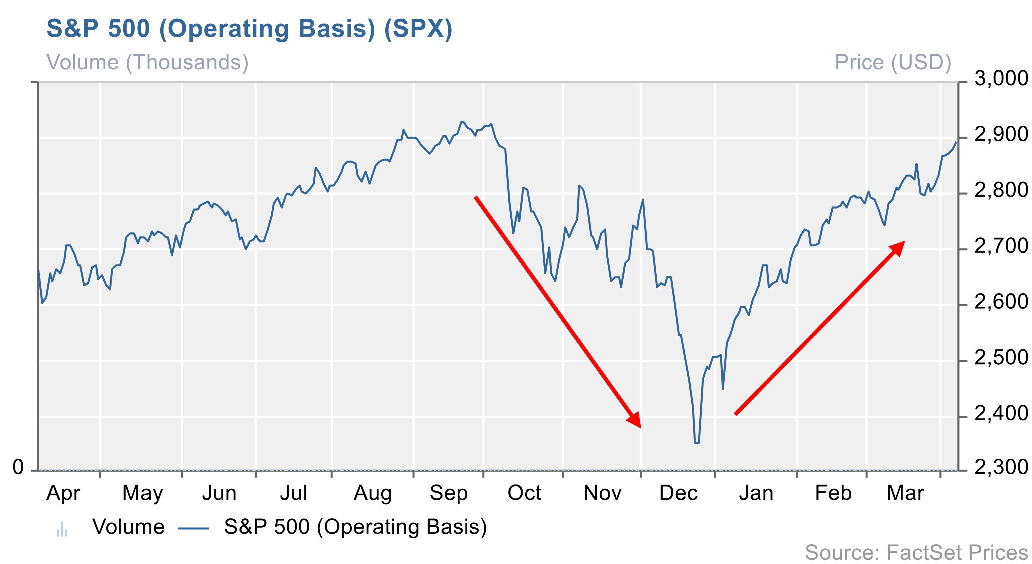
V is for Victory

Summary: The U.S. economy and the corporate earnings continued to grow in the first quarter, fueling the ongoing rally. The fourth quarter of 2018 saw investors sell stocks on the assumption that the Federal Reserve's intention to raise interest rates would hamstring an already fatigued U.S. and global economy, probably sparking a recession. The year-to-date reversal, on the other hand, reflects the Fed's pivot away from raising rates, ongoing growth in the economy and corporate earnings, and lately, investors chasing rising stock prices. At least that's how we see the market's action in the last few weeks. Our view: the opportunity to buy has passed but we remain bullish.

Are Market Returns Correlated to Corporate Earnings?

Each quarter we evaluate the performance of the companies we follow closely and calculate correlations in stock price movement and changes in expected future earnings. Our premise is that, over the long-term, companies that generate growth in profit and cash flow will see increases in their share prices and companies where earnings diminish will see their stock prices do likewise. This is not an original or genius premise. Our work generally proves out these correlations when longer periods are compared (a year or longer, for example). However, when we look at shorter periods (a quarter of the year, for example), we frequently find no correlation in stock price movements and changes in expected earnings or cash flow. In some cases, stock prices and earnings revisions are even inversely correlated. For kicks, we ran the same correlation analysis on the S&P 500, with a focus on the period we just went through. We also wanted to see whether the bearish narrative about *slowing global growth* was present in expected corporate earnings. What we found is that from the market's peak last September to year-end, stocks fell 14%, while during the same period future earnings forecasts for these companies *rose* 3%. Meanwhile, from December 31, 2018 to today, stocks rose 15%, while future earnings forecasts for these companies *again rose 3%.*

Figure 1. Stocks have staged a 15% gain YTD while expected earnings for companies in the index have gone up 3%.



If You were in a Coma Since Last September

And the last thing you remember was checking your portfolio and the first thing you did upon waking up was check your portfolio you might be forgiven for checking to make sure the calendar had really changed. Likely, assuming you (while in the coma) or those managing your money had done nothing, you wouldn't have lost any money. In a way, this is a huge victory, as many professional managers pulled huge amounts of funds out of the market during the September to December decline (or "draw-down" in professional money manager speak) and then spent the start of this year up until the most recent week buying back the positions that had been sold and chasing other hot stocks. Perhaps we are being too harsh, there are surely investors out there who are much smarter than us and anticipated both the decline near year-end and the recovery to start 2019, making bundles during both periods. Those people don't bother talking to us (we don't blame them), so we don't know them, unfortunately.

How We are Managing Our and Client Money:

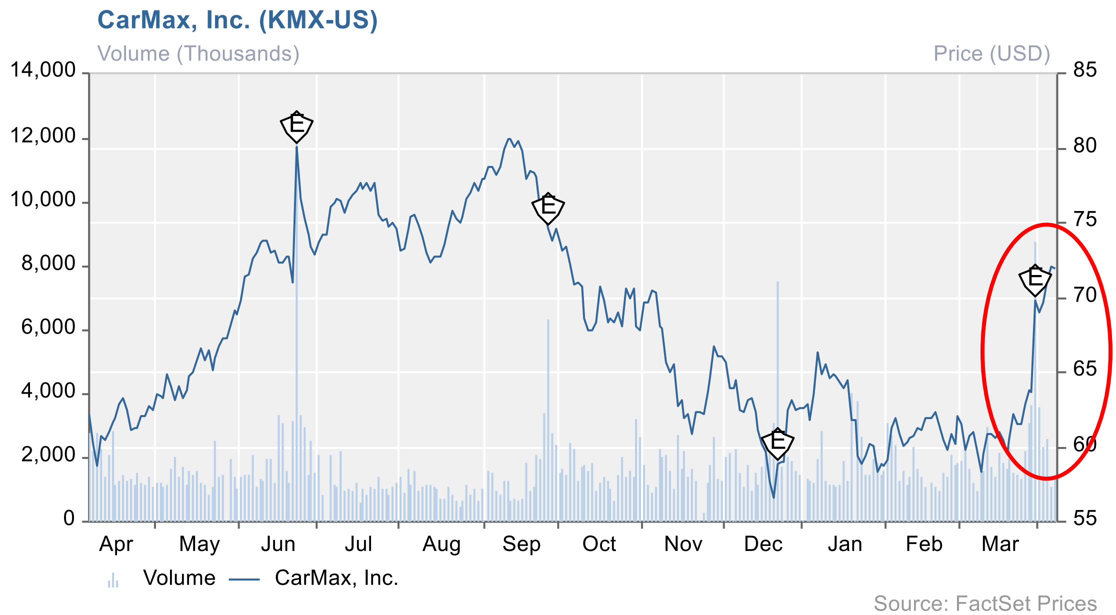
Our assumption is that our ability to forecast the overall market and macroeconomic conditions is highly limited. Accordingly, while we try to understand current conditions and trends, we try to make investment selections based on a long-term view and look for companies we can own throughout the economic cycle. The stocks of the best companies will still go down in a recession, but these businesses oftentimes benefit from challenging economic conditions as weaker competitors fail and cede share.

Selection from our model portfolio: Our approach is to own high-quality companies, bought opportunistically, and own them long-term with the intention to minimize trading costs and taxes. Our portfolio is concentrated (~20 positions) and generally we are favorably inclined towards companies we *know* or at least find easy to understand.

CarMax, Inc. (KMX): We wrote about KMX, the U.S.'s largest used-car retailer, back in our December newsletter. You can read that write-up here. At the time we discussed KMX's edge over competitors as owing to a combination of a superior service offer (which legitimizes the used car buying experience) and sophisticated technology (that permits it to price and managing its inventory). We also discussed KMX's willingness to "disrupt itself" via launching an online-only version of itself, which essentially allows customers to purchase a used car on a computer or mobile device and have the vehicle delivered to their home or office (or even a random street corner). While you may find it shocking that people would want to buy something as complicated and particular as a used vehicle with a click of a phone, what we are seeing is that consumers continue to become increasingly comfortable with buying really anything online/ via mobile. To prove this point, a competitor to KMX called Carvana (which makes buying a used car online similar to obtaining Nirvana – we made that up, sorry) was recently growing its revenues at a rate of over 100% and is expected to do nearly $3.5B in sales this year. While Carvana is controversial, investors are currently ascribing a market value to the company of nearly $9B. Meanwhile, KMX, which is expected to generate revenue of $19B this year (that's more than 5x the size of Carvana) has a market cap of $12B, only 36% greater. Last week, KMX announced that its test of an online offer in the Atlanta market had received a stronger-than-expected response, producing double-digit sales gains. The company also announced that it plans to extend this offer across the country. Initially the costs associated with the launch will offset some of the expected sales gains, but investors looked through to the longer-term potential and sent the stock up 10% on the announcement. (See the chart below.)

In our experience, retailers that successfully integrate online/ mobile offers to an existing model have done much better than online-only retailers or terrestrial-only retailers. We think that used cars is one of the last categories to migrate to digital, and believe we are in the very early stages of this happening. Used cars are also one of the single largest categories of consumer spending and the market is highly fragmented, with no one company really dominating. We believe many used car retailers will be unwilling or unable to make the investments and transition to digital sales, setting the stage for CarMax to take significant share from these competitors. We remain very bullish on KMX and recently increased our allocation to the stock.

Figure 2. KMX shares jumped 10% on recent earnings but remain below recent highs.



This month I am traveling to Naples, Florida and New York City. During these trips I will be making visits to retail stores and also taking meetings with professional investors.

If you or someone you know is looking for help investing in the markets, please get in touch to discuss whether our equity portfolio is appropriate. An archive of our past newsletters can be found on our website by clicking this link .

Yours,

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The analyst who is the author of this report has a long position in CarMax, Inc. (KMX). Quo Vadis prohibits analysts from trading in a way that is inconsistent with opinions expressed in reports [subject to exceptions for unanticipated significant changes in the personal financial circumstances of the analyst].

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