September 2021

Boluan Fanzheng

Unrelenting Bull Market Gives Back 4.1%

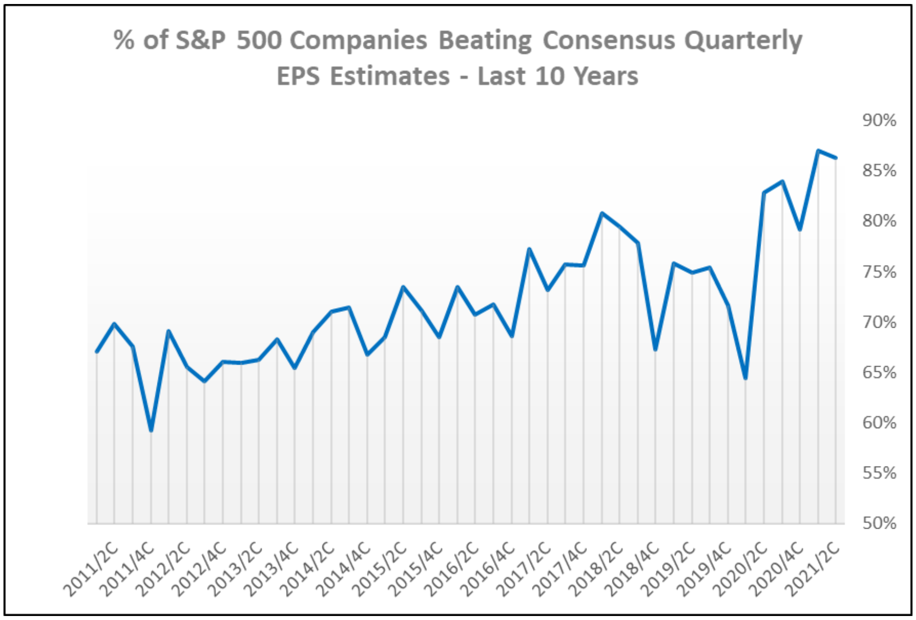
China concerns drop toppy market. Boluan Fanzheng is a Chinese idiom meaning "to bring order out of chaos" but also to "return to the rectitude of the past". Its recent use applied to the period following the cultural revolution (during the 1970s) when the Chinese leadership wished to move forward from social turmoil and to heal rifts by rehabilitating persons and ideas. There is some controversy, but the Boluan Fanzheng period is generally seen as setting the stage for a later shift to modernization and economic growth.

Today, the U.S. markets are receiving more chaos than order from China. There are three areas of concern. First, the company's misguided zero-Covid policy (misguided, in our opinion, because of the economic damage it is causing and because it won't work) is hurting both Chinese and U.S. global businesses operating China. Second, the recent, aggressive uptick in regulation is reducing business confidence and increasing uncertainty. Third, the possible failure of Evergrande, a large and overleveraged Chinese real estate lender is sparking concern about overall access to capital and debt levels in China. Together, these three factors spell trouble for the world's second largest economy with repercussions outside its borders.

The most important factor for stock price performance, in our opinion. Even when we include the recent 4.1% pull-back, the overall market (using the S&P 500 as proxy) is still up 33% over the past 12 months. Yes, the Fed's efforts including ultra-low interest rates are helping. More important, in our view, is that corporate earnings have been very strong. Some large businesses (e.g. large tech) have benefited from the pandemic and its aftermath as their business models were well positioned or adaptable to change. Other companies in the consumer space have seen revenues and earnings surge in recovery as spending increased and weaker competition was wiped away.

Analysts have generally underestimated the strength of the recovery. The Street has also been surprised by the duration of secular change in consumer habits. This has led to an unusually high percentage of companies exceeding analyst forecasts. In fact, it hit a record in the second quarter, with 87% of S&P 500 names reporting earnings that were higher than estimates. Simplistically, when companies report better-than-expected results, stock prices should rise. This bears repeating because sometimes this very straightforward idea can get lost in all the noise generated by Wall Street and the financial media. With this is mind, it should be clear why the bull market has been so robust and unrelenting.

Figure 1: Quarterly "beat" rate for S&P 500 companies. The absolute rate is not meaningful as analysts and company management teams conspire to set estimates that can be exceeded. It's the upward trend in "beats" that we believe is indicative of true strength in results.



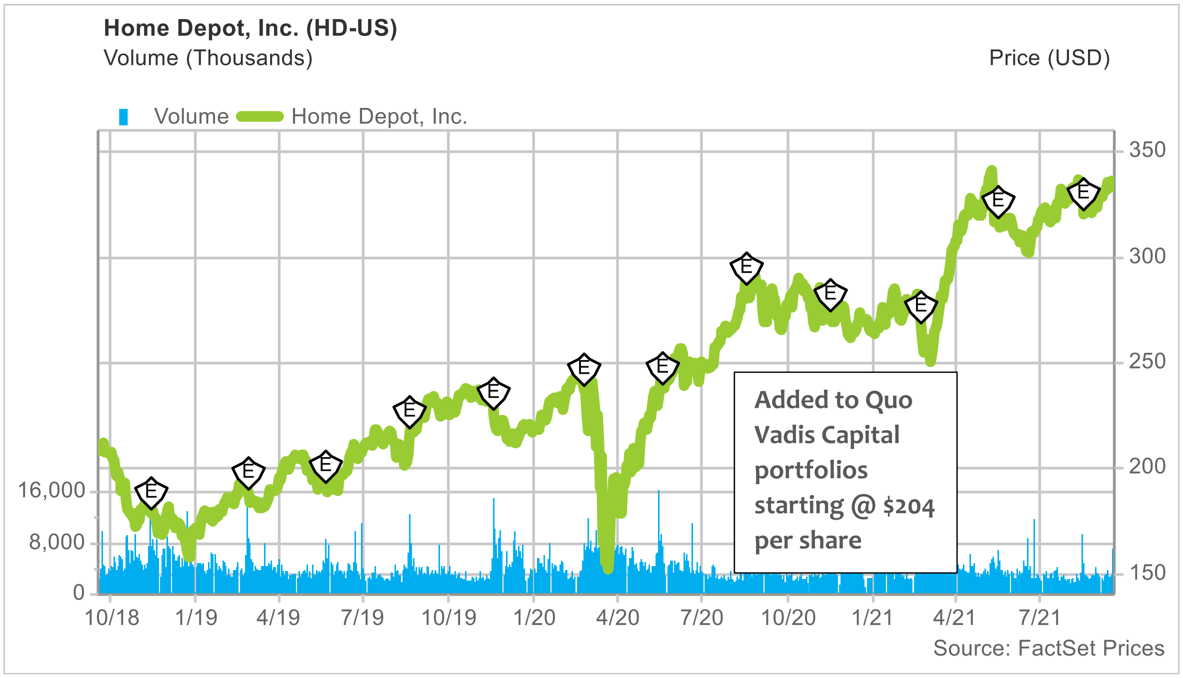
Source: FactSet

Don't Boluan Fanzheng your portfolio. Embrace chaos. Have a plan. in our view, a company's value is determined by its future earnings and cash flow, adjusted for its balance sheet (debt) and any special assets (patents, etc.) it may own. In the short-term stock prices are driven by all sorts of things, most of which will probably be irrelevant to a business' true long-term value. Macroeconomic cycles do matter to earnings and cash flow but are nearly impossible to predict or time. Our approach is to accept that financial markets are volatile and chaotic on a short-term basis and that future changes macro conditions are unknown. We don't look for secret patterns in charts or try to find order within noise or complicated datasets. We further believe it to be a waste of time to try to massage market exposure to reduce the effects of natural volatility or to try to anticipate big moves. Rather, we try to spend as much time as we can reviewing individual company strategies, financials, competitive sets, and management teams. We look for durable models that can adapt to changing conditions and leave it up to the businesses to course correct as conditions warrant. That's what management teams (should) get paid to do. Our approach may lead to swings in portfolio values but has so-far proven to be more tax efficient and we believe is more likely to work than trying to control an outcome in a chaotic world.

Example from Client Portfolios: Home Depot (HD)

Just as the overall market is driven by earnings "beats" so are individual stocks. We're written about Home Depot in several earlier newsletters, but it really epitomizes our message today. Checking the track record, HD has exceeded analyst estimates in 19 of the past 20 quarters. The only "miss" was during the worst of the Covid-related lockdowns. HD is well known and well followed company. There are 30 analysts with published estimates following the company (which is a lot). Yet, the despite this quantity of attention, HD has still managed a nearly unblemished record of upside. Why is Home Depot doing so well and how does it keep beating analyst estimates? Partially it is a function of a strong end market for home-improvement related goods. This is related to the overall economy (and amplified by work-from-home trends) but also due to structural factors around housing, notably a low rate of new home construction over the past decade. Secondly, we believe HD continues to benefit from its first mover advantage which allowed it to establish itself in the best locations in many markets where it operates with limited competition. Lastly, we believe the company has best-in-class management and continues to reinvest heavily in its own business, which is yielding improvements in sales, operations and profitability. Summing up, our investment in HD is based on our understanding of the business, its positioning within its market, and an appreciation how it's being run. Together these things have yielded stronger than expected results, which have served to move the stock and to increase the value of the company's long-term expected earnings and cash flow.

Figure 2: Home Depot (HD) three-year chart. Including dividends shares are up 2/3 over three years. This is about 10 percentage points better than the overall market (including dividends) over the same period.



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Yours,

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Mr. Zolidis started his career in finance in 1996 following degree studies in Philosophy at Kenyon College and the University of Oxford. He has followed U.S. consumer companies as a senior analyst since 1999, mostly on the sell-side, writing research for institutional investor clients. He also managed money in a buy-side role at a long-short equity fund over 2013-2014. He was named in the Wall Street Journal's Best on the Street list in 2005. Mr. Zolidis founded Quo Vadis Capital, Inc., a Registered Investment Advisor (RIA) and research consultancy, in 2017 and works from New York, NY and Paris, France or wherever he has his laptop.

Recent trips to New Orleans, Vail, CO, and upcoming travel to Cyprus and Long Island. I mentioned in my previous newsletter that we were traveling to New Orleans to install my oldest daughter at Tulane University. Well, one big hurricane later, and she is back home. I will spare you the details except to say that she's heading back to NOLA shortly, so fingers crossed for no more storms this year. In addition to my aller-retour to Louisiana in late August, I travelled to the States in mid-September to present an investment idea at the ValueX Vail investment conference. For those that are interested, I will post the slide "deck" to my website where you can also take a peek at past conference presentations (http://quovadiscapital.com/presentations/). In October, I am scheduled to present at another value investing conference, this one in Cyprus. Later in the month, I will travel to the U.S. to spend some time on Long Island.

Eagle River, CO: So, you can only get a shot like the one below by standing directly in the middle of the river. Normally that is only possible if you're getting wet. I didn't mind because the fly fishing (my new non-work obsession) was fantastic. I lost track of how many rainbows and browns I brought in, which is the only time that's ever happened. Does it make up for the many walks on the water when I got completely skunked? Yes.

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The analyst who is the author of this report has positions in Home Depot (HD). 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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