

EQUITY INVESTMENT CORPORATION

Excerpts from EIC's Quarterly Letters

The Large-Cap/Tech Bubble (1996-2000)

Date	Quotations	Further Comments
Q3, 1996	<p>"Given the recent popularity of stocks, and especially growth stocks, it is worth pondering human nature. The proliferation of investors buying many growth stocks today . . . is not entirely unrelated to the proliferation of individuals wearing Nike labels. People want to belong in a group, and derive a feeling of safety and emotional support from doing so. By imitating others we make popular choices, which creates momentum as the group grows and others imitate. But behavior based on imitation is behavior without conviction, and is therefore fickle and unreliable. . . . We remain committed to purchasing companies that offer long-term growth, but we are also wedded to a valuation discipline that prevents us from following the crowd"</p>	<p>Our valuation discipline prevented us from following the crowd – whose behavior ultimately led to losses for so many.</p>
Q3, 1997	<p>"if investors expect these high rates of return in the future, they are sure to be disappointed. This may be seen by examining the mathematics of today's high P/E ratios and long-term earnings growth. . . . if the P/E ratio falls to 15, the 10-year return will only be 3% per year. If the P/E ratio falls to 15 within 5 years, the return (of the S&P 500®) would be -3% per year. . . . Moreover, the market's P/E has been below 15 in 62% of past years. This suggests there is a better than even chance that investors in the S&P 500 today will earn 3% or less per year over the next 10 years."</p>	<p>Over the subsequent 5 years, P/E ratios did fall to about 17, and the S&P 500's return was -1.6% per year. The S&P 500's subsequent return through March 31, 2009, was 0.2% (annualized).</p>
Q4, 1998	<p>"The S&P 500 is viewed as a neutral investment approach, where one owns 'the market.' This is no longer true. Instead, the S&P 500 has become a heavy 'style' bet on large, high growth, high priced companies. . . . History has shown this to be a 'fair weather' strategy that is dangerous, and we will not invest this way."</p>	<p>A commitment to a strong price discipline was necessary to limit the risks of a top-heavy market.</p>
Q4, 1999	<p>"I have no idea how long the high P/E stocks will continue to outperform, nor does anyone else. I can say, however, that owning high P/E stocks has not been a sound long-term investment strategy. . . . There have been periods when high P/E stocks outperformed, but these periods have been short lived. Therefore, we do not plan to change our approach." "Our competitive and rapidly changing world economy makes it difficult for any company to sustain growth unchecked. Inevitably growth stories that seem unstoppable prove vulnerable with time. Therefore, a dose of realism, or conservatism, should be applied when projecting a company's future growth, and in determining its Value, and the price one is willing to pay."</p>	<p>As 1999 closed, the mania for growth stocks, particularly technology and internet stocks, was reaching its climax. As money flow moved away from value managers, toward high P/E growth investors, it became increasingly difficult for value managers to stick to their disciplines. Most of the growth stories that appeared inevitable in 1999 proved to be vulnerable with time.</p>
Q3, 2000	<p>"For several quarters we have discussed the upside-down nature of the market, namely, that the stocks with the highest P/E ratios were rising, while low P/E stocks were falling. . . . The question is whether these prices (of high P/E companies) are justified by the high growth opportunities among new technologies, or whether they represent another example of over-optimism. The 1920's witnessed a similar debate, as new technologies created dramatic improvements in productivity. . . . These improvements resulted in unparalleled growth (and as a side-note, expectations of large federal government surpluses to come). In retrospect it is easy to look at the 1920's as mania-driven and forget the compelling visions of growth that must have provided <i>rational</i>-izations for the prevailing high prices. The same will probably prove true of today."</p>	<p>The <i>rational</i>-izations for high prices, namely expectations of unending growth, did prove to be overly optimistic extrapolations (as were the hopes for future government surpluses).</p>

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The Credit/Building Bubble (2004-2007)

Date	Quotations	Further Comments
Q1, 2005	<p>“our primary message . . . has been that the economic recovery has been unbalanced, overly dependent on unsustainable debt-based spending (from consumers and the U.S. government) and an aggressively stimulative monetary policy from the Federal Reserve. These policies have created once-in-a-lifetime earnings in certain sectors (homebuilding, lending, building materials) that have been the mainstay of the markets during this time. However, our view remains that these sectors’ earnings and prices are at risk when the monetary and credit-driven stimulus diminishes, which it inevitably must.”</p>	<p>Trade deficits and borrowing led to excess consumption and building, resulting in once-in-a-lifetime earnings in certain sectors (building and lending). We felt such earnings carried low quality, and should not be capitalized.</p>
Q2, 2005	<p>“We do know growth in recent years has been unusually imbalanced, achieved through reliance on increasing debt by U.S. consumers and government. It is this imbalance that we are trying to protect against. . . Earnings derived from short-lived or undependable sources should not be ‘capitalized’ in determining value. Yet we believe this is occurring in some industries today.”</p>	<p>The unbalanced growth continued, while investors capitalized unsustainable earnings driven by easy credit.</p>
Q1, 2006	<p>“We accept this difference between our holdings and those of the indices as part and parcel of what we do for clients. To be clear, we do not believe our role is to simply generate the highest returns for clients in a given quarter or year . . . Nor is it our role to track a style-box index . . . Instead, our goal is to provide strong absolute and relative returns over a market cycle, while doing so with relatively low risk, as defined by frequency and magnitude of loss.”</p>	<p>Our under-performance versus the market indices meant we had to explain the differences between our performance and the market’s, and why we were not at the party.</p>
Q3, 2006	<p>“Short-term, however, the ability of the economy to sustain growth is the greater issue. Consumer and government borrowing have been too high, and in each case, the <i>reality of risk</i> and the consequent <i>relevance of prudence</i>, have been disregarded. This is why we have sought to own stable companies whose earnings are less dependent on debt-based spending.”</p>	<p>We continued to warn about debt-based growth and the loss of prudence.</p>
Q1, 2007	<p>“Meanwhile, economic strength was built upon strong monetary and spending stimulus by the government, along with consumer borrowing based on low interest rates and rising house prices. None of these seem likely to be as stimulative going forward when compared to the last 5 years. Our experience has shown that protection has to be built into portfolios long before it is needed.”</p>	<p>Rather than predict when it would end, we tried to protect against the inevitable.</p>
Q3, 2007	<p>“We often say that 95% of our decisions are never seen, because they are decisions <i>not</i> to buy something that <i>looks</i> cheap. Among these was our decision <i>not</i> to buy companies whose earnings were benefiting from excessive consumer borrowing, or whose balance sheets were contingently exposed to credit risks through either their investing or lending activities. We viewed the borrowing boom as unsustainable and potentially dangerous, and sought to minimize our exposure. That is why we decided <i>not</i> to buy subprime lenders such as Countrywide, Citigroup and H&R Block, asset-backed guarantors such as Ambac and MBIA, and investment banks such as Bear Stearns and Goldman Sachs. . . we sold our position in Allstate due to concerns regarding the quality of their investment portfolio”</p>	<p>In 2007, the sins of the past years finally began to surface, and we stressed the importance of avoiding those sectors in the eye of the storm, despite the fact that prices <i>looked</i> cheap.</p>

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The Post Financial Crisis Bubble (2011 - 2019)

Date	Quotations	Further Comments
Q1, 2011	<p>"Today's environment, like those of 1996-99 and 2003-06, is one where the earnings and apparent growth being capitalized in some sectors leading the market (industrials, materials, and consumer discretionary stocks) may be unsustainable by-products of an artificial environment created by government fiscal and monetary policies, rather than reflecting a self-sustaining reality."</p>	<p>Low quality stocks led a market rally early in 2011 and EIC portfolios did not keep pace, as is consistent with our longer term experience. The markets reversed quickly though and our clients were rewarded in 2011 with mid-single digit returns while the relative benchmark was slightly negative.</p>
Q1, 2012	<p>"the principal cause of today's economic situation is the excessive credit expansion in the decade before, which resulted in over-confidence and broad misappraisals of risk, major global imbalances, and inattentiveness to a decline in the structural health of western economies."</p>	<p>Historically, our accounts have declined less in down markets, recovered losses relatively quickly, then lagged late-cycle (when low quality or momentum stocks led). The trouble with "easy money" expansions is they can last much longer than logic dictates.</p>
Q2, 2014	<p>"The rise in asset prices (stocks, bonds, and real estate) since the financial crisis may be applauded as a success by Federal Reserve authorities and their policies. . . . Ultimately, a policy that relies on increased borrowing to support increased spending, while real median incomes are declining, cannot provide a sustainable path to economic health and corporate profitability."</p>	<p>Growth oriented investors, particularly in large- and mega-cap names, have had a strong investing tailwind for nearly a decade. The market has also become very narrow, with recent gains concentrated in a few technology and consumer companies.</p>
Q4, 2015	<p>". . . the economic environment has become somewhat hostile to earnings growth . . . Low rates have encouraged corporations to 'manufacture' earnings growth via buybacks and acquisitions . . . non-GAAP measures are increasingly employed to portray earnings as higher than actual through pro-forma add-backs of stock-based compensation, intangible amortization, restructuring charges, and other 'one-time' expenses."</p>	<p>"Don't fight the Fed" is the backdrop we are investing against. We do not want to stray from our proven investment approach, even if it means not keeping up with the market when our approach is out of favor. This is the price of proper risk management, which has historically protected our clients' assets on the downside.</p>
Q2, 2017	<p>"We believe the recent "risk-on" trend warrants repeating our words of caution to investors about potential market drawdowns and the length of time required to recover from them. A closer evaluation of the S&P demonstrates our concern over valuations. First quarter earnings growth for the S&P 500 came in at a strong 20% but was disproportionately driven by energy earnings turning positive as opposed to being negative last year."</p>	<p>After negative returns for the indices in Q1 '18, we reminded clients that our results were generally consistent with our history of declining less in down markets while not keeping up during periods of strong up movements, leading to overall outperformance over a full market cycle.</p>
Q4, 2019	<p>". . . the current investment environment ... bears more than a passing resemblance to the market of the late '90s . . . little earnings growth coupled with significant valuation expansion – leaving the market poised for modest (or worse) longer-term returns. "</p>	<p>The first quarter of 2020 was extraordinary in the speed and breadth of the decline. We believe the ferocity of the first quarter volatility is likely, in part, a rapid and partial unwind of a decade of complacency.</p>