EQUITY INVESTMENT CORPORATION

Insights from EIC's Quarterly Letters

The Large-Cap/Tech Bubble (1999 - 2001)

Date	Quotations	Further Comments
Q4 1999	"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."	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.
Q3 2000	"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 sidenote, 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 *rational*-izations for the prevailing high prices. The same will probably prove true of today."	The *rational*-izations for high prices, namely expectations of unending growth, did prove to be overly optimistic extrapolations (as were the hopes for future government surpluses). As a result, growth stocks in general (and tech stocks in particular) performed poorly when the bubble burst in 2000 – 2002.
		The Credit/Building Bubble (2004 - 2007)
Q1 2005	"our primary message ... 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."	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 were low quality and unsustainable and thus should not be capitalized.
Q1 2006	"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."	We avoided investing in certain sectors with growing risks and trailed the market indices as a result. Nevertheless, portfolios were well positioned for the ensuing credit crisis.

The Credit/Building Bubble (2004 - 2007) (cont'd)

Date	Quotations	Further Comments
Q1 2007	"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 five years. Our experience has shown that protection has to be built into portfolios long before it is needed."	Rather than predict when it would end, we tried to protect against the inevitable downturn.
Q3 2007	"We often say that 95% of our decisions are never seen, because they are decisions *not* to buy something that *looks* cheap. Among these was our decision *not* 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 *not* 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 … ."	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, even though prices *looked* cheap.
The Post Financial Crisis Bubble (2011 - 2018)		
Q1 2011	"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."	Low quality stocks led a market rally early in 2011 and our 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.
Q1 2012	"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."	"Easy money" expansions can last much longer than logic dictates. Historically, our portfolios have lagged market indexes late-cycle (when low quality or momentum stocks led) but have declined less in down markets and subsequently recovered losses relatively quickly.
Q2 2014	"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*."	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 increasingly narrow, with recent gains concentrated in a few technology and consumer companies.

The Post Financial Crisis Bubble (2011 - 2018) (cont'd)

Date	Quotations	Further Comments
Q4 2015	"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."	In an investment environment characterized by the mantra "don't fight the Fed," companies have increasingly relied on financial engineering to manufacture earnings growth. We've sought to avoid this risk, even though it has meant not keeping up with market indices. We believe this is the price of proper risk management, which has historically protected our clients' assets on the downside.
Q2 2017	"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 [500] 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."	After negative returns for the indices in Q1 2018, 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.
The Growth/COVID Bubble (2019 - ?)		
Q4 2019	"little earnings growth coupled with significant valuation expansion – leaving the market poised for modest (or worse) longer-term returns. … This backdrop colors the current investment environment … . It bears more than a passing resemblance to the market of the late '90s … . "	Q1 2020 was extraordinary in the speed and breadth of the stock market decline. We believe the ferocity of the first quarter volatility is likely, in part, a rapid and partial unwind of a decade of complacency.
Q1 2020	"One of the unique aspects of the market action in this quarter was the extreme outperformance of growth versus value. While our valuation model allows us to pay a premium for growth characteristics, we ultimately have limits regardless of the merits of the business. The future is uncertain, and we don't believe we can forecast cash flows as far into the future as necessary to justify owning expensive growth stocks."	While value outperformed growth in Q4 2020, it remains deeply out of favor across all capitalization sizes. In fact, value has trailed growth for the better part of 14 years, its longest period of subpar performance in history. As a result, value's cumulative shortfall relative to growth now exceeds that of the tech bubble.
Q1 2021	"Within the growth universe, there is significant variation in the degree of over-valuation … . Mega-cap growth companies with dominant market positions, many of which are in the information technology, communication services, and consumer discretionary sectors, are all fully- to over-valued in our estimation. Smaller but proven growth names with revenues and/or cash flow, such as in the software and consumer discretionary space, appear to sport more extreme valuations. Finally, there is a large cohort of "concept" companies, with electric vehicle listings coming public via special purpose acquisition companies (SPACs) as most representative of this group. These companies are often pre-product and pre-revenue, and in our view, have nonsensical valuations."	Despite growth stocks' poor performance in Q1 2022, they remain richly priced compared to history, with valuations still trading well above long-term averages. As we have detailed in past commentaries, history and shareholder-return math continue to suggest that growth should meaningfully underperform value from these lofty valuation levels