

Tuesday, November 20, 2018

PUTTING IT IN NEUTRAL

- We are beginning to favor Value stocks a bit more than we have.
- For nearly a decade we've been overweight Growth stocks. We continue to prefer Growth on a long-term basis.
- We are not shifting portfolios totally to Value, just putting it in Neutral.

For the last nine years, except for a few defensive shifts here and there, we've very much so leaned toward Growth over Value. But we've been shifting more toward Neutral recently. We actually continue to prefer Growth over Value on a long-term basis; this tilt toward Neutral is more tactical.

We've mostly stayed away from heavy Value exposure recently because the biggest Value sector, Financials, had underperformed. We're not necessarily overly excited about the prospects of Financial stocks in 2019, but we've become more neutral on Financials as well (which is an upgrade from our concerns for the sector). But that just changes things at the margin. The larger forces at play are interest rates and earnings.

Rising interest costs will eat into corporate margins in 2019. Interest expense has been rising as companies either refinance at higher rates or are subject to adjustable rates. There was a lot of cash repatriated from overseas this year, and a lot of that went to paying down debt, but not enough to offset the cost of rising rates. The aggregate per share interest expense of S&P 500 companies has climbed to \$24.68, up 38% in four years to the highest level since Q2 2009. That's actually quite a bit less than the \$55 reached prior to the Financial Crisis, so it's not disastrous by itself. But the issue at hand is that Growth companies carry greater indebtedness than Value companies.

Not that anything at all is wrong with debt. The availability of capital financing is the life blood of the economy. But you can see how higher interest rates will take a bigger bite out of the earnings of Growth companies.

But, honestly, normally, I'd just say, "who cares?" Not that financing is what I'd really consider leverage, but it kind of is. Financing allows for growth. The problem is that we're struggling to find the source of margin expansion in 2019. Not that we think economic or sales growth will be bad; we actually think both will be quite good next year. We expect that companies of both the Growth and Value variety will see top-line growth. But the bottom-line growth will be tight as companies struggle to find improved productivity given that the labor market is extremely tight with unemployment at a nearly half-century low. Each new hirer is less productive, and



they will be more expensive as labor costs have been creeping up. This will affect both Growth and Value companies, but it's the coupling with higher interest expense that is putting us in Neutral.

Bottom Line: We remain constructive on the US stock market and will continue to until we see increasing signs of recession (which we've been arguing for a long time is expected in 2020-2022). Our shift to Neutral, from Growth, is tactical in nature and does not currently reflect our longer-term bias toward Growth.

GENERAL DISCLOSURES

Article may include forward-looking statements. All statements other than statements of historical fact are forward-looking statements (including words such as "believe," "estimate," "anticipate," "may," "will," "should," and "expect"). Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. Various factors could cause actual results or performance to differ materially from those discussed in such forward-looking statements. Historical performance is not indicative of future results. The investment return will fluctuate with market conditions. Performance is not indicative of any specific investment or future results. Views regarding the economy, securities markets or other specialized areas, like all predictors of future events, cannot be guaranteed to be accurate and may result in economic loss to the investor. Investment in securities, including mutual funds, involves the risk of loss. Registration with the SEC should not be construed as an endorsement of Advisor's investment skill or acumen. Investment process, strategies, philosophies, allocations and other parameters are current as of the date indicated and are subject to change without prior notice. This article is intended to provide general information only and should not be construed as an offer of specifically tailored individualized advice.

STANDARD & POOR'S

The S&P 500 Index (S&P) has been used as a comparative benchmark because the goal of the above account is to provide equity-like returns. The S&P is one of the world's most recognized indexes by investors and the investment industry for the equity market. The S&P, however, is not a managed portfolio and is not subject to advisory fees or trading costs. Investors cannot invest directly in the S&P 500 Index. The S&P returns also reflect the reinvestment of dividends. Berkshire Money Management is aware of the benchmark comparison guidelines set forward in the SEC Clover No-Action Letter (1986) and compares clients' performance results to a benchmark or a combination of benchmarks most closely resembling clients' actual portfolio holdings. However, investors should be aware that the referenced benchmark funds may have a different composition, volatility, risk, investment philosophy, holding times, and/or other investment-related factors that may affect the benchmark funds' ultimate performance results. Therefore, an investor's individual results may vary significantly from the benchmark's performance. The S&P 500 Index (S&P) has been used as a comparative benchmark because the goal of the above account is to provide equity-like returns. The S&P is one of the world's most recognized indexes by investors and the investment industry for the equity market. The S&P, however, is not a managed portfolio and is not subject to advisory fees or trading costs. Investors cannot invest directly in the S&P 500 Index. The S&P returns also reflect the reinvestment of dividends.

DOW

The Dow Jones Industrial Average (NYSE: DJI, also called the DJIA, Dow 30, INDP, or informally the Dow Jones or The Dow) is one of several stock market indices, created by nineteenth-century Wall Street Journal editor and Dow Jones & Company cofounder Charles Dow. The Dow average is computed from the stock prices of 30 of the largest and most widely held public companies in the United States. Clients of BMM may have portfolios that differ substantially from the composition of the DOW and therefore, their performance may vary significantly from that of the Dow. The Dow is used for illustrative purposes only, as one indicator of the overall US economy, and its past, present, or future performance should not be viewed as an indicator or comparison point for BMM client performance.

