A Case for Owning Quality Stocks
September 30, 2022

Long term investment returns in capital markets, including stocks, bonds, commodities, real estate, private equity and venture capital, are broadly predictable and generally proportionate to the perceived riskiness of the underlying asset class. Over the last 20+ years, returns in risk-free U.S. Treasury bonds, for instance, lag those in high yield bonds and common stocks.[1] Over shorter time periods, however, this apparently rational pairing of higher returns with perceived risk can break down spectacularly, causing some investors to make ill-timed asset allocation decisions that have long term consequences. The adage to "stay invested" is worth heeding, especially at times like these when markets are stressed.

As long term investors in the common stocks of high quality companies, times like these are when our experience and advice count the most. We believe staying invested, even as the hurricane winds of war, inflation and recession rage, is the best advice we can offer. In service of that principle, we have put together a few thoughts on the historical performance of quality stocks and what that suggests for investors today.

Markets overshoot

Despite achieving favorable long term returns, the timeless tension between greed and fear amplifies swings in market prices in the short run and causes investors to misallocate capital. Consider the experience of investors in the late 1990s who funded money-losing dotcom startups in IPOs before enduring a steep and long lasting slide in the NASDAQ starting in 2000. Speculative real estate and the investment banks that packaged securities tied to real estate prices were hammered in the 2008 downturn, contributing to a stock market crash, an ensuing recession and the start of a decade-long ease in monetary policy that itself lay the groundwork for today's excesses. Fueled by cost-free money, assets of all kinds, including money-losing technology stocks, SPACs with no underlying business, crypto currencies and non-fungible tokens, rose and subsequently collapsed in the steep market correction of 2022.

Swings from enthusiasm to despondency have consequences for investors and for the real economy. For investors, reacting too quickly to news that may have little impact on the intrinsic value of their portfolio risks locking in permanent capital loss. In the wider economy, one can argue that the flood of investment into speculative, non-productive assets in recent years came at the expense of investment in critical infrastructure – from microprocessors to ocean tankers and gas pipelines – that made the current inflationary period more damaging. In turn, persistent inflation, broken supply chains and the threat of recession are driving investors to value companies with unattractive long term growth prospects, such as utilities, slow-growing consumer staples and oil exploration and production companies, more highly than some of the greatest and most free cash flow positive businesses ever seen. Such widespread misery is the topsoil of future returns.

History gives reason for optimism

Whatever the future holds, it is worth remembering that stocks have done well over time, better in fact than almost all other assets available to most investors. Owning high quality stocks in particular has been the right strategy for most long term investors for decades. Since 1989 the S&P500 has returned 9.6% annualized, more than investment grade bonds (5.1%), gold (4.4%) and housing (3.1%). Only high yield "junk" bonds come close, returning 7.5% for the period.[2] The "cost" of achieving this excess return in stocks is volatility: there have been many down years for stocks in the past three decades, and we are experiencing one now. Tempting as it may be to time these unhappy periods by selling stocks in hopes of buying back after the storm has passed, that exercise is futile and potentially costly. No one –not Warren Buffett or the investment strategists opining on financial news networks–can reliably time the market. *An investor who missed just the best 30 days in the past 30 years would have experienced a 0%return in the stock market.*[3]

While the performance of common stocks isa primary reason to stay invested, a well-managed portfolio of quality stocks hasother advantages for investors. Start with *liquidity*. Like farms, fine art and venture capital, common stocks are long term assets. Unlike these less liquid assets, however, investors in high quality common stocks have the ability to easily and quickly convert stocks into cash at minimal cost. A second advantage to common stocks is *transparency*–the certainty for investors of knowing what they own and to assess the riskiness and prospects of that particular investment. The *all-in cost* of owning high quality common stocks, including management fees, the absence of carried interest charges and tax efficiency, is far below that of most other long term capital assets. And the *ability to access* these investments far exceeds that of most alternative assets, which are accessible mainly through funds or direct investments in illiquid assets. Since common stocks are traded in nominal terms and can achieve revenue and earnings growth during inflationary periods, they can be an effective *hedge against inflation*, unlike bonds which are typically penalized by inflation.

A look ahead

The S&P500 recorded its worst September in twenty years, closing at 3,586, down 9.2% for the month and -23.9% for the year.[4] Painful as it has been, the decline is far from the steepest on record –however it does rank among the longest in terms of consecutive weekly drops, and the worst year since 2009. Fueling the decline has been a collapse in price-to-earnings multiples from just less than 22x at the start of the year to about15x at September 30,2022.[5]Earnings estimates have declined too but the collapse in multiples has been swift and sharp, fueled by the determination of the Federal Reserve to fight inflation with higher interest rates. The selling has been relentless, and not limited to stocks. 2022 has been the worst year on record for investment grade bonds as measured by the Global Aggregate Bond Index, down -19.9% through September 30, far worse than the previous record decline of-5.2% in that index. Gold, long touted as an inflation hedge, has declined 9.1% YTD as have a basket of commodities including silver-18.4%, copper-23.4% and lumber-63.2%.[6]Sentiment is almost universally negative with more than 60% of retail investors expressing pessimism for stocks, a record reading of bearishness since 2008.[7]

Technical factors suggest a brighter future. The past four earnings declines have averaged a decline of 31% over 6.25 calendar quarters. Applying this math to the current period suggests that earnings will trough in the fourth quarterof2023 but that stock prices will bottom much sooner, perhaps in the current quarter, as investors start to factor in an economic recovery. One indicator worth considering is the ratio of total market capitalization of the NYSE to GDP. This measure is currently about 1.0x,downsharply from its 10-year and 20-year averages of124% and 119% respectively. The ratio was lower in 2009 and 2002, with both times representing important stock market bottoms.[8] We believe these factors make the future more positive, not less.

More meaningful to us than technical analysis or historical precedents is the notion of *intrinsic value*. As discussed above, common stocks are long term capital assets. Paraphrasing Warren Buffett, a buyer of a farm doesn't own it as a trade, to sell whenever a broker quotes a higher (or lower) price; the farm owner looks to the property's intrinsic value, measured by crop production or other values e.g., open space, ecosystem services, employment. In a similar way, market prices for companies such as Berkshire Hathaway, Alphabet and Costco fluctuate continuously based on investor sentiment and factors that may have nothing to do with the intrinsic value of these high quality businesses. Rather than trading the stocks of these exceptional businesses, we believe a wiser approach is to own them as long term shareholders, recognizing their intrinsic value supported by rising free cash flow, high returns on invested capital and value for customers.

Reviewing core principles

Investing in stocks can be volatile in the short run however patient investors can reasonably expect high risk-adjusted returns over time. The highest quality stocks, such as those owned by Douglass Winthrop Advisors, offer other attributes to intelligent investors, such as liquidity, low all-in cost, tax efficient ownership and transparency. To achieve a successful outcome, it is essential for investors to have a long term horizon and to stay invested at times of market stress.

1 Bloomberg, LP
2 Bloomberg, LP
3 Bloomberg, LP and Douglass Winthrop Advisors
4 Bloomberg, LP
5 Bloomberg, LP
6 Bloomberg, LP
7 American Association of Individual Investors: AAII US Investor Sentiment Bearish Readings Index\
8 Bloomberg, LP

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