Annual Letter 2018

To Our Clients and Friends of Parthenon LLC

As the calendar turned to the fourth quarter our thoughts, as customary, turned to potential topics and themes for this letter. One topic at the forefront was the length of the bull market and the economic expansion. More specifically, was the length of the expansion an inherent risk? With the S&P 500 up another 10% year to date, had the nearly 10-year bull market rendered stocks excessively overvalued? As we began to contemplate these and other timely issues, the narrative was altered dramatically in the 4th quarter. For the year as whole, the S&P 500 was down only a relatively modest 4.38%, including dividends. The modest decline hardly tells the tale. The 4th quarter was volatile and extremely negative, with the S&P 500 down 13.5%, the worst 4th quarter since the 2008 financial crisis. How volatile? Follow along on these peaks and valleys: By October 1, the market was up 10% in 2018, then fell 9.4% by Oct. 29, rose 6.5% by Nov. 7, dropped 6.5% to Nov. 23, jumped up 6.0% by Dec. 3, plunged 15.7% by Dec. 24, and now has jumped over 12% as of Jan. 29th. Maybe the best investment advice would be the instruction we heard the last time we visited a theme park, "keep your arms and legs inside the ride at all times."

Last year we assessed overall stock valuations by borrowing a comment from the great Ben Graham, who once opined "stocks are overvalued but not as overvalued as they look." As we judge valuations a year later, we recognize that, given the market's current extreme volatility, it is possible that our valuation thoughts can quickly be rendered obsolete. As you read this, values may rise or fall 5%-10%. But, using year-end values as a starting point, an appropriate summation of our feelings now would be that stocks are more attractive, but not as attractive as they look. We will explore that further in greater detail below. The valuation improvement came from a small market decline combined with a large, double-digit increase in overall corporate earnings – business values rose, stock prices declined. Stock values have fallen to around 15-16 times earnings, which is about average historically. Looking ahead, while we are more positive on stock values for the intermediate/long-term, our enthusiasm is tempered some by issues we will ponder further.

"Doubt is not a pleasant condition, but certainty is an absurd one," *~Voltaire*

Uncertainty has been a recurring topic in our letters. More to the point, we have discussed how to live with and operate with uncertainty as an investor. When the market is strong and rising, it seems as though all is certain. When the market tumbles, the mantra becomes "uncertainty is greater." That, we believe, is an illusion - the uncertainty was always there, but a strong market creates an aura of certainty. Uncertainty is ever-present, and unavoidable.

We have no firm opinion on the likely direction of the market in 2019 (no surprise there). When we look ahead, we will often study what might be termed the market's, and the economy's, "balance sheet" - we examine the "assets and liabilities" of that balance sheet as we see them. Though it is not a predictive exercise and by no means does it eliminate uncertainty, it provides us with a clearer picture of the environment our businesses are operating in and the threats they may face. Though limited in short-term predictive value, it is an informative exercise. We think it would be helpful to list some of those asset and liabilities and some very brief comments on each. This is by no means an exhaustive list but a few of the more important variables:

Assets:

Equity valuations – This is the preeminent market variable for us – nothing is more important than current valuation. The market's modest decline in 2018 coupled with strong earnings growth improved valuations enough to shift this from a liability last year to an asset this year (albeit a tentative one).

Strong employment – The labor market is exceptionally strong, and so far, shows little sign of an imminent negative turn. Consumer spending remains fairly robust (holiday season spending was strong).

Corporate earnings – Earnings still appear solid (we will know more over the next month). It is important to note that profit margins are benefiting from a strong economy, a decade of economic growth, and a significant reduction in the corporate tax rate.

Bank balance sheets – This is not 2008 – banks are in good shape (and after a decade of expansion they should, and better, be strong).

Liabilities:

Slowing global economic growth - China and other major economies are slowing. This may put pressure on US company international sales/earnings.

Corporate earnings growth slowing – While still strong, earnings growth is decelerating.

Interest rates rising – The Federal Reserve is slowly increasing short-term rates, though they have indicated a temporary hiatus is possible.

Housing – Weakening after several very strong years, due in part to rising mortgage rates.

Trade uncertainty – We think this is a current liability though we believe the odds favor a resolution (but the risk of damage is not insignificant).

One variable we did not include in the balance sheet as either an asset or liability, the one we mentioned near the top of this letter, is the near record length of both the current economic expansion and stock market bull cycle. Most commentators view this as a major risk factor. We understand that sentiment, as it is difficult to shake the feeling that "all good things must end." They do, but what is the maximum lifespan of an economic expansion? Maybe it doesn't have to end anytime soon - we are nearing the U.S. record, but Australia just reached a world record, 27 years and counting without a recession. Does a bull market have to die of old age? Just because this has become the longest stretch without a full-fledged bear market, is the end imminent? The economic expansion was very slow in the early years, despite recovering from a very severe downturn. Perhaps the long-lived expansion is understandable and reasonable since the normal excesses and pressures that can occur in a strong recovery did not build as quickly, nor as fully, in this recovery. We do not think the extended length of the current expansion makes its demise imminent. However, it is a caveat to our otherwise more favorable view of equity valuations.

So where do we arrive, after examining the "balance sheet?" Back where we started – the long-term market outlook, we believe, is about average but comes with a qualification. Valuations look attractive (with average expected long-term returns), but should be "discounted" slightly to compensate for the long tailwind that has inflated business operating margins and profits.

Any complacency equity investors may have had in October was likely gone by December. Though not pleasant, higher volatility is an opportunity for long-term investors with an appropriate asset blend and rational expectations. We work, as always, to position your portfolios in anticipation of the certain, but unpredictable, bouts of market turmoil. And, we will look to take advantage of opportunities created by any further volatility and weakness.

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January 2019

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