Perkins
—JANUS HENDERSON—

CIO OUTLOOK

UNCOMMON VALUE℠

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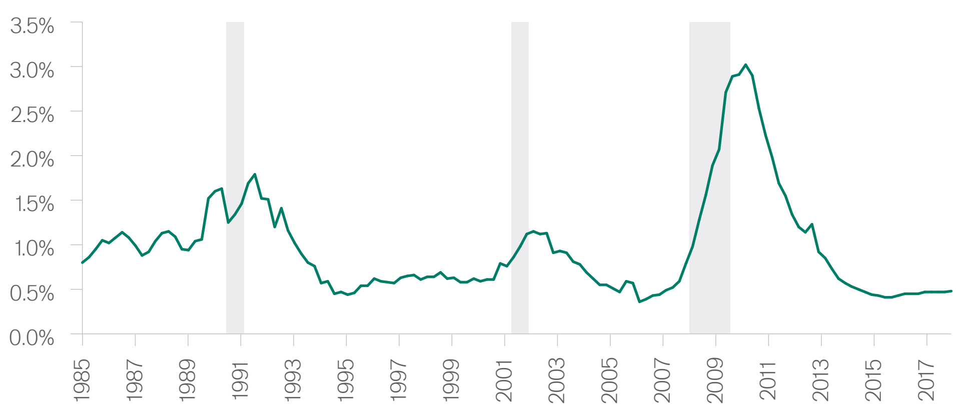
STAYING LEVELHEADED IN A HEADY MARKET

Author and commentator David Brooks describes in his recent bestseller *The Road to Character* a cautious Dwight Eisenhower, the product of an upbringing and life emphasizing self-restraint. In his now famous final presidential speech to the nation (the one warning about the "military-industrial complex"), Eisenhower advised against hubris in favor of prudence and balance. He was a leader who realized that events and life itself could be difficult, and who "used to tell his advisors 'Let's make our mistakes slowly,' because it was better to proceed to a decision gradually than to rush into anything before its time."[1]

Given that so very much has gone right in the stock market in recent years, and armed with the knowledge that financial markets have not always followed a straight line higher, investors would do well to consider Ike's advice in the context of seeking returns from their portfolios. Much is being made of the current U.S. economic expansion (which turns nine in June!) and global growth prospects, too. Specifically, investors are asking: Will the good times last? The debate over whether expansions and bull markets die of old age is beside the point. Leave the yield curve analysis to others. Consider, instead, the historical record of economic and financial fluctuations. Bank credit quality, to take but one example, has traversed a wide range through the years, but has been strong for several years (see Exhibit 1). However, today's incredibly favorable credit experience is unlikely to endure, just as peak losses from the Global Financial Crisis were never going to persist indefinitely. Business cycles – while not easily predicted or timed – bear careful consideration in the context of investment decisions.

We know the current upswing is old and stretched, and things could be significantly worse, judging by historical standards. The real question for investors is how to manage the reward-to-risk balance in their portfolios, given the current circumstance and possible outcomes going forward. In a world of little obvious value, the notion of

EXHIBIT 1: CHARGE-OFF RATE FOR U.S. COMMERCIAL BANK LOANS



Source: Board of Governors of the Federal Reserve System (U.S.), Charge-Off Rate on All Loans, All Commercial Banks [CORALACBS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CORALACBS. Data as of April 30, 2018.
Notes: Charge-offs are the value of loans and leases removed from the books and charged against loss reserves. Charge-off rates are seasonally adjusted and annualized, net of recoveries. Frequency of data is quarterly, January 1985 – October 2017. Shaded areas indicate U.S. recessions.

1. David Brooks, The Road to Character (Random House, 2015), 48–73.

> "Investing in companies reporting weakness in incremental margins may be a mistake to be made slowly, and preferably avoided altogether."

proceeding carefully with investment selections and emphasizing a balanced portfolio would seem wise counsel to follow.

As value investors, our stock level analysis seeks an understanding of cyclical opportunities and context. An area of concern today, particularly in the more economically sensitive sectors, is incremental profit margins. We increasingly observe input cost inflation (raw materials, transportation, labor) accompanied with a delay (or inability?) in achieving commensurate price increases, which results in gross margin pressure. Several U.S. industrial companies have reported this weakness thus far in the first quarter earnings season, and their stock prices have suffered as a result.

Value investment opportunities may exist where there are also secular worries. Consider the media/communications landscape globally. After years of fat margins, incumbent distributors facing competition from new technologies like over-the-top streaming media are seeing both revenue losses amid cord cutting, and cost pressures as content is bid higher; this is adding up to lower margins. Similar secular stories of margins under assault are playing out in a variety of industries. Competitive analysis (Porter's Five Forces) is a crucial tool for distinguishing the margin maintainers. Rising profit margins have been one of the pillars of the current bull market. Therefore, investing in companies reporting weakness in incremental margins may be a mistake to be made slowly, and preferably avoided altogether.

Rising balance sheet leverage is another potential "mistake" worthy of careful consideration. Many companies have availed themselves of wide-open debt capital markets in recent years, in order to finance acquisitions, dividends and stock buybacks. Some management teams will have made smarter (i.e., value per share enhancing) decisions than others, but corporate balance sheets are generally the worse for wear. The increased leverage will likely have at least two impacts for shareholders: Outcomes will be magnified (both good and bad) and staying power in the face of unanticipated negative developments will be reduced. Thus, as investors look forward into the unknown and face cyclical risk, investments in well-capitalized and liquid balance sheets may serve them better than over-encumbered alternatives.

Beyond paying careful attention to the durability of margins and the strength of balance sheets, at the portfolio level, investors can attempt to avoid or reduce the impact of any mistakes via diversification. Our analysts and portfolio managers at Perkins are investing with conviction, identifying what we believe are the best reward-to-risk stocks, and putting significant capital into those positions. At the same time, we recognize the length and magnitude of the current cycle, and as we worry about what appear to be significant downside risks, we work to intelligently diversify our portfolios across many different drivers of alpha. We're aiming to have many investments that we view as high quality in our portfolios, along with plenty of flexibility should the cycle weaken from its current highs. An additional advantage of a well-diversified portfolio may be the opportunity to capitalize on bargain stock opportunities when they appear.

Eisenhower led the country (and world) in a time of great peril and tragedy, a situation wholly different from present day investing, it should be said. Still, having managed through such difficulties and recognizing the prosperity which had been achieved, the great leader urged a fundamentally cautious approach to managing the nation's affairs. It is that careful spirit which I believe holds wisdom for the present, cyclically extended investment circumstance.

Thank you for your investment with Perkins Investment Management.

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Alpha compares risk-adjusted performance relative to an index. Positive alpha means outperformance on a risk-adjusted basis.

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