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COMPLEXITY SCIENCE FOR COVID-19

STRATEGIC INSIGHT: Typical recession and recovery economic behavior offers great stock market buying opportunities.

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DATE: 13 April 2020

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There have been four great stock market buying opportunities in my lifetime. This is the fifth. The first was in 1973–74. There was war in the Middle East in October of 1973; there was war in Vietnam; we had soaring oil prices, double-digit inflation, double-digit interest rates, recession, and a constitutional crisis in Watergate culminating in President Nixon's resignation. I was a young first lieutenant in the Army making around \$400 per month and putting \$25 per month into the Templeton Growth Fund. In the fall of 1974, I went into the Merrill Lynch office in Munich, Germany and bought shares near the market bottom.

The second was in the summer of 1982. We had started our mutual fund in the spring of '82 and kept it mostly in cash as the market continued to decline. Mexico defaulted on its debt, the market fell sharply, and we got fully invested in July. In August, Paul Volcker cut rates and the great bull market was underway.

The third was in October of 1987 — the market crashed 22.6 percent on October 22. We had raised cash in the summer as the market got very expensive relative to bonds. Stocks peaked in August and began to decline. By the end of September, 30-year bonds yielded over 9 percent, a cash return roughly equal to the average annual return of stocks since 1926. The market collapsed and we put all of our 25 percent cash position into stocks. Our fund was the single best-performing fund of 1988 as most others maintained high-cash positions due to fears about the health of the economy.

The fourth was 2008–09. We did not navigate that period well, with the Opportunity Trust Fund being down over 60 percent in 2008. However, we remained fully invested and stayed that way throughout the 10-year bull market. The Fund was in the top 1 percent since the market low in March 2009 through the end of 2019.

We have been hit about as hard as anyone in this decline because we have been overweight

in higher-beta names, believing (correctly) that, since the financial crisis, people have been risk- and volatility-phobic, and that perceived risk has consistently been greater than real risk. Going into 2020, I thought that economic risk was low and that, if the market was going to decline, it would be because of either geopolitical events or some exogenous shock to global aggregate demand or aggregate supply. We got that exogenous event in the form of a global pandemic that took stocks from all-time highs to a bear market decline of almost 30 percent in the shortest time in history.

As is typical of these sorts of egregious declines, we are down a lot more than the market in all of our products. In times such as these, I am reminded of what John Maynard Keynes wrote to his board when he was managing money during the 1937 market collapse. They had been urging him to sell as the market went down, and he refused. He told them, “It is the duty of every serious investor to suffer grievous losses with great equanimity.” He went on to note that their advice to sell more as stocks went down, if practiced by everyone, would be economically disastrous for the country, and that he wanted to be fully invested at the bottom and not out of the market when it recovered, which he would be if he followed their advice.

The market’s behavior in the last week of March 2020 gives a strong confirmation that this recovery from a near-certain recession will follow the pattern of every other one since at least 1973–74. The leaders will be low-P/E, cyclical names with operating or financial leverage, *viz.*, the exact names that were clobbered the most in the decline. Those names were also the worst performers when recession fears were high — fall of 2018, first six weeks of 2016 — yet where no recession materialized. The reason why is fairly straightforward: prices and valuations are highly sensitive to the marginal return on invested capital and to business risk. When the economy is declining, or there are fears that it will, valuations on those companies whose return on invested capital (ROIC) is most sensitive to economic change, mostly traditional cyclicals, will decline more than those that are more resistant, such as consumer staples, utilities, bond proxies, and many recurring revenue businesses. Companies with high debt leverage and economic sensitivity fare the worst as the market discounts the possibility they will experience financial distress. When the market sees a recovery, the exact reverse occurs, which is what we saw March 24–25.

If, as most strategists think, we will have a short, sharp snap-back rally that takes us up 20 percent or more, which will be followed by a retest of the lows, then that retest will see the reverse, and again the cyclicals will lag, but not as much as they did on the initial collapse. I am agnostic on that, as my ability to forecast the market’s short-term path rounds to zero. So does theirs, by the way.

Last week gave a good indication of where the leaders and laggards are likely to be: names that have held up relatively well, such as AMZN, GOOG, FB, NFLX, were all down while most other stocks were up, led by cyclicals and high beta. The commonly offered advice in a steep market decline, such as we are experiencing, to “upgrade your portfolio” and to “buy quality names on sale” is a great prescription for underperformance in a recovery.

Sir John Templeton advocated buying at the point of maximum pessimism. The problem is that point is only known in retrospect. There is much pessimism and little optimism evident now, and it is impossible to tell whether stocks have declined enough to discount what the future holds with regard to the economic damage that the pandemic will inflict. In October 2008, Warren Buffett wrote an op-ed saying he was buying US stocks and urging others to do so as well. A few years later, he was asked how he knew that was the time to buy. He said he did not know the time, but he did know the price at which stocks were a bargain. They were a bargain then and, in my opinion, they are a bargain now. The market may have bottomed at an interim low on March 23, 2020 — or it may not have. I do believe that shares bought at these prices will prove to be quite rewarding over the next year, and perhaps a lot sooner. If you missed the other four great buying opportunities, the fifth one is now front and center.

ADDITIONAL COMMENTARY

Miller Value Partners (3/16/20): How Markets as Complex Adaptive Systems Process COVID-19: <https://millervalue.com/markets-complex-adaptive-systems-process-covid-19/>

CNBC (3/18/20):

Clip 1: <https://www.cnbc.com/video/2020/03/18/buy-amazon-in-response-to-coronavirus-sell-off-bill-miller.html>

Clip 2: <https://www.cnbc.com/2020/03/18/investor-bill-miller-one-of-the-best-buying-opportunities-of-his-life.html>

Full interview (paywall) <https://www.cnbc.com/video/2020/03/18/full-interview-with-bill-miller.html>

Ameritrade Network (3/26/20): <https://tdameritradenetwork.com/video/rB4AoXD6FmuBcRhYlikNzg>