

# BAY HILL *Living*

*A social publication for the residents of Bay Hill*

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## From the Desk of Richard Losch

### Building A Foundation

By Richard Losch



2015 was not a good year for the market, but the market had been going up since March 2009 and was clearly in need of a correction. There is much talk of a bubble that has been created by Federal

Reserve's policy of easy money, but if there is a bubble, it does not seem to be of a magnitude sufficient to create the kind of correction that we experienced in 2000 and 2008. What we do have is a highly bifurcated market where a few favored stocks have become very expensive. Most of the gains in the last 12 months were concentrated in a small number of large cap growth stocks. Last year, the 10 largest stocks by market cap in the S&P 500 gained nearly 23%, while the other 490 stocks were down about 3.5% on average.

The "FANG" stocks (Facebook, Amazon, Netflix, and Google) gained \$415 billion of market cap through the end of the year, a 55% jump. Netflix stock surged 134% in 2015; Amazon 118%. Their average price-to-earnings ratio soared from 49 to 120 times, according to Bloomberg.

Since the bottom in 2009 growth and Momentum stocks have out-performed value stocks by an excess of 1% per year. This is the reverse of the normal long-term performance of these groups, and so as value investors we hope that the current price correction will act as a catalyst for the return to the normal valuation patterns, and a future that offers substantial market out-performance for a portfolio of value stocks.

I am happy with our present positions. Compared to an overall market that still remains moderately overvalued, most of our positions are undervalued, downside risk seems limited, and there a strong potential for long term capital appreciation. While near term uncertainty makes it difficult to predict how the capital markets will perform in 2016, this does not limit our optimism about the next five years.

Since I first got involved with the stock market (as a registered representative at Merrill Lynch in 1967) the market has experienced approximately twenty corrections in the 10%-20% range similar to what we experienced in 2015. This time period also included a correction approaching 40% (1987), and three bear markets that could be classified as generational, with corrections of 50%.

In 1967, on my first day a Merrill Lynch, the Dow Jones stood at 890. Today, after all of the mayhem listed above, a year of slow economic growth in the developed world, the explosion of numerous commodity bubbles, a plethora of problems in various "emerging?" markets, the Dow hangs in there somewhere above 16,000.

There were many fundamental causes for these 20-odd corrections, yet they all carried marked emotional similarities. They usually end in some form of capitulation, in which they have generated a certain flavor of panic in the financial media. Although always painful, these market corrections serve a very important function in our economy that, while painful, is necessary. Corrections show us who went swimming without their bathing suit and, in a broader sense, reveal mistakes made in the preceding bull market. Examples include the oil and gas companies that were borrowing like crazy to expand production because oil was selling at \$100 a barrel, or the emerging economies that have accepted corruption as a viable alternative to productive work for generating personal income.

Corrections are the reason that the market economy works and socialism does not. As mistakes are exposed, individuals, companies, and economic systems that learn from their mistakes grow more prosperous. Those that do not learn disappear. The most important thing about the corrections is not the pain they bring, but problems they expose, because in this way they build a foundation for the next leg of the bull market.

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