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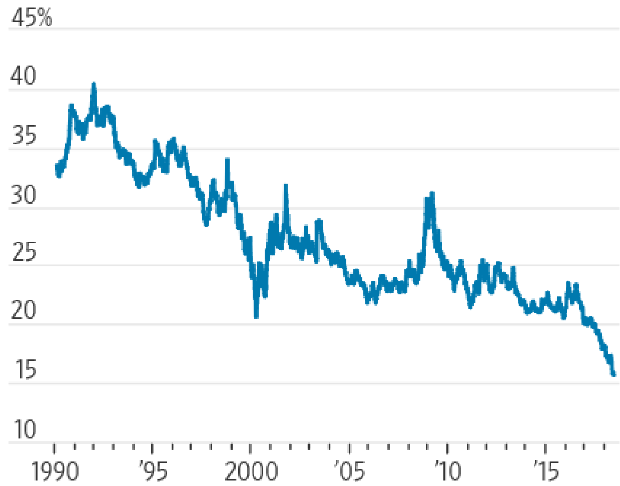
Fundamental Defense

The Best Offense is a Good Defense

High corporate debt levels, a flattening yield curve, and a lengthening economic expansion are just a few of the concerns worrying investors of late. With later-cycle risks growing, it's sadly ironic that the weighting of traditional defensive sectors within the S&P 500 is at its lowest point in modern history.

The S&P's Defensiveness as measured by its component weighting of traditional defensive sectors



Note: Defensive Sectors include utilities, telecom, pharma and consumer staples.
Source: Leuthold Group study published in the WSJ

While the index's defensive sector weighting has been declining for a long time due to structural forces re-shaping corporate America, the rapid decline since 2016 is reminiscent of the dotcom era when defensive businesses were abandoned for much riskier growth stocks. Different fundamental dynamics are at play today, but investors (especially disciples of passive strategies) would be doing themselves a disservice to dismiss the sudden decline in the S&P's defensive mix this late into a market expansion.

In addition to a sustained rise in large growth stocks, the falling weight of defensive sectors in the S&P 500 has been exacerbated by rising US government bond yields. Defensive stocks' stable dividend yields cause them to trade like bond substitutes – when interest rates rise, their stock prices tend to come under pressure. Since June, QV has used this weakness to purchase three new consumer staples businesses in the QV Global Equity Strategy – Pepsi, Molson Coors and Walgreens. These businesses all generate strong free cash flow, are returning a significant amount of capital to shareholders through dividends and buybacks and were purchased at attractive levels relative to their histories. To some, the mid-to-high single digit earnings growth expected from these businesses over the next few years may appear mundane relative to other faster growing, highly valued companies. We think that the risk in our new holdings is much lower, and the return potential over the next few years is quite competitive. Good defense is often good offense.

Follow the Fundamentals

While growing macroeconomic concerns present real, eventual threats, diverging indicators continue to suggest that a positive environment could persist for some time. Amidst these crosscurrents, it's important to remember that company fundamentals remain the best guide for navigating uncertainty.

In QV's strategies, equity valuations remain quite reasonable. The QV Global Equity Strategy, for example, trades at just 15x earnings. Compared to long-term historical multiples, relatively few of QV's individual global holdings are above average valuations, while many appear relatively inexpensive. Rolling bear markets throughout select market sectors such as consumer staples have created white space to recycle capital from strong performing holdings into other good businesses where multiples are more attractive. There is little evidence of cyclical overearning among holdings and many instances where revenues and margins are only just recovering to more normalized levels. Balance sheet strength is excellent and franchises remain diversified and sustainable. None of these fundamental guideposts look like warning signs. Being cognisant of the latent risks of a maturing economic cycle is only prudent. Owning defensive, reasonably valued businesses allows one to be prudently invested.