

The Black Swan

In 2020, the stock market encountered what investors frightfully refer to as a “Black Swan” event. A Black Swan is an unpredictable or unforeseen event, typically one with extreme consequences. The global Covid-19 pandemic that engulfed our world, markets and lives in early 2020 is one of the most scary, disruptive and memorable events of our lifetimes. The reaction of the US equity markets to the virus was at first muted, then when the first known US cases started to appear in February, fear took control of investors and the markets quickly collapsed. By March 23rd, the S&P500 had lost nearly 35% of its value in less than a month. Many nervous investors succumbed to their fears and sold positions into the weakness, others exhibited great confidence in the US markets and the Federal Reserve’s ability to help navigate our way out of this unprecedented crisis. As a result of prompt economic stimulus and building investor confidence in the future of the US economy, the S&P500 exploded to the upside and increased more than 60% by September. Once again, the disciplined, long-term investment approach of riding through uncertain markets (fear) proved to be the best strategy, even in the face of a terrifying Black Swan. Despite the upheaval we experienced in 2020 due to the pandemic, investment returns in the Alta Capital portfolios were remarkably strong, especially when one considers the concentrated nature of the narrow market leadership this past year. In 2020, the three largest companies, Apple, Amazon & Microsoft accounted for more than 55% of the S&P500’s annual return. Some investors are fearful that we may have borrowed investor returns from the future with this robust 2020 performance in the midst of a pandemic. However, we are encouraged by signs that this new “recovery” bull market has legs and that investors are looking with optimism to the post Covid-19 equity market. The extreme investor pessimism seen early in 2020 appears to have been replaced with a more optimistic view of the US equity market’s future.

We tend to agree with Warren Buffett’s assessment of annual forecasts: “Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future.” That being said, we believe that the economic environment this coming year will be constructive for equities. The U.S economy should continue to recover from the pandemic and corporate earnings will likely rebound, although year-over-year growth comparisons will be weak. The S&P500 Index companies reported earnings per share (EPS) of \$159 in 2018; in 2021 the potentially optimistic forecast is for EPS of \$165. Therefore, the lion’s share of the market’s recent price appreciation can be attributed to multiple expansion. This multiple expansion may be sustainable in the short term, but very unlikely to continue in the long term. We at Alta expect inflation to be of increasing importance to investors this coming year. We anticipate interest rates to remain at or near their current historic low levels in 2021. Longer term however, we believe interest rates will likely begin to creep higher. The real estate market remains strong with national inventories of homes for sale at very low levels. The existing home inventory level stands at less than 4 months’ supply, significantly lower than the historical average supply of 6 months. Energy prices will likely remain at or near current levels as we enter the post Covid-19 economy. Given our economic expectations for 2021, we believe the stock market will offer investors the best investment option for the coming year.

With the higher multiples and the richer valuations that we are currently seeing in the markets, we need to be careful that our growth expectations are in line with our intrinsic valuations. Currently, the Alta portfolios have better growth metrics than the overall market and this at more reasonable valuations. Our portfolios’ two-year forecasted EPS and Free Cash Flow relative to Enterprise Value are both well ahead of the overall markets, demonstrating the type of high quality growth companies we favor.

We wish you a happy and prosperous New Year.