Q & A:

The Case for More Moderate Returns

George L. Smith III, CFA
Senior Vice President,
Member, Investment Policy Committee

What are your thoughts on market returns in the coming years?

Since the beginning of 2018, we have been making a case for more moderate returns going forward. With the S&P 500 Index up 0.88% for the year as of October 24, 2018 (although very wild along the way), it seems like 2018 may indeed fall in the category of more "normal" returns after years of outsized appreciation for stocks.

Part of the reason is simply the robust returns from 2013 to 2017 when the market annualized at 15.8%. This is well above historical norms and was fueled by easy monetary policy and ultra-cheap money. Such returns make us think we borrowed from the future a bit. From a fundamental perspective, we also have to consider some abating tailwinds as well as some potential headwinds.

Can you describe these tailwinds and headwinds?

When we speak of abating tailwinds, these items fall in the camp of tougher comparisons, where things have been so good they seem unlikely to get much better:

- Employment gains aren't likely to get much better with unemployment at a record low
- We think that consumer credit quality may not get much better and corporate borrowing seems peakish
- Record buyback activity, which has been a nice crutch for the market, may abate a little
- Perhaps most notable, headline earnings growth should slow because of the waning impact of corporate tax reductions, which provided a big boost in 2018 that shouldn't repeat

But we also have to consider some other headwinds which could slow growth:

- Rising input costs and margin pressures from areas such as freight and labor
- The ongoing trade riff with China (we are hopeful we find common ground here)
- And most important, tighter Fed policy and rising interest rates

In light of these concerns, what positives can we look to as the year comes to a close?

We are long term investors. The economy looks strong, rates are still pretty low in absolute terms and inflation remains fairly subdued. And, some areas of the market have already gone very far in discounting a slowdown and seem to have overshot to the downside. We aren't attempting to predict a bear market or a downturn, we just think a moderation of returns makes sense and aren't as bullish as we were a few years ago. Bottom line: it seems investor expectations need to be in a more conservative place over the next five years, but we have no idea what the next 6-12 months will bring.

What types of stocks do you like to hold in times like this?

In our opinion, this part of the cycle argues for owning quality companies with less leverage. We also continue to think "Value" as a style may start to do better after an extended period of momentum/growth leadership. We hope that owning these types of stocks can help when risk aversion is on the rise. We also think dividends may become a more important component of total return in a more subdued environment.

If you have any questions about the topics covered in this handout, contact your Davenport Investment Executive or call (800) 846-6666.