Chris Davis on the Current Market

While recent wild market swings may have felt stomach-churning and sent some investors running for cover, Chris Davis, Portfolio Manager and Chairman of Davis Advisors, reminds investors that, "market corrections are the norm, not the exception" and that long-term investors, "should root for more volatility."

Christopher Davis

What are you telling investors about today's market environment?

Chris: I think the most important point is that this is normal. The period of low volatility that we had experienced is what is unusual. It is amazing to look at the headlines that come out: "Stocks Plunging," "Markets Tumbling" and "Bloodbath in Stocks." What happened in early October wasn't even in the top 300 days of largest percentage movers. In other words, on average over the past 90 years, there have been three or four days a year in which the market has moved down by a greater percentage.

We've been in a period of unusually low volatility, which breeds complacency. I think we forget that volatility and corrections are the norm. They are an unpleasant but regular part of the landscape. On average, you could expect a 5% correction every 51 trading days. You could expect a 20% correction every 630 trading days.

We've gone more than 2,400 days without a 20% correction. You can interpret that data and say, "We are way overdue," or you could say, "We would have said we were overdue when we were at 700 days, 800 days, and 1,000 days." So the most important thing is not to try to predict when these corrections will occur, but rather to recognize that of course they will occur.

When pullbacks and corrections do occur, the media will overreact and use the language that I shared with you. As investors, we should welcome this—because volatility is when active management is expected to shine more. In an unusual way, this return to normalcy is something that we should welcome because active management may add more value.

How do you manage risk in the current environment?

Chris: When we think about risk, the first thing to recognize is for most people, risk really boils down to the loss of purchasing power over time, or a lower quality of life. It isn't necessarily about volatility, which has a disastrous effect on investor behavior. When prices go down, the wiring in people is not to invest more, it's often to invest less. When prices go up, people get more excited. That is an old story and one of the most important risks out there.

The best world for investors is a world in which they feel that markets are risky. People say, "That stock went from $45 to $30, it must be very risky," and this is where you should invert it. There's a simple truth: Lower prices may help increase future returns and decrease risk.

In a way, we should be rooting for more volatility. Long-term investors should be rooting for that 20% correction that is far overdue and is a normal part of the landscape. And when faced with periods of dislocation, when stocks prices don't reflect underlying businesses value, I always think about what my grandfather told me: "You make most of your money in a bear market, you just don't realize it at the time."

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What is the backdrop for the current market?

Chris: In the U.S., we're in a period of low inflation, low interest rates, relatively full employment, fair valuations and moderate growth—a pretty good landscape. But inflation and interest rates are normalizing and the long-term deficit will have implications sooner or later. We have these unclear trade policies, and we're in an environment where margins are unquestionably near peaks. When you put that together and ask where the opportunities in the U.S. are, we say: selectivity is key, and it's going to be the theme over the next five to 10 years.

Selectivity is going to matter because the averages aren't going to work as well. If you can find wide-moat businesses with room for margin expansion and earnings growth—at a time when the average company could be facing falling margins because of higher labor costs, higher raw material costs and higher interest costs—those businesses are going to be differentiated. We also should be looking for out-of-favor businesses for what I would call "a return to classic value."

The last thing is just simply to say we always like looking at where the headlines are bad.[1] That has drawn us to financial services in particular, as well as energy.

What do you think is in store for financials?

Chris: I think we're a few years into what is going to be a decade-long rotation. This rotation is really going to drive financials to where they should be and how they should be perceived—which is relatively safe, high dividend growth, high value, boring. This is not just a U.S. theme; we're finding select opportunities in financials around the world.

Following the Great Depression in the 1930s, nobody wanted to own bank stocks for another 20 years, but after the first decade had gone by, the businesses themselves were performing quite well. Of course, the businesses do well because after something like the Depression, or in more recent times, the financial crisis, you have less competition, more capital, more regulation and wider moats.

The first thing that changes is people start realizing that the businesses that survived are actually pretty good. So people start to say, "Well, the businesses are doing well." We're seeing that as earnings are coming out year after year, enormous earnings, rising dividends, great credit quality, fattening interest rate spreads, a lot of things are moving the right way—except for one: Valuations remain at a 30% or 40% discount to the averages.

We're now in transition to what I believe may be the next decade of good performance, which will be driven by people coming to recognize that financials are boring, compounding machines. Not all financials, but, again, being selective and recognizing that they could be the next decade's dividend darlings.

These companies had to amass an enormous amount of capital for a decade. Now, they have built up their capital ratios. Now, we can gradually move into distribution mode. Not all at once, but I think we will see dividends for some of these companies rising 10% a year or so on average for the next five to seven years. This is in addition to the fact that financials were big beneficiaries of the recent tax code changes.

How about opportunities outside of the U.S.?

Chris: Europe continues towards recovery. They are following our road map, but they're way behind. They're moving slowly, and dealing with issues like demographics, the regulatory environment and lack of cohesiveness. However, Europe has a global orientation, and that is present in a lot of their best businesses. There is always an advantage for corporations with a global orientation.

When we look for opportunities given that context, we look for premier multinational leaders with strong global growth prospects and avoid companies that have tepid growth tied solely to Europe. We look for companies that are tarred with the European name or negativity, but actually have economic fortunes that are more differentiated.

In the developing markets, we see a lot of opportunities, due in part to strong earnings growth, powerful emerging middle classes and attractive valuations. Of course, one has to be aware of various currency, political, economic and regulatory risks, which are idiosyncratic. These risks vary dramatically country by country, which, of course, raises the same thing on the opportunity side, which is that selectivity is going to be critical—not just in the individual companies, but also in the individual countries.

1. **Headline risk:** Davis Advisors may invest in a company when the company becomes the center of controversy. The company's stock may never recover or may become worthless.

In select developing markets, we see opportunity in rapidly growing, attractively priced consumer service companies. Investors want to be where the middle class is erupting. You don't want to be in the big state-owned and formerly state-owned enterprises. We also like industry-dominating businesses, and are looking primarily in China, India and Brazil.

What are your thoughts on the current U.S.-China trade dispute?

Chris: I think this is a great example of the headlines distorting the reality. Trade disputes are always bad, because once you introduce tariffs, you introduce friction—which basically means money is taken from businesses and consumers and transferred over to the government.

So we start with the fact that there are negatives. However, history is not written in terms of how this will play out long term. Is this a short-term tactic? Is it a long-term war? When you go through country by country and look at historical data, it is amazing how perspectives can get distorted.

Only 10 years ago, net exports from China were 9% of its GDP. Today, they are 2%. In a sense, our perceptions of what is happening in the world or the way China works are outdated. China has transitioned from an export-led economy to a much more U.S. model of a consumer-led economy.

We love bad headlines. We love the prices that they create. The volatility is tough, but this is a great time when looking to select developing markets, and within those markets, the companies that have really dominant growth franchises—that are not sensitive to these trade disputes and so on. When you can buy those at cheap multiples, it is a value investor's dream. We really do see this unfolding now in select developing markets.

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