



March 31, 2020

SUMMARY

- Fueled by near-term economic uncertainty, valuations have recently touched lows not seen since the 2008-2009 financial crisis. We believe long-term opportunities remain in place and investors should be focused on purchasing selective bargains.
- The market is currently fixated on the shape and near-term path of the recession in aggregate demand and consumer spending. We believe investors should be more focused on the near and medium-term balance sheet recession in corporate debt. Our concerns include the effects of previously aggressive accounting in M&A financing and the potential for future write downs in the record \$3.6 trillion in goodwill assets found across balance sheets in the S&P 500.
- We believe there are long-term opportunities for quality balance sheet firms possessing secular growth runways to gain market share in the years to come, as these firms take advantage of the weakened credit environment to invest and grow through the coming cycle.

QUALITY THOUGHTS

Do something where you're performing a real service for people. It'll be a success. I like investment counseling. And I like helping others. It gives you pleasure you can't get spending thousands of dollars.

Sir John Templeton, May 1951

We have written many times before about John Templeton's investment philosophy, including his view that "Trouble is Opportunity." The wisdom of this mindset is apparent to seasoned investors, but in today's global pandemic it is easy to see its broader manifestations beyond investing.

Today's trouble presents an opportunity for *humanity* to perform at its highest level. Healthcare professionals inspire us with their courage and talent. Industrial firms lend their expertise to relieve potential suffering. Technology firms donate productivity tools to school children. Delivery drivers shield the elderly and compromised from health risks. For every financial commentator warning of a new low, there are countless every-day, real-life heroes contradicting the pessimism. If you focus too much on the financial media, you could miss capitalism at its best: men and women coordinating their talents to serve total strangers, those in need.

Our investment perspective is similar. COVID-19 presents the economy with a difficult, but surmountable challenge. The virus will run its economic course. From an investment perspective we remain relaxed and confident. The worry we carry is reserved for the health and safety of our communities, friends, and loved ones.



Yes, near-term GDP is falling sharply, but that does not upend our long-term views. In the years to come billions of people in this world are still set to enjoy their first access to the internet, their first checking account, their first smartphone, their first purchase or payment on that smartphone, their first warm meal prepared in a few minutes (perhaps ordered from their first smartphone), a hot cup of coffee, and yes, their first flight on an airplane. Despite current health concerns, scientists have not revised their views that children born today could live to be 150 years old¹ (*Amazing!*). Irrespective of the pandemic, we are living in a period of remarkable human advances and achievement.

Quality is the Vaccine for the Financial Contagion

For those properly prepared in advance, a bear market in stocks is not a calamity but an opportunity.

Sir John Templeton, May 1962

While we are captivated by the day-to-day heroes we described earlier, our investment focus is on companies that can rise to the occasion during difficult economic circumstances. As capital allocators we have already played defense for several years while cautioning against the risk of excessive borrowing in the fixed income markets. Today, our mindset is to play offense, but with a limited playbook for the time being. Our limited playbook comes in the form of confining our purchases to very specific stocks. To explain, we believe buying stocks in a steep market decline can be analogous to visiting Costco for the first time. We know to walk past impulse buys like the super cheap 7 lb. tub of Nutella (yes, it exists) or the do-it-yourself gazebo kit (also exists). Instead we search for the rarely discounted goods our portfolios need. Within the past few weeks, the quality, growth-oriented firms we seek at a bargain were found in the sale aisle. We acted decisively since we had studied the products beforehand, supplies were limited and competing shoppers were sure to arrive. Of course, another sale could come along, but we would be happy with the prices we paid either way.

Our insistence on quality bargains in this selloff may sound boring, but we believe we are investing in the same exciting future economics that we described at the beginning of our commentary. Our selectivity is also driven by our conviction that in a recessionary environment, certain firms have the potential to grow and perhaps even thrive, but many more will not. For instance, a study shared by Harvard Business Review on the recessions of 1980, 1990, and 2000 found that while 17% of the firms in those downturns disappeared to bankruptcy or buyouts, there was another 9% that outperformed their competitors by at least 10% in sales and profit growth². A similar study produced by Bain on the Great Recession showed that the top 10% of companies saw their earnings climb throughout the recession and afterward³. In terms of share price performance, a study cited by the Economist showed that in the last three recessions the top quartile companies returned +6% while the bottom quartile returned -44%⁴.

Another way to frame our selectivity can be seen in the firms we are avoiding in a recessionary environment. Earlier we referred to a “balance sheet” recession. To understand our reference, think back to the Great Financial Crisis (GFC) and recession that followed (2007-2009). In that case heavily

¹ Arrison, Sonia. Living to 100 and Beyond. Wall Street Journal. August 27, 2011

^{2,3} Frick, Walter. How to Survive a Recession & Thrive Afterward. May-June 2019



indebted homeowners went upside down on their mortgages, owing more than their homes were worth. In some instances bankruptcy resulted, but in all cases, their spending, saving, and even their ability to move houses were hamstrung by their indebtedness. In many ways we see a similar event unfolding in the corporate sector where the debt problems are prominent. In this case though, it will be companies (not consumers) that must struggle under the weight of their debt balances. Similarly though, many of these companies will fall onto a spectrum of survival and/or stagnation. Effectively, many companies could resemble zombies (i.e., like certain Japanese firms) able to cover their interest payments, but otherwise in a state of atrophy. We discuss our reasoning behind this potential outcome in the paragraph that follows.

Over the past several years corporate borrowers have had unbridled access to debt due to low interest rates and yield starved savers seeking returns. Many, but not all, firms abused this access through over-borrowing to fund short-sighted sugar highs: share repurchases, unsustainable dividends, and over-priced acquisitions. Shareholders have been complicit as the near-term rewards flowed in their direction. To emphasize this point, in the developed markets 1/8 of debt is held by firms already unable to cover their interest payments (prior to COVID-19). During the GFC of 2007-2009 this metric was only 1/14 among corporations. Similarly, 60% of mergers and acquisitions in the U.S in 2019 included “add-back” clauses⁵. If you are unfamiliar, an add back clause is used to project a higher, proforma EBITDA as a basis for increased borrowing to fund an acquisition. In the S&P 500, 97% of companies presented at least one metric inconsistent with GAAP, up from 76% in 2007...i.e., adjusted EBITDA⁶. To the extent that these add-back clauses were too aggressive, future impairments and asset-write downs seem likely. Currently, goodwill (representing the premium paid for acquired assets) sits at a record \$3.6 trillion across firms in the S&P 500. In both the dot com bubble and the GFC, goodwill write-downs pressured low quality stocks. In light of all of the above, it is not hard to anticipate debt-related problems across many publicly traded firms.

If, and when the above scenario comes to fruition, our expectation at that point would be to actually bargain hunt in the wreckage. That too could present remarkable opportunities for classic Graham and Dodd style selection methods. Experience has taught us though that these investments are best made at a “Point of Maximum Pessimism” when no other seemingly rational investors will consider them. In the meantime though, we are content to hold our quality portfolio for the long-term until better opportunities surface.

In closing, we hope that you have found these comments helpful in a period of market uncertainty that is challenging to investors of all stripes. We appreciate your support, and we wish you health, safety and peace of mind during this difficult time.

Lauren C. Templeton
Principal

Scott Phillips
Principal

^{4,5,6} The Economist. Downturn, Disrupted. February 20, 2020



Disclosures:

This information is for one-on-one client presentation only. Past performance is not indicative of future results. The actual characteristics with respect to any particular client account will vary based on a number of factors including but not limited to: (i) the size of the account; (ii) investment restrictions applicable to the account, if any; and (iii) market exigencies at the time of investment. Templeton & Phillips Capital Management, LLC ("TPCM") reserves the right to modify its current investment strategies and techniques based on changing market dynamics or client needs. The information provided in this report should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed may not represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings. It should not be assumed that any of the securities transactions, holdings or sectors discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein. Recommendations from the past 12 months are available upon request. Information was obtained from third party sources which we believe to be reliable but are not guaranteed as to their accuracy or completeness. All investments have the risk of loss.

TPCM is a registered investment adviser. Registration does not imply a certain level of skill or training. More information about TPCM including its advisory services and fee schedule can be found in Form ADV Part 2 which is available upon request. LTF-19-03