Bradley, Foster & Sargent, Inc.
Quarterly Market Commentary

October 2018

Time in the Market – Not Timing the Market Redux

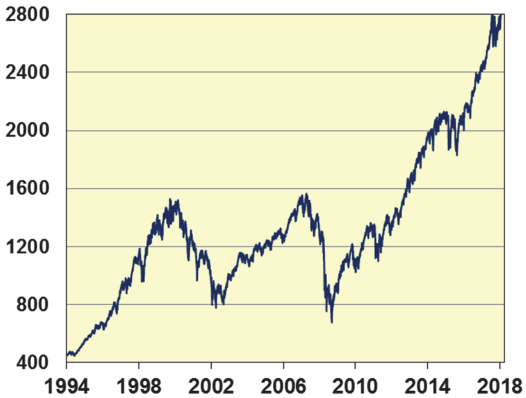
> The Dow Jones Industrials advanced from 66 to 11,497 in the 20th century, a staggering 17,320% increase that materialized despite four costly wars, a Great Depression, and many recessions… Since the basic game is so favorable, Charlie [Munger] and I believe it's a terrible mistake to try to dance in and out of it… The risks of being out of the game are huge compared to the risks of being in it.
>
> Warren E. Buffett, Berkshire Hathaway 2012 Annual Report

Five years ago, we wrote an investment commentary titled "Time in the Market – Not Timing the Market." The purpose of this October, 2013 commentary was to encourage both our clients and our friends who receive this quarterly report not to sell out of the stock market. Most had seen their portfolio drop dramatically during the great financial Panic of 2008. But the bull market, which started in March, 2009, had brought the market value of their portfolio in 2013 well above where it was before the Panic. The last thing that our clients wanted was to have to endure another shattering bear market where stocks plunged 50% or more. Our advice at that time was the same as it is now: Wealth, for the great majority of investors, is created not by trying to time the stock market but by *time in the market.*

One of the questions that we hear most frequently from investors now is: "This bull market is already 9½ years old so how much longer can it last?" When asked to forecast short-term movements of the stock market, we respond that while we seek to make thoughtful forecasts, we, along with others such as renowned investors Warren Buffett, Peter Lynch and John Templeton, think it is impossible to make this kind of prediction with consistent accuracy. This is because there are always so many macroeconomic, corporate, political, and psychological factors in play. Warren Buffett summed it up best as follows: "Let me again suggest that the future has never been clear to me (give us a call when the next few months are obvious to you — or for that matter the next few hours)."

Thus, in this commentary, we thought it helpful to re-examine the truly remarkable returns of the U.S. stock market over the long haul rather than focusing on short-term returns. One way to do this is to track the performance of the stock market and a number of top-quality stocks since Bradley, Foster & Sargent was founded 24+ years ago. The chart below reflects the performance of the S&P 500 Index during this period:

S&P 500 Index
July 1, 1994 – September 30, 2018



Source: Bloomberg

The chart on the previous page, which shows the more than sixfold increase of the S&P 500 Index for the 24¼-year period, does not reflect the full performance of the S&P 500, for it shows only the path of prices but does not include dividends. The total return of the S&P 500 Index was actually more than a tenfold increase, reflecting a compound annual growth rate of 10.17%. And this robust performance was achieved despite two sickening bear markets in 2000-2002 and 2007-2009 when the S&P 500 Index dropped 50% and 57% respectively.

Investment Performance of Great Stocks since 1994

How does the performance of the overall stock market compare with the performance of stocks of some of the top-quality companies during this period? The table below shows the performance of sixteen quality growth stocks that were both publicly traded in mid-1994 and are typical of our core equity strategy:

Company	Compound Annual Growth Rate (%)	Value of $1,000 Invested on 7/1/1994 as of 9/30/18*
Adobe	19.84	$81,000
Nike	18.48	$61,000
Danaher	18.25	$58,000
Microsoft	17.86	$54,000
Cisco	17.13	$46,000
Costco	16.71	$43,000
Home Depot	15.41	$32,000
United Technologies	14.75	$28,000
Union Pacific	14.65	$28,000
Chubb	14.43	$26,000
Johnson & Johnson	13.69	$23,000
Automatic Data Processing	13.67	$22,000
McCormick	13.56	$22,000
Abbott Laboratories	13.11	$20,000
McDonald's	12.91	$19,000
J.P. Morgan	12.55	$18,000
S&P 500 Index (Total Return)	10.17%	$10,479

**Rounded to the nearest $1,000*

Source: Bloomberg

It is interesting to note the breadth of industries and sectors represented by these winners. First of all, there are only three technology companies (the market's current darlings) in the mix — Adobe, Microsoft and Cisco. Four of the fifteen are consumer discretionary firms — Nike, Costco, Home Depot and McDonald's. There are three health care companies — Johnson & Johnson, Danaher and Abbott, and only two financials — Chubb and J.P. Morgan. The list is rounded out by a transportation company (Union Pacific), a payroll processing company (Automatic Data Processing), a consumer staples firm (McCormick), and an industrial conglomerate (United Technologies).

Another key observation is that each of these 16 companies except for Adobe pays a dividend. And the great majority of these companies have maintained a policy of increasing their dividend every year over the past decade. J.P. Morgan was the only one to cut its dividend following the financial Panic of 2008, and Microsoft did not raise its dividend in 2009. Cisco only commenced paying a dividend in 2010 but has raised it every year since then. Clearly, most companies which have the financial strength to raise their dividends annually over long periods (and maintain a modest payout ratio) have produced excellent returns for their investors. An example of how important this can be is Johnson & Johnson: In 1994, the company paid an annual dividend of 28.25 cents when the stock was trading at $9-$10 a share (split-adjusted), resulting in a dividend yield of 2.9%. Currently Johnson & Johnson pays a dividend of $3.60 with the stock trading at $140 – a dividend yield of approximately 2.6%. However, the current dividend of $3.60 represents a cash on cash return of 37.9% based upon an investor's purchase price in 1994. The power of compounding!

Three other companies whose stocks have had exceptional performance over all or part of this period are not included – Apple, Google (Alphabet), and Amazon. Apple had a compound annual growth rate of 26.02% during this period. But in 1994 Apple's stock traded for less than one dollar (split-adjusted). Steve Jobs only returned as Apple's CEO in 1997, and it took many years to turn the company around. Another great performer has been Google, which went public in August, 2004. Since its IPO, its average annual return has been 26.72%; an investment of $1,000 at the time of its IPO would have resulted in a market value as of September 30, 2018 of $28,000. Amazon has shown the highest return since its IPO in May, 1997 – an average annual return of 39.99%, producing $1,334,333 on a $1,000 investment at its IPO. Of these three stocks, only Apple pays a dividend.

In reviewing the above 19 companies, it is important to point out that the majority of these companies went through periods of ten years or more during which the prices of their stock were either flat or down. This happened during the "lost decade" between 2000 and 2009 when the total return of the S&P 500 Index was -9.1%. Some of these stocks experienced heart-stopping declines. An example of this is Amazon, whose stock dropped from $115 a share in December, 1999 to $5 a share in October, 2001 – a plunge of more than 95%. Another example is Cisco, which fell from a high of $82 in 2000 to $8 a share in 2002.

We have chosen to highlight 19 stocks that provided remarkably strong performance over a period of almost two and a half decades, but in doing so, we do not wish to imply these stocks were owned in our client portfolios for the entire period. Several of these stocks were holdings in our client portfolios in 1994, but the table simply represents the performance of stocks that are typical of our core equity strategy.

Key Characteristics of Top Performing Large Cap Stocks

What are some of the common characteristics of these 19 companies which have outperformed the S&P 500 Index so dramatically over this period of almost two and a half decades and created such wealth? What does Bradley, Foster & Sargent look for? In broad terms, we seek companies with a competitive advantage, great brands, a sound business model, and strong financial metrics. More specifically, these 19 companies have all or most of the following features:

- A strong business franchise with a proven business model
- Operates in an attractive industry
- Great and well-recognized brands and a leading market position
- A wide moat to protect against competitive threats
- Top notch, proven management
- Strong balance sheet (low levels of debt)
- Attractive profit margins
- Consistent growth of revenue and earnings
- Robust and growing operating cash flow
- High return on equity
- Record of dividend growth (or the ability to pay dividends in the future)
- Effective allocation of cash flow (including share buybacks and dividend growth)

Pricing Discipline

One of the two biggest difficulties in translating the purchase of companies with these characteristics into superior investment performance is buying them at a reasonable or advantageous price. Companies with these strong characteristics generally sell at very expensive valuations, and one key to great performance in a stock is to purchase it cheaply. Over the past 25 years, the average price/earnings ratio of the S&P 500 Index has been 16.1 times forward operating earnings. The majority of the 19 companies identified above currently sell at P/E's of 50% greater than the average. To achieve superior returns, investors usually must buy these stocks at opportune moments when the stocks or the industry are under pressure. This is not easy to do and often takes great patience until the right moment arrives. The other major difficulty is to discern whether a company which has displayed all or many of the characteristics above in the past will continue to do so in the future. Is IBM a fallen angel that will rebound? Or are there greater problems to come? Should an investor buy formerly great blue chips like Eastman Kodak or Xerox, or has their time come and gone? Does one purchase GE now for great future returns or will the stock only decline further? Discerning whether a stock is a good value or a value trap is an art, not a science, and takes good judgment, experience and emotional fortitude.

Time in the Market

An investment in the S&P 500 Index of $1,000 in 1926 would have produced $7,598,130 by the end of 2017 – a compound annual growth rate of 10.2%. Top notch stocks, held for the long haul, can do even better than the S&P 500. Also, buying and holding these kinds of stocks can be very helpful in minimizing the payment of capital gains tax. How long will this bull market last? We don't know, but we do know that the empirical data of the past century shows that one of the asset classes which has shown enormous wealth creation over the long haul has been growth stocks bought at a reasonable price. Pursuing this goal for our clients is our main mission at Bradley, Foster & Sargent.

Bradley, Foster & Sargent, Inc.
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