Focus on Equities

Morningstar Investment Management LLC

The S&P 500 lost ground in the second quarter, delivering a total return of negative 16.1%. Foreign stocks, as measured by the MSCI ACWI ex USA Index, declined 13.7%. Small- and mid-cap U.S. stocks traded lower, with the Morningstar US Small-Mid Cap Index down 16.1% for the quarter. Dividend stocks also declined this quarter, with the Dow Jones US Select Dividend Index down 7.4%.

Staying the Course in a Turbulent Market Environment

Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell.

— Sir John Templeton*

It wasn’t long ago, starting around mid-2020, when it appeared that some market participants started to suffer from FOMO, or fear of missing out. We raised questions about some of the resulting pockets of euphoria in prior Focus on Equities letters, such as special purpose acquisition companies (SPACs), increase in options trading, Robinhood, and money-losing IPOs. At the mid-point of 2022, it appears that FOMO has been reduced to one letter, F. Fear surrounds inflation, rising interest rates, and the potential for a recession—all of which have spooked the equity markets.

The average U.S. consumer is feeling squeezed, too. It is easy to understand why inflation is top of mind for the general population after a visit to the grocery store or gas station. Inflation readings in recent months are hitting 40-year highs as the Consumer Price Index rose 8.6% year-over-year in May. The war in Ukraine has contributed to commodity price increases and created a series of new supply-chain bottlenecks.

Inflation appears more persistent than the Federal Reserve anticipated, so in response they have raised their benchmark interest rate three-quarters of a point to a range of 1.5%-1.75% in their June meeting. Fed Chair, Jerome Powell, also stated that either a 50-basis-point or a 75-basis-point increase seems most likely at their next meeting.

These are undoubtedly big developments. In response bond yields have increased meaningfully, with both short- and long-dated maturities moving significantly. Notably, the benchmark 10-year U.S. Treasury note yield increased from roughly 1.5% to 3.0% from the start of the year through June 30.


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The net result is uncertainty. The Federal Reserve continues to attempt a balancing act of reining in inflation without stalling economic growth too much. Moreover, it is difficult to envision how the next three to six months might play out—which can be unnerving to investors. The equity market does not like uncertainty or negative surprises, and we’ve had both. When stock prices are moving steadily higher, market participants often take a long-term perspective to justify investment decisions. However, when markets tumble, the opposite is often true—they focus on the next three to six months instead of the next decade. Our investment team remains focused on assessing the competitive advantage of businesses and the durability of future cash flow generation over the next five to 10 years.

What we wrote in last quarter’s Focus on Equities letter still applies:

*Given the unusual economic circumstances, especially rising inflation, we expect upcoming corporate earnings results to have more variability and less predictability than usual. This could cause greater price fluctuation than we’re accustomed to for some portfolio holdings, even when there is minimal impact on the intrinsic value of the business.*

Rising input and labor costs may prove to be temporary for some companies and longer lasting for others. In our analysis we look to strike a balance between not overreacting to short-term results and incorporating new information.

We believe stock market “chaos” creates opportunities as prices can diverge significantly from business values. Our approach to investing in equities is founded firmly on the premise that the intrinsic value of a business, at times, can differ materially from its market price. In simple terms, we look to buy stocks when the price trades at a discount to the value of the business. Conversely, we aim to sell stocks when the price far exceeds intrinsic value.

In our Select Equity Portfolios, we have a natural bias toward—and preference for—investing in high-quality companies. We define high-quality as having sustainable competitive advantages, strong balance sheets, and shareholder-friendly management teams. We believe a business with these characteristics can weather any potential economic headwinds better than the average firm.

Following this market selloff, future returns from equities look more promising than they did just six months ago. That said, we don’t have any special insight on how the stock market—or any individual stock—will perform over the next month or year. As history has persistently demonstrated, prices can swing both well above and below intrinsic value, sometimes for extended periods. Yet, for risk-tolerant investors with a proper investment horizon, we believe the long-term financial potential of owning a portfolio of high-quality businesses can far outweigh the more challenging periods with volatility and market corrections like we’ve experienced so far in 2022.

We recommend consulting with your financial advisor, who can help you make sure your current asset allocation is appropriate for your risk tolerance and is on track to help you reach your long-term financial goals.

As always, we thank you for your business.