TJIM QUARTERLY INSIGHT

First Quarter 2021

Tom Johnson Investment Management, LLC

Have you ever looked up at the sky and noticed a flock of geese migrating in a V formation? When embarking on their biannual intercontinental migrations, these birds employ this V shaped formation to achieve greater efficiency, and thereby extending the range of each bird. In the V formation the bird at the front bears the brunt of shear forces so that the rest of the flock, by flapping in synchrony with the leader, can benefit from the lift created by the lead bird. Once the leader becomes exhausted, one of the birds from the back of the V fly up to the front to relieve the bird at the tip of the V.

The parallel in the world of investing is referred to as "factor performance". Factors include such strategies as value, momentum, and high dividend payers, et al. Investors use this type of analysis to attempt to characterize what investment themes have recently outperformed and extrapolate why certain individual securities outperformed others and potentially what themes will outperform in the near term.

As market narratives become exhausted, the leading factor styles tend to lag and, as a matter of course, make room for the lagging styles to take the leadership role. As mentioned above, these investment styles tend to gain and lose favor over time. It has been several years since value investing has led the overall market. In fact, value was the worst performing factor in two of the last three years. With investors favoring companies with far off prospects and extremely high hopes that the company will one day grow into the stock price, value stocks have been in the doldrums.

In the first quarter of 2021, we saw the continuation of something that started in the fourth quarter 2020; value has begun to gain favor in lieu of these high-flying growth stocks. Since the middle of November, the Russell 1000 Value index has outperformed the Russell 1000 Growth index by nearly 18%.

Some of the value rotation has been aided by the Federal Reserve and fiscal policy makers throwing trillions of dollars around like Santa tossing candy at a Christmas parade. Remember, prices for value stocks are predicated much more on current earnings, rather than the far-off expectations baked into growth stocks. While value stocks have benefited from extensive efforts to stimulate commerce in the wake of the economic calamity caused by Covid-19, growth stocks were equally and negatively impacted by the recent rise in interest rates.

The rate on the US 10-year Treasury has increased by one percent in recent months. Rising interest rates has the effect of lowering the value of expected future earnings. With earnings expectation so far in the future, growth stocks were affected disproportionately by the increase in the discount rate. To put it intuitively, if investors have increased earnings opportunities in low-risk assets, why continue to bet on some far-flung world-altering technology?

I am tempted to call this reversal a return to rationality, but the first quarter also included probably the most bizarre trades I have ever seen. To return to the geese analogy, it's like the geese are flying north after a winter in Cabo San Lucas with Sammy Hager. These geese are…hungover. GameStop, AMC Theaters, ViacomCBS, and Discovery, are all examples of stocks that started out the year at reasonable or cheap valuations. However, all of the stocks experienced some sort of mania in the quarter, and all of which, ultimately, were driven by excessive use of leverage.

201 Robert S. Kerr, Suite 510 ✧ Oklahoma City, Oklahoma 73102
Telephone (405) 236-2111 ✧ Fax (405) 236-2008

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GameStop is the most prominent example. At one point GameStop, was up over 1700% for the year and was trading at 4.4 times sales (GameStop was 0.23 times sales to start the year). Short interest in GameStop, or those betting on the price of the stock to decline, had reached over 100%. This meant that there was more money betting on a decline in the stock price than betting on an increase in stock price. The sudden and violent increase in price caused a short squeeze, which is essentially a virtuous feedback loop driving the stock higher at the expense of those betting the stock price would decline. It was this use of leverage and the accompanying structural dynamic which allowed GameStop stock to continue to rise despite the disconnect from the company's fundamental operating metrics.

Irrational trading in a few select names aside, there are real signs for economic optimism. Consumers are seeing the light at the end of the pandemic tunnel and the associated pent-up demand is starting to be reflected in consumer activity. According to Bank of America, total credit card spending for the week ending March 20th was up 45% versus March 2020 and 23% versus March 2019.

Additionally, there are signs of improvement in the hard-hit travel and entertainment industry. US hotel occupancy is now at 83% of the March 2019 occupancy, that is considerably improved from March 2020 when hotel occupancy was at 69% of the pre-pandemic levels. ("STR: US Hotels Achieve 83% of 2019 Occupancy for Week of March 27", 1 April 2021, https://www.costar.com/article/1037675844/str-us-hotels-achieve-83-of-2019-occupancy-for-week-of-march-27)

Finally, the employment picture has shown breathtaking improvement from the depths of the pandemic induced economic shutdown. Consensus estimates have the current unemployment rate at 6%. Considering the unemployment rate pre-pandemic was 3.5%, a 6% print does not represent anything close to full employment for a healthy domestic economy. However, consider the Global Financial Crisis, during which unemployment peaked at nearly 10% at the end of 2009. It took 5 years for unemployment to get back down to 6%. Here we are 11 months after unemployment reached a pandemic high of 15%, and we are already back at 6%.

The question remains, is the rotation from growth-oriented stocks towards value-oriented stocks a transitory factor? The fundamentals say it should not be. The disparity in valuations in the S&P 500 is still extremely stretched, meaning the companies with the highest price-to-earnings ratios in the S&P 500 are trading at higher valuations relative to their low price-to-earnings peers than at any point since 1996 (JPM: Guide to the Markets). There is still ample room for value stocks to close the valuation gap and continue to outperform.

As always, TJIM appreciates the trust you place in us, and we will continue to be stewards of your capital by building diversified portfolios of high-quality securities that we believe will provide attractive risk adjusted performance going forward.

Sincerely
TJIM Investment Team

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