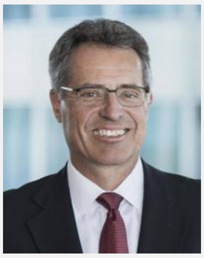
NATIXIS INVESTMENT MANAGERS

HARRIS ASSOCIATES L.P.

U.S. Equities: Mind the gap

"If you can keep your head when all about you are losing theirs…" –If by Rudyard Kipling

I won't mince words: It was a bad quarter for the market and the economy. With that backdrop, it's no surprise the American Association of Individual Investors announced in April that bearish sentiment among its members reached the highest level since 2009. What follows is an attempt to put this environment—bear markets, recessions and high inflation—into historical context and evaluate whether it warrants portfolio repositioning. It also includes some comments about our performance and current investments. Though our portfolio returns lagged some of our value peers last quarter, we are excited by how well our businesses performed and believe that bodes well for future stock performance.



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Bear Market

On Monday, June 13, the S&P 500 Index fell 3.9% to 3750, bringing the decline from its January 3 record high to 21.8%. The media focused on the market being down more than 20%, meaning this decline was now a "bear market." Financial professionals in the media advised investors to act "appropriately." What that meant went unexplained, but the implication was that, with the market down so much, you need to be more careful.

Can history help us decide how we should invest in a bear market? Over the 77 years for which we have daily price data for the S&P 500, there have been 12 bear markets. Let's look at the previous 11. The median bear market low occurred 117 days following the day the market was down 20%. The shortest time to the ultimate bottom was one day after falling 20%, which occurred in October 1957. The longest was more than two years, September 1946 to June 1949. If this bear market behaves like its predecessors, it is a coin-flip whether it bottoms by October.

What were equity returns immediately following bear markets? For the 11 previous bear markets, the median additional decline after the market was down 20% was another 10% loss. Despite those declines, two years from the time the market first hit down 20%, the median gain was 33%.

That statistic is especially interesting because the two-year price increase from a random purchase date has been just over half as much, 17%. Perhaps the advisors who are now urging extra caution are being driven by their emotions rather than data.

Recession

On April 28, the U.S. Commerce Department's Bureau of Economic Analysis reported that first-quarter GDP grew at 6.5%. On the surface, that looks like a nice increase from the sub-5% growth over both the past 5 and 10 years. But the GDP number that merits the most attention is real GDP, where the growth is adjusted for inflation. With first-quarter inflation running at 8.1%, the highest in more than 30 years, real GDP declined 1.4%. Economists attributed the first-quarter decline to high inflation, a high trade deficit and a decrease in inventory investment, saying that all three should improve throughout the year. But with the second quarter now in the rear-view mirror, it doesn't look like the headwind has lessened. A recession is typically defined as two consecutive quarters of declining real GDP, so if the June quarter also declined, we are already in a recession. It's probably 50/50. So, what should that mean for your investment strategy?

> *"Though it is tempting to believe that one should sell stocks following the onset of a bear market, a recession or a period of high inflation, the data suggest otherwise."*

We looked at the 12 recessions that have occurred since 1945 (the period we have access to daily S&P 500 prices) to see the price change in the S&P 500 during the two years after it was known that a recession had begun. The median two-year price increase in the S&P 500 was 25%, and only one of the 12 periods showed a negative return. Remember that the median two-year price increase from random purchase dates during those 77 years was only 17%, so the recession returns were actually higher. If the late July announcement of the second-quarter real GDP turns out to be negative, don't be bothered: There is no evidence that below-average investment returns are likely to follow.

Inflation

Inflation, as measured by the annual CPI, spiked above 8% in October 1973 and remained elevated until its peak of 14.6% in March 1980. It fell back below 8% in February 1982 and remained mostly under control until this past year. After troughing below zero in 2009, inflation increased to 5.4% in July 2021, and we were asked to believe that it was caused by the Covid-19 pandemic and would prove to be transitory. The steady climb of inflation to 8.6% in May of 2022 is stretching the meaning of the term "transitory."

High inflation almost always leads to higher interest rates, which erode the value of long-duration assets because they make future cash flows less valuable. Bonds, with their fixed interest payments and maturity values, are the hardest hit. Businesses can offset inflation by raising prices, but historically that has only been a partial offset. We expect our portfolios to perform better than average during higher inflation because we own banks that profit from a larger spread between their lending and deposit rates. Further, our portfolios have P/E ratios significantly lower than the S&P 500, meaning our "duration" is less than the market's, diminishing the value reduction caused by higher rates.

If inflation is a negative for equities, does that mean we should sell stocks when inflation is high? We went back to our 77-year data on S&P 500 prices and examined what the two-year returns were following inflation rising above 8%. Before this quarter, there were only five periods since 1945 when inflation exceeded 8%. An investor purchasing the S&P 500 following the announcement that the trailing annual CPI increase was above 8% and holding for two years showed a median price increase of 17%, the same as for a random two-year period over the past 77 years.

Though it is tempting to believe that one should sell stocks following the onset of a bear market, a recession or a period of high inflation, the data suggest otherwise. Stock prices anticipate future events before they occur. After the news is out, it is typically too late to profit. That's what makes timing the stock market so hard, and that is why we suggest not trying. Instead, we encourage dollar-cost averaging for investing new capital and rebalancing the portfolio after large market moves.

Disappointing Quarter

The Russell 1000 Value Index fell 11% in the quarter, much less than the 17% decline for the S&P 500. We expected to compare more favorably to the Russell Value in a down market. What happened? Though we had a couple of company-specific disappointments, including Netflix, we were most surprised by how poorly bank stocks performed. I said "bank stocks" instead of "banks" because I want to differentiate between business performance, which was good, and stock price performance, which wasn't.

We believe that investors are simply looking at how much bank stocks declined in the past two recessions and anticipating a repeat performance. But we believe several facts make that unlikely. First, banks are much better capitalized today. As an example, Bank of America projects a higher tangible equity ratio at the bottom of the Fed's severely adverse scenario than it had at the top that preceded the Great Recession. Second, banks have historically lowered lending standards before a recession to maintain revenue growth, but every bank we own today is committed to maintaining lending standards and measuring growth on a per-share basis, which gives credit for capital used to reduce shares outstanding. Third, banks today benefit from economies of scale much more so than in the past: Costs for regulatory compliance, fraud protection and digital banking, for example, do not grow linearly with size. That means that being big is a competitive advantage, which results in market share gains as measured by primary checking account relationships. Finally, valuations are extremely depressed: The S&P 500 sells for about 15 times expected 2023 profits, compared to the banks we own that range from 4 to 8 times expected earnings. Our short-term focus is always on business performance, which has been good, rather than stock performance, because in the long run, they converge.

Current Portfolio

To people who expect value investors to own only stodgy, low-growth businesses, there would be no surprise in seeing electric utilities in value portfolios. Those stocks fit the high-dividend, low-growth profile that is expected to be of little interest to anyone except value investors and, therefore, they are expected to trade at cheap prices. Why don't we own any electric utilities in our portfolios? The average electric utility sells for 16.7 times consensus 2023 earnings adjusted for cash. Only 15 of the 49 stocks we own in the Harris Associates U.S. Value Equity Fund sell at higher P/Es. Twelve of our holdings have single-digit P/Es, and our portfolio's median is 12 times cash earnings. We wouldn't deem any of them inferior businesses to electric utilities.

Stocks we own that raise eyebrows for being "too growthy" for a value investor, such as Alphabet, Booking, Meta and Netflix, all sell at lower P/Es than the average electric utility. Value investing shouldn't mean limiting one's portfolio to below-average businesses. A value investor should be willing to buy any business, but only at a significant discount to its intrinsic value. When businesses like Alphabet, Booking, Meta and Netflix are priced as if they weren't as good as electric utilities, the question should be, "How can a value investor not own them?"

In Closing

We encourage investors to take advantage of increased volatility and price declines. If you began the year with your assets appropriately divided across cash, bonds and equities, the large declines in bonds and equities have increased the percentage of your portfolio represented by cash. Investing some of that cash now would move you back to your target weightings. As value investors, most of the Harris Associates' managers are wired to buy opportunistically, especially after declines. So, last quarter most of us added to our personal investments in funds managed by Harris Associates. In the Berkshire Hathaway Annual Report several years ago, Warren Buffett encouraged investors in bear markets to read the Rudyard Kipling poem If: "If you can keep your head when all about you are losing theirs…yours is the Earth and everything that's in it." You won't regret re-reading it.

Written in June 2022

All data as of 30.06.2022, unless otherwise indicated. Past performance is no guarantee of future results.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas. Average price data for select utility, automotive fuel, and food items are also available. https://www.bls.gov/cpi/
The S&P 500 Total Return Index is a float-adjusted, capitalization-weighted index of 500 U.S. large-capitalization stocks representing all major industries. It is a widely recognized index of broad, U.S. equity market performance. Returns reflect the reinvestment of dividends. This index is unmanaged and investors cannot invest directly in this index.
The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000® companies with lower price-to-book ratios and lower expected growth values. This index is unmanaged and investors cannot invest directly in this index.
EPS refers to Earnings Per Share and is calculated by dividing total earnings by the number of shares outstanding.
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Top 10 holdings of the Harris U.S. Value Equity Fund as at 30.06.2022:

MAIN ISSUERS (%)	Fund
ALPHABET INC	6.2
FISERV INC	3.7
CHARTER COMMUNICATIONS INC	3.3
BERKSHIRE HATHAWAY INC	3.3
THOR INDUSTRIES INC	3.3
CHARLES SCHWAB AND CORP SAN FRANCIS	2.8
WELLS FARGO & CO	2.8
SALESFORCE INC	2.7
BLACKROCK INC	2.7
WILLIS TOWERS WATSON PLC	2.6
Total	**33.5**
Number of issuers per portfolio	**49**

Additional Notes

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