Finding Value in a High-Flying Market

At a time when the stock market is near, or at, all-time highs – how are portfolio managers finding investment opportunities? Weitz portfolio managers Wally Weitz and Drew Weitz share their views on the current state of the market, possible scenarios for the economy going forward, and where we're finding value today.

Jenna Dagenhart:

It seems like just about every week markets push higher and higher into unchartered territory with indexes like the S&P 500 and the Nasdaq hitting all-time highs and then subsequently breaking their newly set records. But the high-flying market inevitably brings an underlying sense of what goes up must eventually come down. And nobody knows exactly how long the rally will last.

Today, we're talking to Weitz Investment Management founder, co-CIO and portfolio manager Wally Weitz and portfolio manager Drew Weitz. Wally, Drew, thanks for joining us. And starting with you, Wally, with the market momentum as a backdrop, can you give us a quick update on the Weitz equity portfolios and your current view on the market?

Wally Weitz:

Yeah, well, the short answer is that business is good for our companies, and our stocks are doing well. But part of the reason they're doing so well is that the Fed is keeping interest rates artificially low. So, some of the gains are probably borrowed from the future. We own high-quality, growing businesses that are financially strong, well-managed, have high returns on investment, they're less cyclical and less capital intensive than average. So, they've adapted well to the COVID lockdown. And as fiscal monetary support is withdrawn someday, we would expect some valuation headwinds and some market volatility. But these are companies that we're going to be glad to own in any environment.

Jenna:

Regardless of that monetary and fiscal policy. Now, Drew, as we move further into the second half of 2021, what are you seeing in the economy through the lens of companies that you currently own?

Drew Weitz:

Yeah, thanks. I mean, I think what we're hearing from companies so far has been continued optimism about the continued reopening, though, with some caution related to the Delta variant increasingly being mixed in. As we have come through the most recent earnings period, we're moving through the anniversary of sort of the depth of the earnings hit from COVID-19. And so, as we move through the back half of this year we anticipate year over year comparisons are going to slow. But one thing that hasn't slowed down at all has been talk about inflation. We're hearing from companies really all across the economy talking about higher costs in their business, whether it's higher input prices or input costs for raw materials that go into their products or whether it's higher labor costs, again, to manufacture those products or to sell them in the marketplace. All those being equal, those higher cost structures are going to be a headwind to profitability. But as we all know, not all companies are created equal and some do have the ability to offset that pressure through pricing. This is something that we've been focused on for a long time at Weitz. Under our Quality at a Discount framework, we're focused on sort of studying these businesses and assessing their competitive positioning and assigning quality scores to all of these businesses. And again, competitive positioning is really at the top of that list. And the way that that gets evidenced

oftentimes is through a company's ability to take price. Pricing power can come from a number of different sources, whether it's having the superior product in the marketplace, so it generates more value for customers, whether through some sort of physical or other kind of network effects that give them an advantage or simply through limited competition. We're seeing the benefits of this in our portfolio today. And I'll give a brief example of Martin Marietta. So, they're a building materials supplier that produces cement aggregates that go into pretty much any construction site that you may encounter. These products are critically important, but they're exceptionally heavy relative to what they cost. So, a customer's ability to sort of bid Martin Marietta against suppliers further away really doesn't work because it becomes uneconomic to bring those in. So, Martin Marietta sort of enjoys these kind of pseudo-local monopolies for their products, and that is allowing them to deal with their current inflated cost structures as well by announcing a second price increase this year, as opposed to their typical sort of one and done pricing structure for a year. So, we're seeing different examples of that through the portfolio. And it's a critical reason why we focused on this for a long time.

Jenna:

Coming back to you, Wally, you started Weitz Investment Management back in 1983. You've been investing for over 50 years. How does the economy and the current market situation compare with past times over your investment career?

Wally:

Well, I have been at it for a long time. And in the old days, the Fed chairman thought his job was to take away the punch bowl when the market got overheated, and they would raise margin requirements to dampen speculation. And 40 years ago, Paul Volcker raised short-term interest rates to over 20% to get inflation under control.

These days, the Fed seems sort of obsessed with the stock market and to be afraid to do anything that might hurt stock prices. For example, in the fourth quarter of 2018, when it made its first tentative steps towards tightening credit, the S&P dropped 20% in about two months, and the Fed immediately backed off. And now we get these almost comical statements from the Fed, like we're thinking about thinking about tapering our QE program so that in a year or two or three, we might think about raising interest rates. And what a contrast with Volcker. It sounds odd to us, and it sound like some of the voting members of the Fed are starting to get a little restless, too. So, it may not take much longer to have them actually start.

So, we're not expecting hyperinflation. We're not expecting double-digit interest rates, but we do think it's inevitable that rates would rise to something a little more normal. When the Fed's buying bonds with zero return, they don't mind that because that's how they do their QE. But an actual bond investor wants to earn a real return of a percentage point or two over the inflation rate. So, if the Fed were to succeed in bringing inflation to around 2%, then you might expect 3 or 4 or 5% 10 year Treasuries. No disaster. But a little a little more normal. And with that, we think you'd probably get a little bit lower P/E ratios.

Now, if that happens gradually, as the Fed seems to be trying to program it, investors might stay calm. We doubt that. Or they might panic and trigger a selloff. We don't know. We don't know when or how fast it would happen, but we really don't think it matters. We're focused on what our companies will be worth in five years. And if prices do drop in the short run, those companies will be able to buy their own stock back in cheaply and we'll be able to go shopping. And we really look forward to the day when we can call up our clients and say we think it's finally time to do some buying. Now, what we'd not like to see is just more of the same. So, if the Fed begins to raise rates

and then panics if the market dips a little, the return to normal will be postponed again. And that just makes the market more fragile, and it's not helpful to investors.

Jenna:

Yeah, you've really seen the extremes there, Wally, 20% and near zero. Now, as your team considers the implications of multiple scenarios, how have your discussions shaped your investment decisions today?

Drew:

Yeah. Wally has laid out a number of different scenarios that can take place. And as a team we just acknowledge that in the short run, anything could happen. And so we try to just stay laser focused on sort of business as usual and executing our investment philosophy.

So as Wally mentioned, we're really focused on the next three years, five years, even further out than that. And so, when we're thinking about sort of how these businesses will evolve over time we are factoring in a moderately higher interest rate environment for our businesses.

And again, as Wally pointed out, we're not modeling rampant inflation. We're not making investment decisions predicated on financial crises or anything of those sorts. But we are cognizant that all else equal, a higher rate environment would put downward pressure on valuations. So as that happens, we think if you're using a P/E ratio construct, as that happens, it really pushes additional emphasis onto that earnings or the E component of the P/E ratio. For the life of the firm, we've always been pretty nervous or wary of investing in the really high speculative growth businesses that trade at super-premium multiples. And I think consistent with our outlook, we'd be a little more wary of that today. Instead, we prefer to own a portfolio of businesses that blend in a mix of businesses that have really durable earnings and cash flows that, Wally said, that management teams can go to put to work on our behalf. Businesses like the broadband providers Charter or Comcast. And then we really like pairing those up with businesses that have stronger secular growth potential but are still trading at pretty reasonable multiples in the market. So, thinking about the digital advertising giants like Alphabet and Facebook at the heart of our Quality at a Discount framework, what we're doing is – regardless of the market environment – scouring, scouring the market for really great businesses that are trading at attractive prices. We're going to follow what we own very, very closely, and we're going to track the businesses that we'd like to own just as closely. And since we manage concentrated portfolios that process and that work needs to surface really only a handful of ideas every year to have a pretty meaningful impact on the portfolio.

So again, regardless of the rate environment and sort of the direction these things may go, we think these first principles are pretty timeless. So, in the end, if we're right about how our businesses can evolve and grow their business value over time, we think we're in a great position to benefit from their continued success. And as Wally points out, if there's volatility along the way, we think we can benefit not only through our own actions in the market, but through those of our management teams as well.

Jenna:

Well as we wrap up, Wally, anything you'd like to add?

Wally:

Well, we've been in an artificially manipulated market for a long time, years, and our stocks have gone up a lot and that's great. And if the market pauses for a while, that's really okay with us. Long-term investing is just really about patience and not brilliance, really. We look forward to a return to normal where bond yields respond to market forces instead of the Fed. And where stock valuations are based on business values. That's when active managers can find some bargains and add some value. So, bring it on.

Jenna:

Well, Wally, Drew, thanks so much for joining us today.

Drew:

Thanks for having us, Jenna.

Wally:

Thanks.

Jenna:

And thank you for watching. That was Weitz Investment Management's founder, co-CIO, and portfolio manager Wally Weitz and portfolio manager Drew Weitz. I'm Janet Dagenhart with Asset TV.

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As of 06/30/2021, the following portfolio company constituted a portion of the net assets of Balanced Fund, Hickory Fund, Partners III Opportunity Fund, Partners Value Fund, and Value Fund as follows:

- Alphabet, Inc. – Class C: 2.2%, 0.0%, 5.9%, 6.7%, 7.0%
- Charter Communications, Inc.: 1.7%, 0.0%, 0.0%, 0.0%, 0.0%
- Comcast Corporation: 1.6%, 0.0%, 0.0%, 0.0%, 2.9%
- Facebook, Inc.: 0.0%, 0.0%, 4.9%, 3.6%, 4.9%
- Martin Marietta Materials, Inc.: 1.3%, 2.9%, 0.0%, 2.8%, 0.0%

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