

Navigating market highs and (avoiding) value traps - U.S. equity market commentary 1Q24

March 31, 2024

Last quarter, the S&P 500 Index hit a new high every month as did each of our U.S. Funds. In March, I wrote a [piece](#) for our website discussing why new highs are important to us. On one of the recent new high days, I heard a portfolio manager on TV urging caution because it is “dangerous” to invest after new highs.

At Oakmark, we are long-term investors. We attempt to identify growing businesses that are managed to benefit their shareholders. We will purchase stock in those businesses only when priced substantially below our estimate of intrinsic value. After purchase, we patiently wait for the gap between stock price and intrinsic value to close.

In the past 50 years, selling after the S&P 500 reached a new high would have allowed an investor to avoid four very painful declines: 44% after the dot-com bubble popped in 2000, 38% entering the great financial crisis in 2007, 19% in the 2020 Covid-19 shutdown, and 25% in 2022 when inflation and interest rates sharply increased. As with many market-timing schemes, the positive result from those correct calls has made selling after a new high a popular strategy.

But if we look back at the past 50 years (600 months), the S&P 500 achieved a new high in 156 of those months—or 26% of the time. It’s much more common than people think. Despite those four very timely sell signals, selling all the new highs would have given many more sell signals that destroyed value. An investor who sold every new high and waited for a lower re-entry price would have missed the opportunity to make more than 200 times their money by just buying and holding the S&P 500 for 50 years.

As you know, we aren’t market timers at Oakmark because we don’t believe we can be right often enough to overcome the strong tailwind of rising equity values. Our approach to new highs is to do what we always do: make sure we sell those stocks that have achieved our price targets and reinvest in stocks that are selling well below our estimates of value. Today’s market is giving us ample opportunity to find stocks we believe are inexpensive, despite the elevated P/E ratio of the S&P 500. For example, since the beginning of 2023, the stocks we added to the Oakmark Fund had a median P/E of 12 times 2024 estimates, just over half the S&P 500 multiple. We believe that by staying invested while always shifting the portfolio to the stocks that appear least expensive, we will achieve results far superior to moving in and out of cash.

Motley Fool Interview

Last quarter I was interviewed by John Rotonti for The Motley Fool. Below is an excerpt from that interview and you can find the full interview [here](#). John also hosts a new podcast, “The JRo Show.” Here are links to two episodes about Oakmark: one is an interview with [me](#) and the other is with [Mike Nicolas and Alex Fitch](#).

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John Rotonti: In a recent Morningstar podcast chief investment officer for T. Rowe Price Investment Management David Giroux said, “GARP investing over long periods of time generates the highest returns in the market—beats value, beats growth, and has better risk-adjusted returns than those two as well...” My take is that he's really describing value investing (buying an above-average business at an average multiple with the thesis that the multiple should be higher)? What are your thoughts?

Bill Nygren: Buying great businesses at average prices is as much value investing as buying average businesses at great prices. The idea that every business trading at a low P/E, P/B, P/anything ratio is a “value stock” is just plain stupid. Some businesses are truly inferior and deserve to sell at low multiples. GARP is a segment of value investing. Munger says always invert. What would GAUP (Growth at Unreasonable Price) be? It would be a price-insensitive style of investing, much like momentum investing. It would be the opposite of value.

John Rotonti: If I remember correctly, you previously owned Amazon in the Fund and sold it for a roughly 100% return. Was selling it a mistake? If you take into account where you redeployed the funds, taxes, opportunity cost, sticking to your proven framework, and everything else, do you think previously selling Amazon stock was a mistake?

Bill Nygren: We bought Amazon in 2014 and no doubt we would have made more had we kept it than reinvested the sales proceeds. Looking only at results, I guess you would conclude it was a mistake. But it's one I'd make again in the same circumstance. We bought Amazon back then because it was selling at what we believed was an unjustified discount to other retailers using a price-to-sales metric. After about a year, Amazon had risen to roughly what we thought the retail business was worth. Amazon Web Services (AWS) was brand new, and analyst reports were starting to attribute large potential valuations to it. We thought it was way too early to conclude that AWS would become one of two winners in the cloud business. Because the stock price fully reflected the values that we thought we understood, our process required us to sell it. That same process has kept us out of trouble in countless other situations. Because of that, I don't look back on selling Amazon as a mistake. (And as you know, now that the AWS value seems better defined, we again own Amazon on the theory that it sells at a discount to the sum of the retail and AWS businesses.)¹

John Rotonti: Do you look for ten-baggers or even multi-baggers of larger size than 10x? Specifically, do you ever ask your analyst if they think the stock can 10x in a reasonable amount of time? Why or why not?

Bill Nygren: We don't set out looking for them, but have ended up owning some anyway (Visa, Mastercard, Apple, TE Connectivity, Capital One Financial). When we bought those stocks we thought we were buying fifty cents on the dollar, but the magnitude and duration of growth positively surprised us. I think a mistake young analysts often make is being too anxious to claim a win and recommend selling a successful stock too early. With experience, analysts learn to reassess their sell targets both up and down based on new fundamental information. Many times, when stocks are first recommended, the analysts present models that they think are conservative. We try to avoid conservatism in favor of better being able to rank order our Approved List based on attractiveness.

John Rotonti: Why is paying a low P/E multiple so important to compounded returns?

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Bill Nygren: I'd like to slightly shift the question to, "Why is it so important to pay a low price relative to business value?" While that always translates to a low multiple on some metric, it doesn't have to mean a low P/E multiple. Efficient market theorists will say that regardless of the price you pay, you can get a fair return relative to the risk you incur. However, if you believe as we do, that most of the time a stock will trade reasonably close to intrinsic business value, then buying at a discount to business value beats a mostly efficient market. By purchasing at a discount to value, risk is reduced because the expected terminal price is a higher percentage of business value. Further, reward is amplified for the same reason, the terminal value is a higher percentage of business value. The efficient market hypothesis would say that an investor's holding period return should roughly match the change in business value during that time. To that, we add the increase in price due to the gap closing between initial price and initial value. Note that paying more than business value has exactly the opposite effect.

John Rotonti: What makes the investing process at Harris/Oakmark repeatable? Why will the proven process endure once you, Clyde McGregor, David Herro, and Tony Coniaris decide to retire?

Bill Nygren: First, let me make clear that we are not the first generation of leaders at Harris|Oakmark. The firm had a successful investing record before any of us joined, and I expect that will continue long after we are gone. Second, it is important to understand that there is a long list of current employees who contribute to our success today. Most of our investment decisions are made by people other than the four you mentioned.

I think most firms struggle with generational transitions because they typically have a dominant leader who fully controls decision making until they retire. That means that the retiring leader is replaced by someone who is new to being responsible for decision making, which of course, is a big risk. At Harris|Oakmark, our structure is much more horizontal, with democratic decision making on most products. So, when we retire, we are replaced by investors who for years have been responsible for important decisions. Further, we only hire investment teammates who believe in value investing, meaning we won't be facing a change in investment philosophy as today's leaders retire.

John Rotonti: What is your definition of a value trap? What types of stocks do you think are the most likely to end up being value traps? Do you think that companies with low or declining terminal values are susceptible to being value traps? And what actions do you take to actively try to avoid investing in potential value traps?

Bill Nygren: We define value traps as companies where value does not increase with time. The term would primarily be applied to structurally disadvantaged companies that currently trade at low multiples. To avoid them, we require analysts to project business value seven years into the future. If the combination of expected annual value growth and dividend yield doesn't at least match the market, we won't buy them.

Of course, sometimes we expect value to grow as time passes, but we turn out to be wrong. We try to sell those mistakes as rapidly as we can. We track an analyst's estimated business value from the time the stock goes on our Approved List, and if actual growth meaningfully lags projected growth, the stock is given extra attention, including extra reviews, devil's advocate reviews and maybe even changing the analyst who covers the stock. The goal is to make the path of least resistance selling the stock rather than holding it.

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John Rotonti: ...What sorts of conversation are you and your team having around the performance of the U.S. stock market in 2023 and around market valuations?

Bill Nygren: First, I think it highlights how hard market timing is. Most market timers a year ago were talking about what a tough year 2023 would be for equities. Our discussion has mostly been about the growth/value performance chasm. At the end of 2021, we agreed with most value investors that low P/E stocks had become unusually undervalued because of the decade-long bull market in growth. While 2022 was a relatively good year for value, dodging much of the S&P's decline, that entirely reversed in 2023. We look back on the two-year period and are surprised that growth has slightly outperformed despite the increase in interest rates. Because high P/E stocks have their cash generation further into the future than low P/E stocks do, they generally perform worse when interest rates rise. Given the attractive starting point for low P/E stocks at the beginning of 2022, and the subsequent underperformance, we again think low P/E stocks are unusually attractive today.

John Rotonti: Thoughts on the Magnificent 7?

Bill Nygren: We own a lot of Alphabet, so I can't say we think they are all grossly overvalued. I don't have much to add to a topic that dominated financial news in 2023, but one point I think is generally missed is that the group's strong performance has really increased the technology industry concentration in the S&P 500, and to an even greater degree, the Russell Growth and NASDAQ. Many investors who have been taught to think of index investing as low risk may be unaware of how risky those investments have become.

John Rotonti: Have you ever considered launching a family office after you retire from day-to-day at Harris|Oakmark and shift more into a mentorship role at the firm?

Bill Nygren: No, I haven't considered that. I expect to stay with Harris|Oakmark for an extended period, eventually transferring my current responsibilities to the younger generation, but maintaining a role as an external spokesperson and internal mentor. I've been very happy having my assets invested in Harris|Oakmark and expect that to continue when I eventually retire.

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¹Note that Oakmark Fund sold Amazon last quarter because we believe the current market price better reflects the combined value of retail and AWS.

The securities mentioned above comprise the following percentages of the Oakmark Fund's total net assets as of 03/31/2024: Alphabet Cl A 3.1%, Amazon 0%, Apple 0%, Capital One Financial 2.5%, Mastercard 0%, TE Connectivity 0.8% and Visa 0%. **Portfolio holdings are subject to change without notice and are not intended as recommendations of individual stocks.**

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The securities mentioned above comprise the following preliminary percentages of the Oakmark Select Fund's total net assets as of 03/31/2024: Alphabet Cl A 6.5%, Amazon 0%, Apple 0%, Capital One Financial 6.1%, Mastercard 0%, TE Connectivity 0% and Visa 0%. **Portfolio holdings are subject to change without notice and are not intended as recommendations of individual stocks.**

To obtain a full list of the most recent quarter-end holdings, please visit our website at www.oakmark.com or call 1-800-OAKMARK (625-6275).

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Growth at a reasonable price (GARP) is an equity investment strategy that combines growth and value investing attributes.

The price to earnings ratio ("P/E") compares a company's current share price to its per-share earnings. It may also be known as the "price multiple" or "earnings multiple", and gives a general indication of how expensive or cheap a stock is. Investors should not base investment decisions on any single attribute or characteristic data point.

The Price to Book Ratio is a stock's capitalization divided by its book value.

Magnificent 7 stocks refer to Alphabet Class A, Amazon.com, Apple, Meta Platforms, Microsoft, NVIDIA and Tesla.

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 NASDAQ Composite Index is a broad-based market-capitalization weighted index of all common type stocks on the NASDAQ Stock Market, including common stocks, American depositary receipts, ordinary shares, shares of beneficial interest or limited partnership interests, and tracking stocks. The index includes all NASDAQ listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debentures. This index is unmanaged and investors cannot invest directly in this index.

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Russell 1000® Growth Index is an unmanaged index that measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000® companies with higher price-to-book ratios and higher forecasted growth values. This index is unmanaged and investors cannot invest directly in this index.

The Oakmark Funds' portfolios tend to be invested in a relatively small number of stocks. As a result, the appreciation or depreciation of any one security held by the Fund will have a greater impact on the Fund's net asset value than it would if the Fund invested in a larger number of securities. Although that strategy has the potential to generate attractive returns over time, it also increases the Fund's volatility.

Because the Oakmark Select Fund is non-diversified, the performance of each holding will have a greater impact on the Fund's total return, and may make the Fund's returns more volatile than a more diversified fund.

Oakmark Select Fund: The stocks of medium-sized companies tend to be more volatile than those of large companies and have underperformed the stocks of small and large companies during some periods.

Investing in value stocks presents the risk that value stocks may fall out of favor with investors and underperform growth stocks during given periods.

All information provided is as of 03/31/2024 unless otherwise specified.

Before investing in any Oakmark Fund, you should carefully consider the Fund's investment objectives, risks, management fees and other expenses. This and other important information is contained in a Fund's prospectus and summary prospectus. Please read the prospectus and summary prospectus carefully before investing. For more information, please visit Oakmark.com or call 1-800-OAKMARK (1-800-625-6275).

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