Keep It Smart

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- Overemphasizing ever-shifting economic variables can lead to the wrong conclusions. We think it’s better to keep it smart and focus on what matters.
- With financial conditions tightening and growth slowing, companies face too many cyclical and secular pressure points to maintain record margins.
- While the market environment ahead may prove less favorable than that of the recent past, we believe there will still be companies that can compound value over time.

Sadly, MFS recently lost one of its own, Steve Eastman, to cancer. Steve was a relationship manager who had a unique talent for connecting with people. While that was evidenced by his deep relationships with clients, it was driven home by the touching tributes from many of his colleagues after his passing. He was liked by everyone.

Early in my transition to my current role, Steve asked me to accompany him on a client visit. I was still feeling my way (i.e., making a lot of mistakes), but it was hard to say no to him. My performance in that meeting was mediocre. In those early days, I was forcing it, saying what I thought people wanted to hear from an investment strategist versus what felt right to me. On the drive back to Boston, I voiced my frustrations. Steve, always upbeat and elegant, said I should be nothing but authentic. Numerous times he said, “Keep it smart!” It became our inside joke. I’ve tried to follow his advice ever since by focusing on what matters and keeping it honest and direct.

Beware overanalysis

In trying to predict what asset prices will be, talking heads across the industry have recently been doing mental gymnastics over a host of market signals — including the slope of various yield curves, multidecade-high inflation and rising labor costs — to figure out which way markets are headed.

But investing is hard. It’s hard because economies and markets are complex, adaptive systems in which the behavior of some changes because of the actions of others. It’s also hard because when previously distinct viewpoints converge, and herding occurs, signals usually become distorted.

While investing is hard, it’s simple too. All financial assets, whether public or private, equity or debt, ultimately derive their value from cash flows. So let’s keep it smart and take a closer look at what matters rather than let the overanalysis of ever-shifting economic variables send us down the wrong path.
Margins and cash flows

Using profit margins as a proxy for cash flows, the illustration below shows US and non-US margins over the past 20 years.

Exhibit 1: COVID-related stimulus fueled record margins

You can see that in 2018, during the cycle that followed the global financial crisis, margins reached all-time highs despite the weakest economic recovery in over a century. That’s because companies got creative in not only protecting margins but also in pushing them to new heights by stretching supply chains, restraining labor costs and financializing balance sheets. Actions such as these were meant to be profit-generating placeholders until growth normalized. But growth remained slow and margins began to wane.

Margins contracted following the lockdowns in early 2020. But what looked like a probable decline to the recession-like margin levels of 2002 and 2009 was quickly offset by unheard of levels of monetary and fiscal stimulus. Policymakers undertook a historic transfer of wealth from the public sector to households that sparked a sugar high of double-digit economic and corporate revenue growth. Against what were then falling costs, margins reaccelerated to new all-time highs, where they remain today.

Pulling no punches

I could waste your time with numerous and conflicting examples of what economic growth and profit margins look like when one yield curve steepens but another flattens, or we could debate the crosscurrents consumers face in a situation where the rising cost of living is rapidly eroding what were substantial savings. We could do all of that and more, yet still come up with the wrong answers.

Irrespective of what signals the economy or segments of the market may be sending, Steve would tell us to go straight to what matters and not pull any punches: With financial conditions tightening and growth slowing, companies face too many cyclical and secular pressure points to maintain record margins.
Keeping it smart

At MFS we don’t buy the market. While we think there could be immense pain ahead for the owners of bad assets and mediocre returns for the average, our objective isn’t to own the average. We take equity stakes in companies that we believe can compound value over a period of many years and we lend money to enterprises and institutions with sustainable growth prospects who we believe can pay our clients back. In summary, we try to allocate capital responsibly, which to us means funding organizations that we believe will be around, and successful, for many years. 

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Standard & Poor’s 500 Stock Index measures the broad U.S. stock market.

MSCI EAFE (Europe, Australasia, Far East) Index measures the non-US stock market.

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