July 2019

I'm writing to you at the end of a week in which the Dow Jones Industrial Average crossed 27,000 for the first time ever *and* in which the S&P 500 crossed 3,000 for the first time ever. There's something about these market averages reaching "all-time highs" that increases fears in the hearts of investors. Now, this isn't necessarily a bad thing. After all, the formula for successful investing is not just *buying low*, but *selling high*. By the way, many investors seem to get those activities confused, particularly when they let their emotions get the best of them and "run with the herd." Emotional investing inevitably leads to *buying high* and *selling low*. So, there's a sense in which it's nice to find someone leaning the right way when prices are high.

I'd like to point out, however, that high *prices* don't necessarily equate to high *valuations*. Years ago, I read a piece by Warren Buffett that made this clear to me. On this subject of all-time high prices, he noted that a passbook savings account, where the interest is compounded daily, hits an *all-time high* price every day! No one would argue that this savings account is over-valued; it is simply growing on plan. Over the long-term, that is exactly what the U.S. stock market does, albeit with more volatility. As the U.S. economy grows over the decades, and the profits of American businesses grow with it, the market prices of U.S. stocks should regularly hit all-time highs. The year-to-year irregularities of profit-growth, combined with the ebbing and flowing of investor sentiment, mean that the all-time highs don't occur daily, as with your savings account, but we shouldn't be shocked when they periodically occur.

In the past I've referred to Oscar Wilde's famous saying that, "A cynic is a man who knows the price of everything, and the value of nothing." Knowing the price is easy: it's reported every day! Thus, journalists write stories about the S&P 500 crossing 3,000. Everyone with a smartphone knows when it happens. But not nearly as many stories are written about the *value* of the S&P 500, as to whether at 3,000 it's over-valued, fairly valued, or under-valued. Your smartphone can't tell you that. Knowing the *value* of anything (stocks, bonds, real estate, artwork, etc.) requires diligent study into both the nature of the item to be valued *and* the market for it. When studying the market for an item, one must study both the prevailing market and the historical market. This is the hard stuff of investing.

So, you may ask, is the S&P 500 overvalued at 3,000? In our opinion, no, it's fairly priced. As we noted in our January letter, we thought the fourth quarter 2018 sell-off had reduced the market to prices that reflected excess pessimism about the future of profits, and therefore represented a buying opportunity. Thus, it was under-valued. By our April letter, that discount had been erased by a strong first quarter rally, taking the market averages back to where they had been the previous September. We thought then that stocks were fairly valued. Three months later, the S&P 500 is now just 3.5% higher than it was in April. Relative to expected earnings, dividends, the economic climate, and the interest rate environment, we continue to think the market averages are fairly valued. They're not "dirt-cheap," but they're not "over-priced" either. This is where stock market valuations usually dwell, where the *short-term* upside opportunity and downside risk are in balance. This is why we at Confluence don't play a short-term game. For short-term investors, the risk and return structure usually offers difficult odds.

We much prefer the long-term game. The only way to enjoy the long-term compounding effect of the U.S. economy, as described above, is to take a long-term perspective of investing; the odds in this game are much better. And you may enjoy the all-time highs.

We appreciate your confidence in us.

Gratefully,

Mark A. Keller, CFA
CEO and Chief Investment Officer

This letter was prepared by Mark Keller of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change. This information does not constitute a solicitation or an offer to buy or sell any security.