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A bubble waiting to burst or a continued bull market?

Year-end investment and market outlook

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Q. The Federal Reserve’s massive bond-buying programs and low interest rates have helped fuel the stock market; the S&P 500 is up more than 100% since they began in March 2020. With inflation at more than 6%, a 30-year high, unemployment below 5%, and with strong economic growth, why is the Fed continuing its liquidity injections and keeping interest rates at zero?

The Fed has said that it is going to start to taper its \$120 billion monthly bond purchases at a pace that would end them by next June, and that it also wants to stop buying bonds before raising interest rates. Slamming on the breaks by tapering and raising interest too fast would likely trigger a sharp market correction in both stocks and bonds, but not slowing down will fuel inflation. It is a delicate balancing act for the Fed as it is beginning to remove some of the emergency support for the economy to get the high inflation under control. The Fed has done a very nice job though of decoupling rising rates and tapering, so it is quite possible that, while the bond purchases will come to an end, interest rates could be kept lower for longer, which would further buoy the stock market. The introduction of the new Omicron Covid-19 variant could actually push inflation lower and could cause the Fed to be even more dovish. The market is currently expecting two quarter of a percent rate hikes by end of 2022, and Powell has said the pace of tapering will step up from ending in June to a few months earlier.

Q. Fed Chairman Jerome Powell and other Fed officials have insisted that the increase in inflation is “transitory,” but recently modified their view and now expects higher inflation to persist well into next year. What does this mean for the markets and companies?

Powell has now given up on inflation being transitory. Higher inflation should ultimately lead to higher interest rates. The Fed has pretty successfully decoupled the taper from rising interest rates, so while the Fed will taper, it could leave rates lower for longer. Higher rates would be very tough for technology companies, especially those that do not make money, where a terminal value is calculated and the present value is discounted from that; a higher interest rate would mean that the present value would be much lower. On the flip side, we could see smaller-cap stocks and sectors like financials perform well as higher interest rates would increase net interest margins for banks.

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Q. While inflation concerns have dominated the markets in recent months, strong corporate earnings above expectations and the reopening of the economy have helped the market reach all-time highs. What is your outlook for corporate profits and earnings, and what is the overall impact on the stock market?

Corporate profits have been quite strong. Last quarter, we saw 81% of companies report a positive earnings surprise. Certainly, the theme on conference calls was that many companies are having supply chain issues. The forward price/earnings ratio (P/E) on the S&P 500 is about 21x and the 10-year average is closer to 16.5x, so it is possible that the market will deliver lower returns in the future as the multiple probably needs to contract a little.

Q. The ultra-easy monetary policy by the Fed and other major central banks around the world has led to an everything-rally, and what some argue has encouraged increased risk-taking by investors and an “everything asset price bubble.” Stocks, bonds, commodities, the housing market, the so called “meme stocks,” and cryptocurrencies all seem very frothy. Some people think the bull market will continue and others believe this is a bubble waiting to burst. What is your perspective?

I believe there are always cheap parts of the market and expensive ones. I believe that the “meme stocks” are trading completely outside of their fundamentals and when things settle down I can see major drops in their stock prices. I also feel that cryptocurrencies are in a bubble. I think far too many people who have invested in crypto have very unrealistic expectations of what that asset class should return. The past returns of crypto are completely unrealistic, and those who purchase crypto today are buying when the risk to reward ratio is really not in their favor.

Q. What do you believe are the biggest risks and challenges for the markets in 2022?

It is interesting as I would have told you the biggest risk to the markets was really a Fed that became a bit too hawkish and spooked markets by ending support too quickly. I also always fear any black swan that may be out there. We have just learned of the new Omicron COVID-19 variant and that the likelihood of potential further spread at the global level is high according to the World Health Organization. The markets are now trying to digest this with “stay-at-home” stocks rallying and biotech and vaccine-related stocks outperforming. Our belief is to absorb the data as it comes in, but basically, we would be buyers of a major weakness with the belief that should things get worse, the Fed will back-stop things. We also believe that while the Omicron Covid-19 variant is more contagious, it appears to be much less lethal. The major issue last time was our hospitals getting overrun and running out of ventilators. With the high percentage of people now vaccinated, and a variant that appears to be less lethal, I am not overly concerned about a repeat of the dark days of March and April of 2020.

Q. Why is investing in small- and mid-cap stocks appealing to you?

We believe small- and mid-cap stocks offer wider appreciation potential than larger-cap stocks as they are more misunderstood and illiquid, and truly inefficient versus larger-cap stocks that are closely followed and quite efficient. We like that smaller companies can be more nimble in tough environments and also have the ability to get acquired by larger companies. In short, we believe they offer higher risk but higher reward as well.

Q. Villere’s investment philosophy is built on the core belief that growth should be achieved at a reasonable price. What are a couple of stocks you hold in the portfolio that represent your investment approach, and where do you find good values and stocks that are attractive given the strong market rally?

We are always looking for growth companies, but our discipline keeps us from paying too much for them and getting involved where the margin of safety is too low. One

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company that is very appealing is Palomar Holdings, Inc., an insurance technology company, given its very small market share of just 2% of the total addressable market of \$18 billion. We believe Palomar is going to grow earnings about 40% over the next two years and the stock only trades at 24x 2022 earnings and just 18x 2023 numbers. I find this to be just an incredible opportunity to buy a great franchise at a very reasonable price compared to its growth rate.

Another business that is a bit larger is Teleflex, Inc. It is a medical technology company that uses disposable products in the operating and critical care setting. It has a product called UroLift that helps men with an enlarged prostate, and the product is growing rapidly. However, Teleflex’ stock trades at just 17x EV/CY 22E EBITDA while its peers trade at 40x—comparing the company’s Enterprise Value (EV) to its calendar year (CY) Earnings Before Interest, Taxes, Depreciation & Amortization (EBITDA).

Q. Part of the reason for the strong performance of equities is many investors’ belief that “there is no alternative” (“TINA”) to stocks. What is your view on the bond market?

We remain quite negative on bonds, believing it is like picking up a penny in front of a steam roller; there is a lot of risk without the commensurate reward. We do own fixed income and are staying quite short in duration, not reaching for yield by buying lower than investment grade bonds that carry higher risk. Bonds move inversely to interest rates and our fear is that should rates climb at some point, bonds will fall. The 10-year Treasury yield is just 1.48% and while the S&P 500 carries a yield of 1.33%, an investor gets the opportunity for those S&P 500 companies to raise prices to get a higher total return and battle inflation. The 10-year Treasury is really locked in and carries a negative real yield—that is the actual yield you will get when you adjust for the effect of inflation.

Q. How are you positioning the portfolios for the end of the year and going into 2022?

We are positioning for a solid end of year. We want to take advantage of the weakness in the stock market due to the Omicron COVID-19 variant and buy smaller-cap names that have been unfairly punished during the recent market volatility. We are expecting a rally going into the end of the year, with the belief that rates will actually be staying lower longer.

Q. Many investors find it difficult to stay the course and remain calm during volatile and uncertain times. FOMO, or “fear of missing out,” has helped drive the markets, lifting everything from stocks to cryptocurrencies to record highs. However, some investors have been more reluctant to invest as the markets have looked expensive for a while. What do you say to your clients?

Staying out of cult stocks or popular stocks is one of the most difficult things to do. The problem is that these popular stocks always look the very best when they are at the top. We reflect back on the dot-com boom in 1998 and 1999, and remember the bust in 2000, caused by excessive speculation. We feel like it is a similar environment now with the crypto and popular tech stocks, and we steer clear of things like crypto where coming up with an actual intrinsic value of such assets is very difficult. When I invest in something, I always like to know what it is worth. This way, I can ideally buy a stock at a discount to what I believe it is worth. If I cannot get even close to calculating the intrinsic value of Bitcoin or Ethereum, I find it very difficult to put my clients’ money into it.

With stock valuations at current levels, there is more risk in the market, so investors should take a balanced approach to their portfolio holdings and not try to time the market. We believe that we are in a stock picker’s market. Rather than simply investing in the “market” via passive investments, such as ETFs, it is important to carefully select individual stocks and avoid following the herd.

Opinions expressed are subject to change, are not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

RISK CONSIDERATIONS

A mutual fund's investment objectives, risks, charges, and expenses must be considered carefully before investing. The statutory and summary prospectuses contain this and other important information about the investment company and may be obtained by calling 866.209.1129 or visiting villere.com. Read carefully before investing.

Mutual fund investing involves risk; loss of principal is possible. Investments in smaller and medium sized companies involve additional risks such as limited liquidity and greater volatility than large-cap companies. The Villere Balanced Fund will invest in debt securities. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower rated and nonrated securities present a great risk of loss to principal and interest than higher rated securities. The Villere Equity Fund may invest in foreign securities. Foreign investments involve additional risks, including currency fluctuation, political and economic instability, lack of liquidity and differing legal and accounting standards. These risks are magnified in emerging markets. The Equity Fund's ability to invest in initial public offerings (IPOs) involves a higher degree of risk than more seasoned companies. Past performance does not guarantee future results.

The information on earnings growth is based on certain assumptions and historical data and is not a prediction of future results for the Fund or the Fund holdings.

References to securities are not a recommendation to buy or sell.

Yield is the income return on an investment and refers to the interest or dividends received from a security; is usually expressed annually as a percentage based on the investment's cost, its current market value, or its face value.

Duration measures a bond price's sensitivity to changes in interest rates. The longer a bond's duration, the higher its sensitivity to changes in interest rates and vice versa.

Black swan is an unpredictable event that is beyond what is normally expected of a situation and has potentially severe consequences. Black swan events are characterized by their extreme rarity, severe impact, and the widespread insistence they were obvious in hindsight.

Price-to-Earnings (P/E) Ratio measures share price compared to earnings per share for a stock or stocks in a portfolio. Earnings growth is a key indicator for measuring a company's success and a driving force behind stock price appreciation. Earnings growth is the percentage gain in net income over time.

Price-to-Earnings (P/E) Multiple is used to compare a company's market value (price) with its earnings. A P/E of 10x means a company is trading at a multiple that is equal to 10 times earnings. A company with a high P/E is considered to be overvalued and a company with a low P/E is considered to be undervalued.

EBITDA, or earnings before interest, taxes, depreciation, and amortization, is a measure of a company's overall financial performance and is used as an alternative to net income in some circumstances.

EV/EBITDA, or the enterprise value to earnings before interest, taxes, depreciation, and amortization ratio compares the value of a company—debt included—to the company's cash earnings less non-cash expenses.

Cryptocurrency is a digital asset designed to work as a medium of exchange where individual coin ownership records are stored in a ledger existing in a form of computerized database using strong cryptography to secure transaction records, to control the creation of additional coins, and to verify the transfer of coin ownership.

The **dot-com bubble, or dot-com boom**, was a stock market bubble caused by excessive speculation of Internet-related companies in the late 1990s, a period of massive growth in the use and adoption of the Internet.

S&P 500 Index is an unmanaged index which is widely regarded as the standard for measuring large-cap U.S. stock market performance. The stock index does not incur expenses and is not available for investment.

It is not possible to invest directly in an index.

As of December 2, 2021, the Villere Balanced Fund held 92,739 shares of Palomar Holdings, Inc. and 19,885 shares of Teleflex, Inc. The Villere Equity Fund held 31,610 shares of Palomar Holdings, Inc. and 7,060 shares of Teleflex, Inc. Neither fund held any shares of Bitcoin or Ethereum.

Fund holdings and/or sector allocations are subject to change at any time and are not recommendations to buy or sell any security.

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