2018
2ND QUARTER
QUARTERLY COMMENTARY

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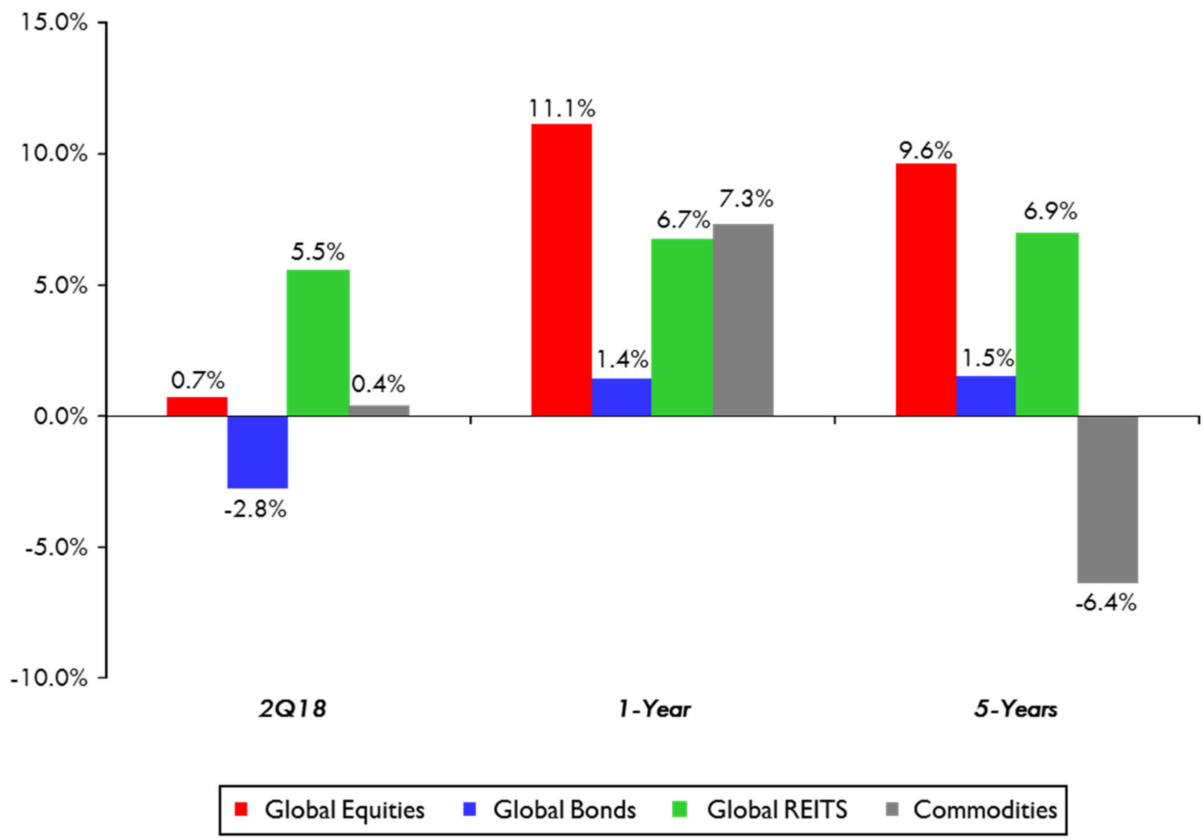
En Vogue

Nothing about her beginnings in rural France pointed to a life other than one of poverty, obscurity and a likely early death. Her unwed mother was a laundress in a poorhouse. Her father was an itinerant peddler in the Loire Valley. When she was 12 years old, her mother died, aged 32, of tuberculosis, and she was sent to an orphanage where she learned the domestic chores of cooking, cleaning and sewing. At 18, no longer able to stay at the orphanage, she moved into a poorhouse in the town of Moulins. She earned a meagre living as a seamstress, a skill she picked up at the orphanage, and supplemented her income by singing in cabarets, passing the hat for tips.

Chart 1 **Capital Market Performance**



There must have been something coquettish about her on stage, because she attracted the attention of a wealthy textile heir, Étienne Balsan. She moved into his chateau as his mistress, and was introduced to his wealthy friends. After a few years, she dropped Balsan for one of his friends, Arthur Capel, a wealthy Englishman, who moved her to an apartment in Paris. She opened a clothing boutique on rue Cambon, financed, of course, by Capel.

She certainly had come a long way: from an orphanage near Moulins to the très chic 1st arrondissement of Paris. But this was only the beginning for her. In time, she would supply her special stylistic sensibilities to an adoring public, and parlay her relationships with wealthy men into a fashion empire, becoming the most influential designer of the 20th century. But she also had a dark, unsavory side that would be a permanent stain on her reputation.

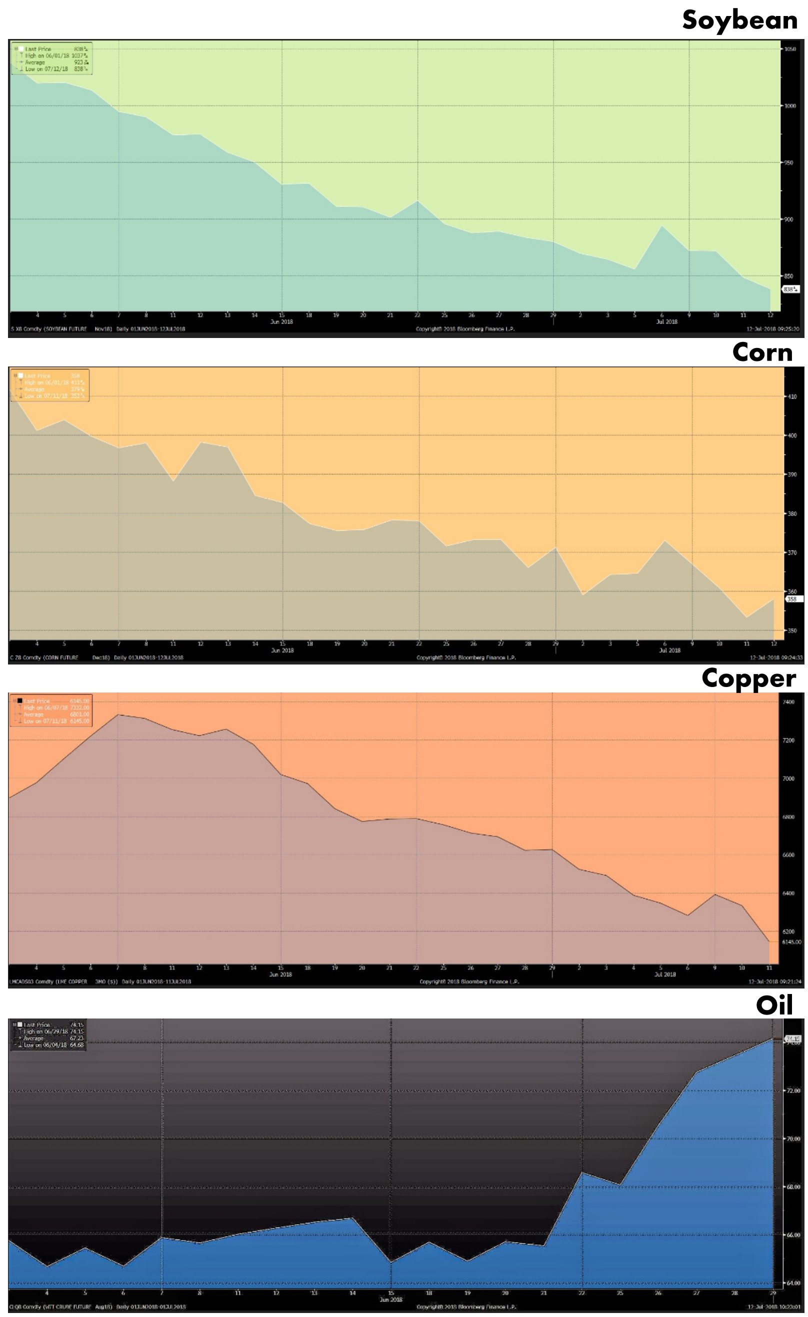
The worlds of fashion and investing may seem far apart. But investors have much to learn, both from her life, as well as in her approach to style, from this visionary design icon.

It was a difficult quarter for most asset classes. Equity markets were flat in the period, while higher interest rates sent bond markets lower. As usual, there was a wide dispersion in results. Israeli stocks turned in one of the best gains in the quarter, up 10%, despite growing tensions in Gaza. Turkey and Brazil, each facing political challenges, both lost more than 20%. Leading the losers was Argentina, off 42% in the past three months, as it had to turn to the IMF for a bailout. Vietnam cooled off (its market, not its weather), dropping 17%, although it is still up 40% over the past year, among the best in the world.

Farmers wished they had planted more wheat, as prices rose 10%, instead of corn and soybeans, which dropped 10% and 18%, respectively, over the last three months. All of these declines occurred in June on retaliatory tariff fears from China, our biggest agricultural export market. China had been accumulating stockpiles of most commodities in anticipation of tariffs, and in June, those flows dried up. The result was huge declines in most commodities (Chart 2 shows the month's performance of Soybeans, Corn, Copper and Oil; the latter typically rises with geopolitical tensions).

Fears of an escalating trade war may have disturbed the markets, but global equities and bonds are lower this year over uncertainty about the strong recent economic data. The Institute for Supply Management (ISM) Manufacturing Index and its Non-Manufacturing Index both have seen their

Chart 2 **Select Commodity Prices, June 2018**



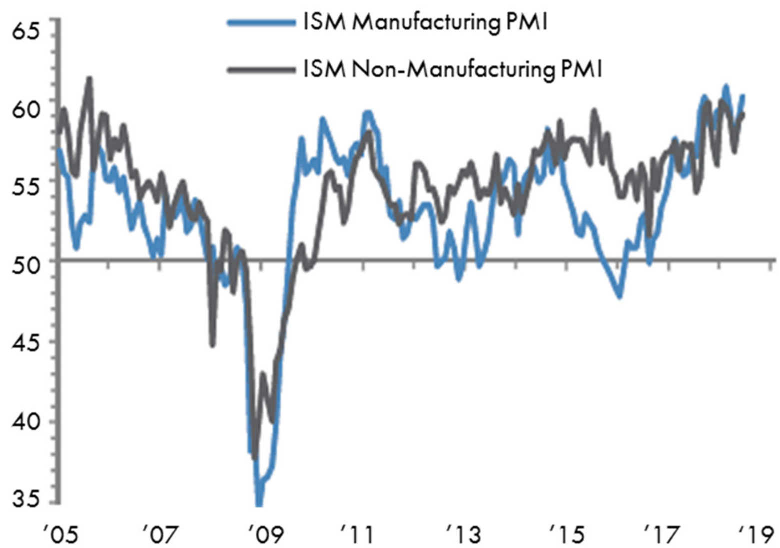
Source: Bloomberg, L.P.

strongest growth since 2004 (Chart 3). Payrolls added on average 211,000 net new jobs per month in the second quarter, an acceleration over the 198,000 per month average in the past year. Last month, 601,000 people entered the job market.

The jitters seen in the equity and bond markets are due not to the unambiguously positive economic data, but over concerns about the Fed's reaction to them. The Fed, and especially its new Chairman, Jay Powell, are on a path to tighten monetary policy more quickly than many anticipated. The Fed has raised the overnight Fed funds rate twice this year, and is now on track for two more hikes in the next six months, and more after that.

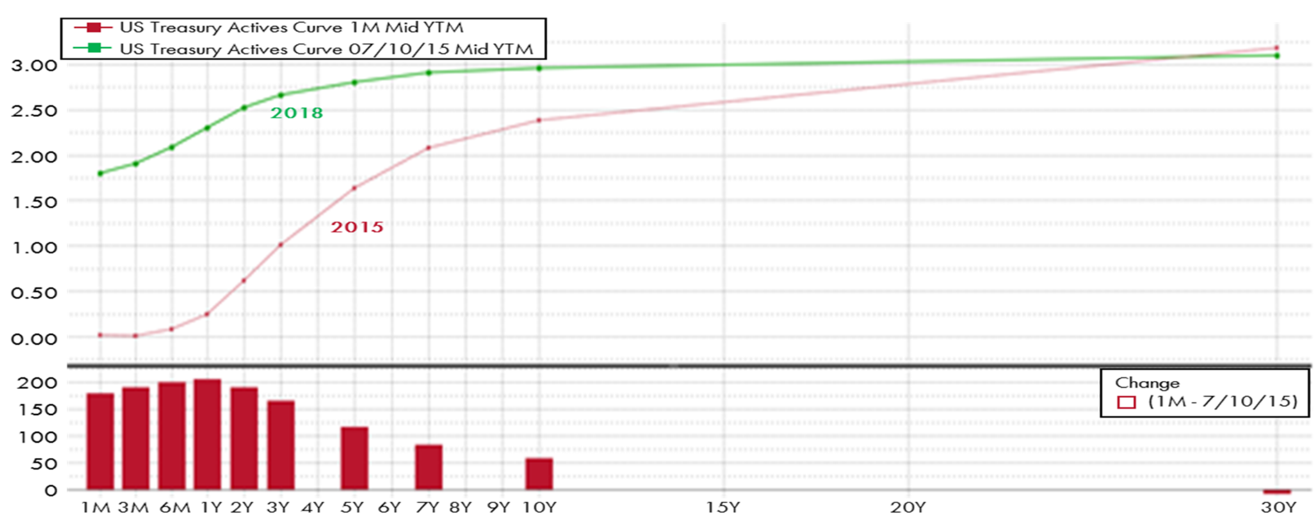
Over the past three years, short-term rates have risen nearly 200 basis points (2%) whereas the 30-year Treasury bond yield has actually declined (by 8 basis points—see Chart 4). The much-feared Inverted Yield Curve is approaching!

Chart 3 **US Manufacturing and Services PMI**



Source: J.P. Morgan US Equity Strategy & Global Quantitative Research

Chart 4 **US Treasury Yield Curve, July 2015 and July 2018**



Source: Bloomberg, L.P.

An inverted yield curve, where short-term yields are higher than long-term yields, sends shivers through the markets because every economic downturn in the past seventy years has been preceded by an inverted curve. But there are three points to consider. The first is that while every recession has been preceded by an inverted curve, not every inverted curve has preceded a recession. Secondly, a negative slope historically has reflected the Fed's response to overheating economic conditions—capacity constraints and accelerating inflation—but these conditions are not (yet) present. The slope of the curve also reflects the term premium investors demand, and investors currently demand a much lower term premium likely because the market anticipates sluggish long-term growth and inflation. Thirdly, the yield curve is not inverted! It may get there, or not, but the slope is still positive.

Stocks are struggling this year, and bonds have sold off, on worries that overly tight monetary policy will choke off the economic recovery. That's not an illogical or illegitimate worry, but there is no evidence, yet, of this happening.

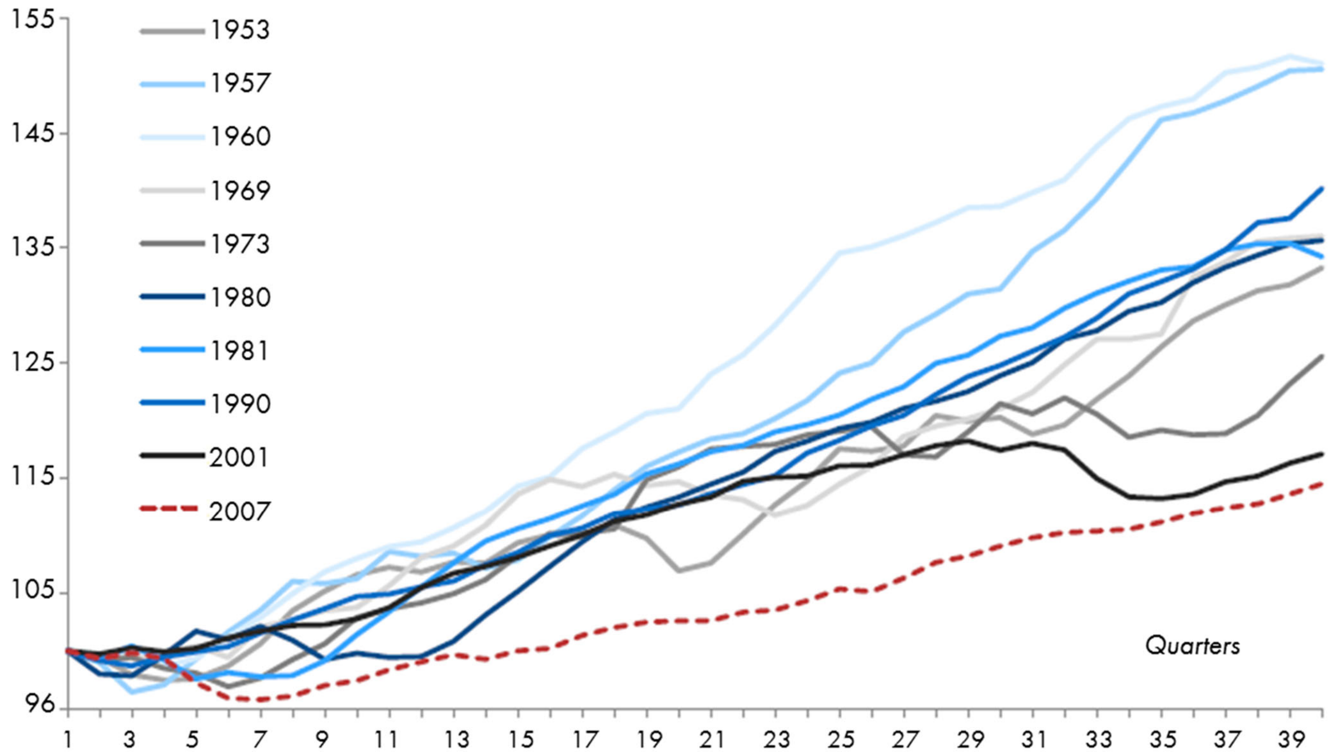
Fashion is as much a part of investing as it is of haute couture. Benjamin Graham and David Dodd wrote *The Intelligent Investor* in 1934, which advised buying stocks with "a margin of safety," and this approach of buying "cheap" stocks became known as "value investing." There were a handful of investors who rejected value investing, most notably Thomas Rowe Price, Jr., who started his eponymous firm in 1937. Price favored buying companies that could be expected to grow faster than the overall economy. Thus the line between "Value" and "Growth" investors was drawn. These two approaches to investing were codified in the 1970s when MSCI and Russell created special indices for each style.

Since then, there have been alternating periods of generally 3-5 years when one approach outperforms the other. But for the past eleven years, the "growth" style has been ascendant, outperforming "value" by 60% (Chart 5).

Chart 5 **MSCI World Value vs. Growth**

Source: Datastream, Goldman Sachs Global Investment Reserach

Chart 6 **US real GDP following recessions**



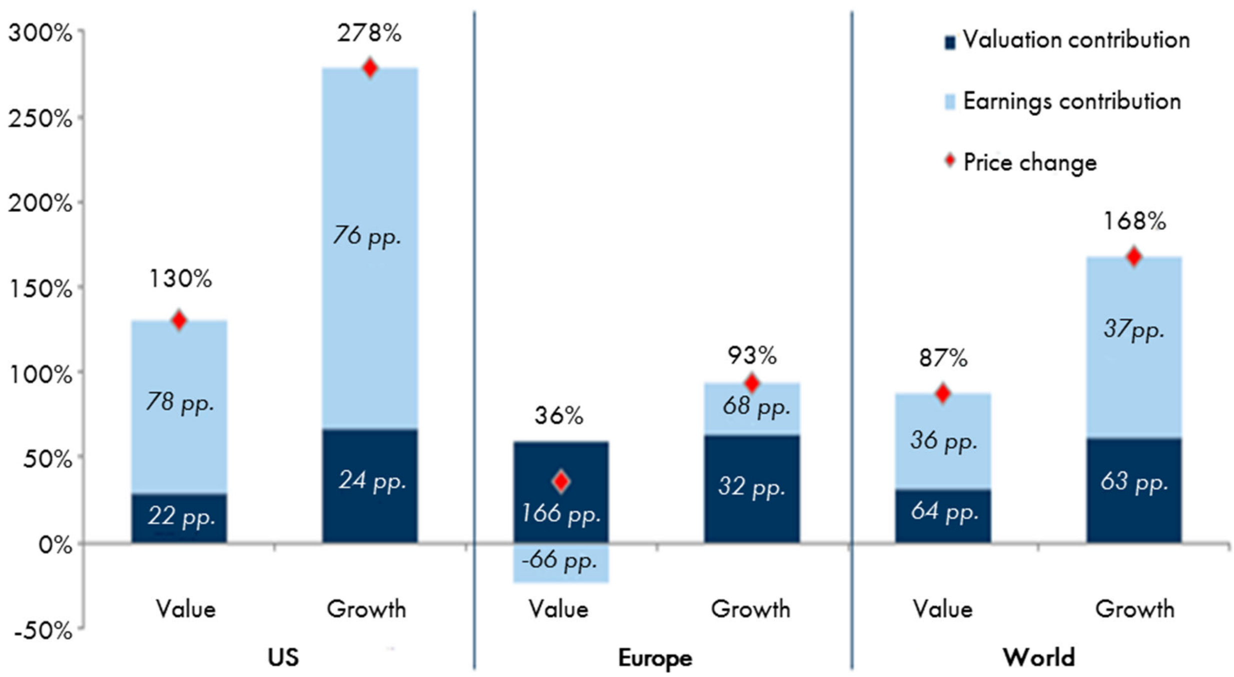
Source: FactSet, Haver Analytics, Goldman Sachs Global Investment Research

There may be an element of fashion attracting investors to the growth stocks (Amazon, Facebook, Netflix, et.al.), but there are substantive explanations for growth's outperformance. The fundamental economic principle of supply and demand requires a higher price for scarce goods, and growth, whether a country's GDP or a company's revenue, has been scarce. This economic recovery has been the most sluggish since the 1930s (Chart 6). The percentage of companies in the MSCI World Index with sales growth expected to exceed 8% p.a. for the next three years has fallen from more than 40% as recently as 2011, to just 25% to-day. In a world where growth is rare, it will be more highly prized where it can be found.

Importantly, the outsized gains of growth companies have been driven more by actual earnings, than by investors assigning higher multiples to those earnings. In the US, and globally, multiples have risen for both Growth and Value indices, but earnings have contributed far more to price appreciation (Chart 7).

The outperformance of Growth over Value for the past decade is no mania or bubble, but is based on the legitimate, fundamental factors of scarcity and earnings. As we've seen, style goes in and out of fashion, and the conditions that favor one approach over another do eventually change. But growth's outperformance can be explained by more than fickle fashion.

Chart 7 **Contribution to price performance since Jan-09**



Source: FactSet, Datasstream, Goldman Sachs Global Investment Research

Gabrielle's career took off when a popular actress wore her hats in a 1912 hit show. She soon opened another boutique in Deauville, and then another in Biarritz, all widely popular. Her success enabled her in 1918 to expand her Paris store by buying the five adjacent properties on rue Cambon.

The wartime shortage of most materials led her to use jersey, a machine-knit fabric used primarily for undergarments. It was cheap and plentiful, and well-suited for her uncluttered designs inspired by men's fashion and sportswear. This especially appealed to women who had moved out of the home into the workforce, and freed women from corsets and restrictive clothing.

Her now legendary suit, introduced in 1925, was a jacket and skirt made with a light wool and designed for comfort and movement. Shoulder pads were eliminated, and pockets were added for practicality. It was enormously popular, as was her next innovation, what became known as the "little black dress" (opening photo). She took a color associated with mourning, common among the many widows following the First World War, and transformed it into something chic. Many male journalists snubbed the design as unflattering to women, but *Vogue* dubbed the look *garçonne* ("little boy") and predicted this simple yet chic design would become ubiquitous. They were right.

More innovations came in the 1920s beyond clothing. Jewelry had traditionally been segregated between costume and fine jewels, but she introduced bold designs that combined both. Her wealthy clients could keep their precious jewels in a safe when out on the town, and she turned costume jewelry into a highly desired accessory.

A handbag design was inspired by a soldier's bag, its thin strap freed the hands, its quilted exterior added a sporting look, taken from the jackets worn by jockeys. She introduced suntan lotion, single-handedly transforming a suntan as a mark of common laborers to a symbol of a rich and leisurely life.[1]

At the Longchamps races, Théophile Bader, founder of the famous department store Galeries Lafayette, introduced her to businessman Pierre Wertheimer, head of the prominent perfume and cosmetics company Bourjois. They agreed to collaborate on a new perfume that she chose. The Wertheimers would receive 70% of the

[1] To the consternation of mothers and dermatologists ever since.

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profits, Bader 20%, and Gabrielle 10% in return for licensing her name. It, too, became enormously successful.

Her collaboration with Sergei Diaghilev of the *Ballets Russes* introduced her to Igor Stravinsky and later to Vaclav Nijinsky. In 1931, she met Samuel Goldwyn in Monte Carlo, who persuaded her (with a $1 million salary) to design dresses for MGM. Gloria Swanson, Greta Garbo, Marlene Dietrich all became clients, but she hated Hollywood ("the capital of bad taste...and it is vulgar"). The feeling was mutual, as her designs were not flamboyant enough for Hollywood.

Hobnobbing with the wealthy and famous brought her into the highest circles of British aristocracy, including Winston Churchill, Edward, Prince of Wales, and "Bendor" Grosvenor,[2] Duke of Westminster, with whom she had a ten-year affair.[3] The two shared more than a bed. They were both outspoken homophobes and anti-Semites.

When World War Two started, Gabrielle closed her shops, and moved into the Hotel Ritz, the preferred residence for senior Nazi officers in Paris. There she met, and began an affair with, Baron von Dinklage, the senior German intelligence officer in France. There is some evidence that she collaborated with the Nazis in a plot to use her personal connection with Churchill to persuade him to negotiate a truce, but what is clear is that in 1941 she petitioned the Nazis to gain sole control of her perfume from the Wertheimers, who were Jewish, on the grounds that they had "abandoned their property" after the Nazis had seized all Jewish assets the previous year. She was unaware that the Wertheimers had sold their business to a friendly (Christian) businessman, Félix Amiot, who returned the business back to the family after the war.

In 1947, Gabrielle continued to agitate for control of the perfume business, and Pierre Wertheimer knew that a public dispute risked exposing Gabrielle's wartime collaboration with the Nazis, thus damaging the brand. Wertheimer agreed to make a substantial one-time payment to Gabrielle, promised her a 2% royalty on all future revenue, and agreed to cover all of her living expenses (with her Nazi lover, von Dinklage) without limitation for the rest of her life. She was soon to be the richest woman in the world.

2 Now Hugh Richard Arthur Grosvenor was nicknamed Bendor, after the horse, Bend 'Or, owned by his grandfather, who won the 1880 Derby.

3 In admiration, he gave her land on the French Riviera where she built a villa.

But Gabrielle was not content to retire in luxury. She abhorred the overdressed masculinity of women's fashion in the years after the war, dominated by designers such as Dior and Balmain, whose homosexuality likely rankled her as well. She asked Pierre Wertheimer to finance her first new clothing line in twenty years. Wertheimer agreed, in exchange for all rights to her name across all products. Her new collection was presented in February 1954 to wide acclaim, her soft suits seen as youthful yet chic. She was 71.

Gabrielle died in 1971 at the age of 88, the richest woman in the world. She began her life in an orphanage. She seduced and used men to further her business. Her personal views and Nazi sympathies were, and are, abhorrent. But her impact on fashion was profound. Her woolen suit and little black dress, quilted handbag and No. 5 perfume, are ubiquitous today. The Wertheimer family continues to own this multi-billion dollar company, still headquartered on rue Cambon, where Karl Lagerfeld has been creative director for the past 35 years. Considering the changing fashions over the past century, how remarkable it is that Gabrielle's, known as Coco since her days singing for tips, style endures.

A strict adherence to dogma makes as little sense in haute couture as it does in investing. Investors are best served by firmly adopting core principles, such as seeking undervalued assets, while having a flexible approach in how to achieve those goals.

Photo: Conde Nast Archive (*Vogue*, 1964)

Adherence to the Value style this past decade has meant meaningful underperformance. Likewise, a Growth approach was devastating to portfolios in 2000 (see Chart 5 on page 5). The fact is that successful (and unsuccessful) investors can be found in both the Growth and Value camps.

At the same time, Growth and Value may be a distinction without much of a difference. All investors seek to buy assets at a price below fair value, whether that fair value is determined by faster future growth than priced in, or by a price that is below even pessimistic assumptions. Money can be made (and lost) both ways.

One thing for certain is that Growth and Value will go in and out of fashion. But, as Coco Chanel famously said, ***fashion changes, but style endures.***

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