

## INTERVIEW

### An Investment Pro Who's Seen It All Still Sees Upside for Stocks

By Leslie P. Norton January 27, 2018



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Marvin Schwartz, one of Neuberger Berman's most renowned investors, joined the firm's research department in 1961 at an hourly wage of \$1.25. He caught the eye of Philip Straus, the great contrarian investor who was one of the firm's first partners, and who taught Schwartz the tenets of value investing. Today, Schwartz leads Neuberger's Straus Group, whose stock picks have roundly beaten the market for the 30 years that Neuberger has kept track, even counting a recent disappointing stretch when oil investments fizzled.

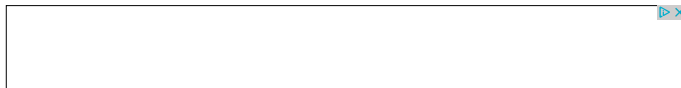
At age 76, Schwartz continues to spend nearly all of his time reading research reports and can recite a blizzard of statistics about individual companies and the economy. *Barron's* spent a couple of hours recently with him on the 43rd floor of Neuberger's midtown Manhattan offices, discussing tax reform, the outlook for oil, what Phil Straus might have thought of the elevated levels of today's market—"He would be 75%-to-80% invested, because he was fundamentally risk-averse"—and, as always, what to buy. Here's what Schwartz said.

#### ***Barron's:* What does the U.S. economy look like after the tax overhaul?**

**Schwartz:** There will be very little incentive for U.S. companies to move operations abroad: They will have to pay a U.S. tax of up to 10% on foreign earnings if the tax they pay abroad is less than the new 21% U.S. rate. We're going into a two-year period where gross domestic product will grow 3.5% to 4%, instead of 2%. That's a big difference. At 2% growth, there's no big pressure to expand capacity. A couple of quarters of 3.5%—we're kind of there already—and you'll see capital expenditures take off. Capex will grow 8% to 9% in 2018, and be stronger in 2019. Tax reform permits companies to depreciate 100% of new equipment in year one, versus 50% before.

As for individuals, remember that 47% of working Americans pay no federal income tax. Maybe yours will go up suddenly if you live in New York City. But I wouldn't call it crumbs if somebody gets an extra \$2,000 or \$3,000 a year. If you have a job and feel secure about it, you have a propensity to spend almost all of your income. You shouldn't, but you do, and that contributes to a stronger economy.

#### **You must be concerned about inflation.**



Wages are starting to go up at the lower end of the scale. I believe the federal government will raise the minimum wage this year to \$10 an hour. It has been at \$7.25 since 2009. That should lead to more inflation and higher rates. The robot phenomenon is a slow process. It's miraculous that this country has been able to replace the huge number of jobs we've exported: Over 40% of Standard & Poor's 500 revenues now comes from abroad. Consumer price inflation for 2018 will be 2.5% to 3%, still quite a bit below the 50-year average of 4.1%. Rates will rise, but it's unlikely they'll rise to the level that will choke off expansion. Very few people think the 10-year goes beyond 3.5%.

#### **Are tax reform's benefits already baked into stock prices?**

Partly. All last year, we were led to believe that if tax reform passed, it wouldn't take effect until Jan. 1, 2019. Not a single portfolio manager or analyst revised their 2018 earnings estimates. Now, earnings estimates have suddenly been revised upward. It is dramatic. The consensus estimate for 2017 operating earnings is \$132, up from \$119 in 2016. That means the S&P is selling at 21.2 times 2017 earnings, which usually makes people like me nervous. But in 2018, the consensus estimate is for \$153, a 16% improvement, which is very realistic and, in fact, a little conservative because normal earnings without tax reform would be up 8% or 9%, given 3% GDP growth. Now the multiple is 18.3 times. For 2019, the estimate is \$165, which is 17 times. In 1998-99, when technology stocks drove the S&P 500, it was 28 times.

#### What else drives stocks higher?

No other country is shrinking its equity base to the extent we are. We're now in our ninth year of share buybacks equal to 3% of the market value of all S&P 500 stocks, based on Laszlo Birinyi's work. For 2017, he estimates buybacks of \$630 billion and for 2018, \$750

### Schwartz's Picks...

Company / Ticker	Recent Price
Devon Energy / DVN	\$43.91
JPMorgan Chase / JPM	115.70
Lincoln National / LNC	83.40
FedEx / FDX	268.04

Source: Bloomberg

billion. Companies will repatriate cash. Apple recently surprised people by saying it would repatriate most of its estimated \$230 billion in cash; of that, it will spend \$30 billion on capex over the next five years, creating 20,000 jobs. What happens to the other \$200 billion? I can assure you it will go into either buybacks or mergers and acquisitions. U.S. M&A volume was roughly \$2 trillion a year for 2014, 2015, 2016; last year, it was \$1.7 trillion. About half of that—\$1 trillion annually—is in cash. The S&P 500 is \$25 trillion, so M&A alone shrinks the equity base by 4% a year.

We also have the highest profit margins. From the 1960s until 2000, the S&P 500's operating margin bounced around 6%. In recent years, it rose to 10.5%, as companies moved offshore for multiyear tax holidays. As a result of corporate tax reform, the 10.5% now becomes 12.5%.

#### Aren't you concerned about the speed of the rally?

For 20 years, the average price/earnings ratio has been 19.3. If you go back 50 years, it's 15.6 times. In periods where inflation grew 3% or less—which is 22 of the past 50 years—the P/E of the market was 19.7. Now, at 17 for 2019 and 15.9 for 2020, P/Es don't look particularly stretched. If earnings are rising 16% this year and a minimum of 8% next year, and if companies buy back 3% of shares, and M&A reduces them by another 4%, then I don't see why the market can't rise 10% to 15% this year and another 10% or so next year.

#### You've had uneven performance since the financial crisis.

In 2008, we had too much in finance stocks, and then energy badly hurt us from June 2014 to December 2015. I didn't believe the price of oil, which had been at \$110 a barrel, would fall to \$27. Today, West Texas Intermediate is \$65. It's a different ball game.

#### Will we ever see \$100 oil again?

I'm not saying it's around the corner, but yes. There has been a dramatic reduction in exploration. In 2014, Royal Dutch Shell, Exxon Mobil, Chevron, Total, and BP spent \$165 billion in capex. In 2017, it was \$95 billion. This will come home to roost. Worldwide, even national oil companies like Pemex and Petróleos de Venezuela and Petróleo Brasileiro [ticker: PBR] have cut capex dramatically. Meanwhile, oil consumption keeps increasing, and worldwide inventories keep going down. What nobody talks about is that every single oil well in the world eventually depletes to a very low level of production. Why? Because pressures dissipate. For most oil wells in the U.S., only 15% to 20% of the oil in the ground is actually pumped in primary recovery, because the pressure gives out. The depletion rate is 60% or higher in year one and 30% to 50% in year two. You have to keep drilling and drilling. I can assure you that nobody believes worldwide consumption will roll over [decline] for a long time: BP and Exxon both say it will be 2035 or 2040. Most electric cars are hybrid. The U.S. Energy Information Administration sees consumption growing through 2040.

Devon Energy [DVN] is an underappreciated rate-of-change story. Tier 1 drilling prospects account for 90% of its future capital expenditures. It's a leading low-cost, high-growth oil shale producer with core assets in the Permian Basin and The Stack. It will grow oil production more than 30% in 2018. It's also deleveraging. Management will likely sell \$2 billion of noncore assets over the next 18 months.

#### What do you think of value investing today? Have you had to adjust?

The S&P 500 has in recent years become heavily influenced by a handful of growth companies. In 2015, the S&P 500 had a total return of 1.4%. The 10 largest companies, which were mostly technology stocks, were up 17%. That year, the S&P Value index was down 3%. Since then, the value index has started to detach. In 2016, the S&P 500 was up 11.9%; the Straus Group equities rose 14%. We also had a pretty good 2017: The index was up 21.8%, and our equities were up 22%. Last year, five Faang stocks [Facebook, Apple, Amazon.com, Netflix, and Alphabet, parent of Google] were up 47% and accounted for 23% of the appreciation of the S&P 500. I find it hard to believe that will happen again this year. If the economy grows only 2%, an aggressive investor might concentrate on momentum and growth stocks. But when the whole economy is growing 3.5%, 4%, it's a different story. It's pleasantly surprising how much earnings are going up.

#### So what else are you looking for in stocks today?

We know we won't always be right, but we want to see significant—30%, 40%, 50%—upside. Turnover is 30% to 35% a year. Buying is relatively easy; selling is difficult. Right now, our big investment theme is rising rates. We have purchased insurers, banks, and specialty financial-services companies. JPMorgan Chase [JPM] now trades at \$115 a share. They just reported \$6.87 a share earnings for 2017. The consensus is \$8.69 for 2018, \$9.69 for 2019. That doesn't mean in 2020 you won't have another 5% to 7% increase. It trades at 13 times this year's earnings, 11.7 times next year. In my opinion, this stock has \$150 a share written all over it. Jamie Dimon, one of the five best financial-services CEOs, has an unbelievable ability to judge risk and to choose the right people and the right segments of the banking industry in which to concentrate.

Lincoln National [LNC] is a very high-quality life-insurance stock. It sells at \$83. It is buying in its own stock. By the end of 2019, it will have 197 million shares outstanding, down from 315 million in 2010. Lincoln will earn \$8.50 a share this year, \$9.25 next year. The book value is \$74 a share. Two-thirds of their business is annuities, mostly variable. They have heavily derisked the variable business. Management is outstanding and would do anything intelligent, including sell the company, to meaningfully benefit shareholders. Meanwhile, they buy 5% to 7% of the stock every year. The stock sells for nine times earnings; it should sell at 13 to 15 times.

#### What else do you like?

FedEx [FDX] has had a very big move, but you might be impressed by their earnings. FedEx will probably earn \$13 a share for the fiscal year ending in May, after a \$1 a share charge attributable to cyberattacks. Management said lower corporate taxes will add \$2 a share to earnings. If they can grow the business by 15%, which we think they can, that's another \$2 a share. So you are talking \$18 a share of reported earnings for fiscal 2019. That works out to 15 times earnings. There is no reason that FedEx should sell at a lower multiple than the S&P 500. Historically, it has traded one to two multiple points higher. It has brilliant management. You get the benefit of continuing growth in internet buying. Also, Amazon [AMZN] ships 70% of their packages via the U.S. Postal Service. If Congress addresses the Post Office's deficits and the Post Office raises prices, it will have a very positive influence on FedEx.

**Thanks, Marvin.**

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