July 31, 2017

"History doesn't repeat itself, but it does rhyme."

- Mark Twain

Dear Client,

In our last quarterly letter, we discussed seven transactions from early 2017: two buys and five sells. We also provided an update on our then largest position, Express Scripts. There was zero analysis of the economy, asset classes, and central banks. We have been relatively quiet on the transaction front since then. It is now eight years into the current bull market, the Shiller[1] price to earnings ratio is near 1929 highs, and other metrics, such as the S&P 500 price to sales ratio, are at all-time highs. With that backdrop, while we recognize almost every reader prefers to read about specific companies and investment ideas (and that is also what we prefer to write about), here goes a macro commentary.

The macro environment always provides the setup for reasonably specific absolute return prospects at the asset class level. Not this month, quarter, or year, but certainly over a seven-, ten-, or twelve-year period. In the case of equities, to simplify, future returns are a function of earnings growth and the starting and ending multiple investors are willing to pay. Earnings are cyclical, but they grow at a steady rate decade to decade. Investor sentiment regarding risk is also cyclical (it rises and falls as fear and greed are amplified), but decade-to-decade investors are willing to pay, on average, a similar multiple for the future earnings stream of equities.[2] Thus, if earnings are at a cyclical low and investor sentiment is shifted toward fear, prospective returns for equities will be high. If earnings are at a cyclical high and investor sentiment is shifted toward greed, prospective returns for equities will be low.

Today, numerous factors (most prominently, central banks fixing interest rates near zero) have led to a macro backdrop where US profit margins are near peak AND investor risk sentiment is so risk-seeking that multiples on different measures of corporate fundamentals are at their highest level ever. From today's starting point, future returns on US equities are expected to be negative over a seven-year period. That is, investors who buy the S&P 500 (or other US equity

[1] Professor Shiller's price to earnings ratio uses a ten-year earnings average to mute the cyclicality of earnings.
[2] There are reasonable arguments that both corporate profit margins and average, cyclically adjusted multiples have (and should have) risen over the last few decades. Even accepting these arguments, profit margins and multiples are both at the very high end of the range today.

indices) today, should plan on losing money.[3] In today's environment, a similar situation exists for almost every single global asset class (e.g. foreign equities, US bonds, foreign bonds, etc.)

If we are not indexers, why does this matter? Many active investors will make the argument that in a world of thousands of securities, there are always pockets of opportunity. This is probably true. However, there are several flaws in this thinking. First, the macro is made up of all of the "micros" (i.e. individual securities). Second, in a world where absolute returns at the asset class level are very low, the universe of individual securities with good absolute returns is small. The chances of a cheap security being a value trap as opposed to true value are much higher than if everything is absolutely cheap. Third, even if one can identify a portfolio of investments with a high probability of strong relative returns, when absolute return prospects at the asset class level are low enough, they can swamp the relative return and even the cheapest individual security has a miniscule absolute return. Fourth, when absolute returns are very low at the asset class level, the likelihood of a significant correction rises considerably. When a correction happens, even cheap securities go down, especially in the initial wave of panicked selling. Finally, purists following the relative return doctrine ignore the most important fact. <u>You cannot eat relative returns.</u> If the asset class goes down by 40% and the relative return investor significantly outperforms and only goes down 30%, it is still a negative return. Even for active managers, "stock pickers," the macro matters.

A Simple, Yet Historically Accurate Quantitative Model

In August of 2008, *The Economist* magazine published [a short piece] analyzing the accuracy of the institutional fund-management group GMO's ten-year asset class return forecasts from July 1998 – just before the dotcom "bubble" was to burst. The piece began:

> *TEN years ago, GMO, an American fund-management group, was losing clients. GMO was skeptical about the dotcom boom and thought that equities offered poor value. Its performance lagged that of other groups who appeared to be more in tune with the "new paradigm" of the late 1990s.*

The point of *The Economist* piece was that GMO's skepticism of the "new paradigm," while short-term painful, proved quite sound, their forecasting methodology generally correct, and surprisingly precise. Not only did GMO forecast each of ten assets class annual returns for the ten-year period to within a percentage point or so of accuracy on average, they also ranked the asset class returns in perfect order for eight of the ten. (They flipped foreign bonds and

[3] A slightly more complex, but better, way to think about future return prospects is as a probability distribution. Negative returns of -3.9% annualized are the most likely outcome in this probability distribution (see GMO forecast below), but slightly positive and more negative are also possible as well.

Treasury bills.) As expected, the S&P 500 provided very low returns over that ten-year period. Nil, to be exact.

The Economist continued:

> *… it also suggests that long-term market movements may be rather easier to predict than short-term ones. In the short-term, markets can be pushed to extremes, and thus away from fundamental values, by fear and greed. But bubbles don't tend to last for a decade.*
>
> *In other words, if you buy shares on a price-earnings ratio of 30-40, there is always the chance that they will shift to a rating of 50 or so over the following 12 months, allowing you to make money. But in ten years' time, the shares will likely trade at around the market average of 15. You need a lot of earnings growth to make up for that potential halving in valuation. The odds are not on your side.*

Today, GMO forecasts NEGATIVE real annual returns over the next seven years[4] for seven of the eleven asset classes it currently tracks. Worst are US large capitalization equities (essentially the S&P 500) with an expected real annual return of -3.9% for the next seven years. US Bonds are also negative at -1.0%. Only emerging market equities, emerging market debt, and US inflation-linked bonds show modest positive real return expectations. And, emerging market equities are only expected to provide 2.9% real returns. This compares to the historical US equity return average of 6.5% real per year. That is not a lot of return for the historical volatility emerging market equity has provided.

And, Some Qualitative Support

In the past few weeks, two famed investors – one recently retired and one very much still active – have offered extremely cautionary comments on the current investment environment. The comments provide context for the current GMO forecast, as well as offer a few theories for why investors find themselves where they are today.

Robert Rodriguez is the former CEO and fund manager at FPA, a multibillion-dollar investment firm with a focus on balanced, contrarian, value-oriented mutual funds. In a June 2017 interview, Mr. Rodriguez began by commenting on the state of the investment management industry:

> *Given that I am no longer involved professionally in managing money, I believe the standards in the industry are being compromised; monetary policy has so*

[4] GMO changed their methodology from ten years to seven years.

> *totally distorted the capital markets. You are now into the eighth year of a period that is unprecedented in the likes of human history.*

In other words, central banks (the Federal Reserve, the European Central Bank, the Bank of Japan, and the Peoples Bank of China) have so manipulated the money supply and interest rates that he believes the typical investment manager is having to compromise on valuation fundamentals in order to avoid career risk (i.e. being fired for being too conservative).

Mr. Rodriguez later goes on to discuss contributing factors beyond central banks. The move to passive investing and a concentration in a few story stocks.

> *Thus, since 2007, indexing or passive activities have risen from approximately 7% to 9% of total managed assets to almost 40%. As you shift assets from active managers to passive managers, they buy an index. The index is capital weighed, which means more and more money is going into fewer and fewer stocks.*
>
> *We've seen this act before. If you didn't own the nifty 50 stocks in the early 1970s, you underperformed and, thus, money continued to go into them. If you were a growth stock manager in 1998-1999 and you were not buying "net" stocks, you underperformed and were fired. More and more money went into fewer and fewer stocks. Today you have a similar case with the FANG stocks. More and more money is being deployed into a narrower and narrower area. In each case, this trend did not end well.*

Both the passive investing shift and the story stock focus are "pro-cyclical." As more and more investors index, the index constituents are purchased with no regard to fundamentals (i.e. valuation). Securities outside the indices are sold by the indexers and bought by non-indexers. The non-indexers are for the most part fundamental buyers and thus are not willing to pay any price. There is some fundamental ceiling on the securities outside the index. In the upcycle, these securities underperform, perpetuating the cycle. Logically, and historically, these phenomena are equally pro-cyclical on the downside. And thus, Mr. Rodriguez is both extremely cautious, but also flexible in his thinking:

> *I am at my lowest exposure to equities since 1971. They represent less than a fraction of one percent. Liquidity is north of 65%, all in Treasury-type securities, nothing beyond a three-year term. I do not trust what is going on fiscally or monetarily, and I'll circle back on this in a moment. The balance is in rare fully paid-for physical assets.*
>
> *I am managing my estate in a hedged fashion because what we are going through is without any precedent in human history. How can anybody have confidence that their particular view is the right view?*

Howard Marks is the founder and CEO of Oaktree Capital Management. Oaktree is an institutional investment firm with $99 billion in assets under management with a focus on highyield and distressed credit. Here are some highlights from his July 2017 memo, There They Go Again…Again (emphasis his). Like GMO and Mr. Rodriguez, Mr. Marks believes that prospective returns across most assets classes are both absolutely poor and relatively poor compared to history.

> *In the vast majority of asset classes,* ***prospective returns are just about the lowest they've ever been.***
>
> *…*
>
> *The Shiller Cyclically Adjusted PE Ratio stands at almost 30 versus a historic median of 16. This multiple was exceeded only in 1929 and 2000 – both clearly bubbles.*

Mr. Marks goes on to delve into the agency conflict that helps to elongate cycles. The central banks have had their collective thumb on the scale for so long that both retail and institutional clients have lost patience and many investment managers have capitulated.

> ***Investors should choose their risk posture based on an assessment of what's being offered in terms of absolute return, absolute risk, and thus absolute risk-adjusted return. But today – on that famous other hand – investors generally don't have the luxury of holding out for absolute returns and safety like they enjoyed in the past.***
>
> ***…***
>
> *Everyone's investing on the basis of relatives these days; they see no alternative. But that reminds me of former Citigroup CEO Chuck Prince, who gained fame in the months leading up to the Global Financial Crisis for saying of the bank's leveraged lending practices, "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."* ***Today I think most investors know the good times will end someday, as Prince did, but for now they feel they, too, have no choice but to dance.***

The Grey Owl Strategy

If you believe the analysis that nearly every global asset class is set up for the worst prospective returns in history, the natural question is how can one earn any absolute returns in the short-term without putting principal at risk long-term? Here is our approach:

1. **Don't be binary (yet).** As Mr. Rodriguez concluded his interview, "I am managing my estate in a hedged fashion because what we are going through is without any precedent in human history. How can anybody have confidence that their particular view is the

right view?" While we are keenly aware of asset class valuations, we recognize that the current cycle could continue for some time. Thus, we are not fully invested, but we are not fully in cash either. This also means that recognizing investment factors other than valuation have relevance. We are actively working on how and when to incorporate "momentum" into our process, so that a value focus does not leave a portfolio out of phase for too long.

2. **All Weather.** Building on point one, the "all weather" philosophy seeks to own assets that do well in distinct environments. We want to have some exposure to risky assets that do well in growth environments (equities), recessions (Treasury bonds), stagflation (gold), and inflation (commodities and emerging market equities). And, while all (or most) asset classes may be expensive, the all weather approach can add value when some assets "zig" and other assets "zag." For example, historically equity corrections see Treasury bond rallies. In the case where inflation and rising yields are the cause of rising rates AND an equity correction, inflation hedges such as gold and commodities should act as portfolio ballasts.

3. **Individual security selection.** We do not have to own the index, and so we don't. We have built a portfolio of securities that we believe offers reasonable to excellent prospective returns. We also recognize that in the current environment where almost every security is elevated in price there is a far higher risk that cheap securities are more likely value traps than value. Despite the want (need) to be invested, extra caution is necessary. And, we recognize that in market corrections cheap securities go down too. (See points two and four for risk mitigation on that front).

4. **Watch investor sentiment.** Valuation matters in the long-run, investor sentiment matters far more in the short-run. Today, market breadth and credit spreads (two gauges of investor sentiment) still signal investors' willingness to take risk. This keeps us more invested than we otherwise would be if only considering valuation. Over the past year or so, we have become far more sensitive to this factor and continue to work on both the degree and timing of further incorporating it into our process and portfolio construction.

As we wrote last quarter, big picture items like economics, asset class valuations, and investor sentiment <u>really do</u> matter. We continue to spend most of our time following the individual companies we own today and researching opportunities for new investment. However, the economic and market backdrop is probably as relevant today as it ever has been. It is important that we maintain our vigilance AND our <u>clients fully understand and embrace</u> our process. Thus, we need to spend some time in the philosophical investment "weeds" in these letters from time to time. History does not repeat exactly, but it does follow cycles (or rhyme). We appreciate your attention and trust.

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As always, if you have any thoughts regarding the above ideas or your specific portfolio that you would like to discuss, please feel free to call us at 1-888-GREY-OWL.

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Sincerely,
Grey Owl Capital Management
Grey Owl Capital Management, LLC

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