January 28, 2019

**Fata Morgana**: a complex form of superior mirage that is seen in a narrow band right above the horizon.

Dear Client,

The fourth quarter of 2018 proved to be one of the most negative quarters for financial risk assets since the current bull market began in March of 2009. The S&P 500 finished down 13.5% and commodities were down an even worse 22.6%. As one might expect, safe haven assets performed well. Long-dated United States Treasury bonds returned 4.6% and gold rallied to close the quarter up 7.5%.[1] In fact, the quarter-long move understates the violence of the sell-off: from its all-time high on September 20th through the low on December 24th, the S&P 500 lost 19.3%.

For the full year, there was no place to hide: the S&P 500 lost 4.6%, commodities were down 13.9%, and while less dramatic, long-dated Treasury bonds and gold were both down for the year, 1.6% and 1.9% respectively. Global equities performed even worse than domestic equities with the MSCI All Country World Index down 9.1%.[2] As we write, Christmas Eve appears to mark the (at least, short-term) low. From the close on December 24, 2018 through the recovery-high on January 18, 2019, the S&P 500 rallied 13.7%.

What caused the sell-off? Was it the Federal Reserve rate hikes on September 26 and December 19 despite a flattening yield curve? Could it be the downgrade of General Electric debt in October by both Moody's and Standard & Poor's to one notch above "junk," signaling that the increase in overall corporate debt and covenant-lite underwriting has reached a point of danger? Perhaps it was the ongoing "trade war" with China and/or the (partial) government "shutdown?" It is impossible to know for sure.

Rather than trying to divine the proximate cause of this or any sell-off, we aim to keep two things in mind. First, we are attentive to asset class valuations as they both determine long-run return expectations <u>and</u> influence market resilience or vulnerability to external shocks. Second,

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[1] The market (or asset class) returns are measured on a total return basis using index exchange traded funds (ETFs): SPY for the S&P 500, GSG for the S&P GSCI Commodity Index, TLT for 20+ Year Treasury Bond index (i.e. "long-dated" US Treasury bonds), and GLD for gold.

[2] The MSCI All Country World Index is represented by the ACWI ETF.

we monitor specific indicators of investors' willingness to take risk. These data points, more than anything else, guide our propensity to use market weakness as a buying opportunity or a signal to become more defensive.

We have frequently, and in detail, commented on the topic of asset class valuation in these letters. In summary, we agree with the analysis that most financial assets are expensive – that is, most financial assets will provide meager returns, relative to their historical averages, over the next 7-10 years.[3] In addition, the high valuations increase the potential for violent sell-offs. When valuations are high and indexers and trend-followers abandon buying, much lower prices are required before fundamental value investors step in. Unfortunately, the last 10 years have proven valuation is not a tool for timing buy and sell decisions for broad market indices.

The second factor, indications of investors' risk preference, is much more informative on a shorter-term basis. In the context of the recent equity market correction, two specific data points highlight the type of analysis we do on this front. Credit spreads began to widen all the way back in December of 2017. As it relates to investor's willingness to take risk, this was a yellow light for sure. However, it is important to note that the widening was modest in both its degree and rate of change (it never got that wide, and it never widened at too quick a rate). Spreads between Moody's BAA and AAA bonds reached their widest point in 2018 at the end of December, but were still only 1.15% apart. In comparison, in December of 2015, this spread was at 1.48% and was 60% wider than six months earlier. Therefore, while wider, the spread today is not yet reason for heightened concern. The economic consulting firm, HCWE points out that spreads need to get wider than 1.4% to begin to signal even a mild recession.

The other risk-preference data point worth highlighting is market breadth, and specifically the advance/decline line. This line indicates how many of the underlying stocks are participating in a market (or index) move. It is possible (and common at significant market peaks) for a market capitalization weighted index (e.g. the S&P 500) to make new highs while a majority of securities in the index are beginning to decline. When this occurs, it is a warning sign. Conversely, when a new index high is confirmed by the advance/decline line, it indicates investors are broadly willing to engage in risk taking and no particular market segment is sounding an early warning. In fact, when the S&P 500 made a new high on September 20, 2018 the advance/decline line also made a new high.

Given the weak caution from credit spreads and an "all clear" signal from the advance/decline line (among many other factors that would overcomplicate this explanation), we felt

[3] However, we might quibble with the most strident and alarmist commentators on details around profit margins, corporate competitive advantage, and market structure – all of which could argue for slightly higher normalized valuations. In that case, equity valuations are not quite as egregious as they appear relative to historical metrics such as price to sales and price to book.

comfortable using the fourth quarter sell-off to increase our equity exposure. Fortuitously, we had raised significant cash earlier in the year when our investments in both Express Scripts and Zoe's Kitchen were acquired. Further, as we describe below, we also raised cash by trimming our TripAdvisor position after excellent earnings and a 125% price increase from the last 2017 low.

## Portfolio Update

During the quarter, company specific developments, as well as, the significant market volatility created opportunities for us to adjust our portfolio. For the most part, we added to existing positions that we know well and believe have the opportunity for positive near-term developments.

### Partial Sale – TripAdvisor (TRIP); sold 60% of approximately 10% position

On November 8, TripAdvisor reported financial results for the third quarter of 2018. The stock reacted positively to the news and was up over $10/share and 17% that day. We took the opportunity to trim our position – selling approximately 60% of our 10% position at $68.60/share. Our return on those shares was approximately 47% over a period of roughly twenty-two months.

It is important to note just how bumpy the ride was. From our first purchase at $49.52/share (already down 55% from its July 2014 high), the stock proceeded to drop to a low of $30.52/share in November of 2017. It then advanced almost 125% in just under a year to the point where we made our partial sale.

When we initially purchased TRIP shares in the first half of 2017 our thesis (articulated in our Q4 2016 letter) was that recent difficulties were masking the value of TRIP's network of travel listings and unique visitors. We were not exactly sure how TRIP would improve site economics and monetization of visitors, but we knew they had a history of navigating challenges in the past and a good idea in the Instant Book product they had recently introduced. We were also optimistic about their nascent attractions business. In the end, Instant Book was not as successful as we hoped, but the value (and ongoing growth) of the network (the core of our thesis) proved itself after a few product and user interface iterations. The attractions business, where they are now the clear market leader, is doing even better than we might have hoped.

**Buy – Jefferies Financial Group (JEF); added 2.5% to existing position**

On December 13, 2018 we increased our position in Jefferies Financial Group by 2.5% to 12%. At $18.62, JEF was trading at less than 75% of what we believed would be year-end tangible book value of approximately $25/share. In addition, as we have pointed out before, the current JEF is the most diversified it has ever been (we believe greatly mitigating risk of permanent capital impairment) and in the process of executing transactions that have the potential to catalyze a valuation improvement while continuing to grow book value.

Indeed, on January 10, 2019 JEF reported year-end results for their 2018 fiscal year ended November 2018. Net income was $2.90/share. The company repurchased 50 million shares and paid dividends combining to return 17% of tangible common equity to shareholders. Through operating earnings and gain on investment sales, fully diluted tangible book value grew 22% during the year to $24.90.

**Additional Buys and Position Increases**

Given the information we were getting from credit spreads and market breadth, we used the sell-off to add to several other positions, besides Jefferies. On November 12, we initiated a position in Caesar's Entertainment (CZR). The stock is cheap relative to other casino operators, they have a long pipeline of property sale leasebacks that should be accretive, and activist investors (Tilman Fertitta and Carl Icahn) have shown interest in acquiring stock. On November 20, we added to our Allergan (AGN) and Booking.com (BKNG) positions. We continue to believe AGN has a solid portfolio and is particularly cheap with a price to earnings ratio under 10. With its focus on European hotels, we believe Booking.com has the best assets of all the online travel properties. On November 28, we added to the MSCI Momentum ETF (MTUM). The majority of our individual security holdings are "value" oriented and this ETF helps diversify our market exposure. Finally, on December 6, we added to Labcorp (LH), the largest player in the critical diagnostic area of healthcare. In total, we increased equity exposure by approximately 17% during the fourth quarter.

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It seems to us, the fourth quarter sell-off was a Fata Morgana. At first blush, it looked like the beginning of a new bear market. Like the unique conditions caused by rays of light bent through layers of different temperature air, modern market structure – increased programmatic trading, decreased relevance of market makers, and the growth of indexing – is adding volatility to what historically were shallower market corrections.

From a superior vantage point, the mirage dissolves. Market internals provide additional, critical information that the price indices leave out. As we wrote last quarter, despite the recent market volatility, nothing that has proven useful historically is signaling we should become significantly more defensive. This could change quickly – even in the next few weeks. The recent volatility created an opportunity to add to many of our favorite positions. We still maintain modest exposure to long-dated US Treasury bonds and gold, as well as, hold some cash as portfolio ballasts. In general, we are relatively neutral – cautious on valuations, but constructive regarding signs of investors' willingness to continue to take risk in the near-term.

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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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