

MARTIN
CAPITAL MANAGEMENT, LLC
Registered Investment Advisor

“I made my fortune by selling too early.”
—Baron Rothschild

“Stability—even of an expansion—is destabilizing in that the more adventuresome financing of investment pays off to the leaders and others follow.”
—Hyman Minsky

“[I would] rather see finance less proud and industry more content.”
—Winston Churchill

“The clear and present risk of the stock market is we’re living...in a hall of mirrors because the Fed’s accommodative policy is distorting the calculations by which the market has been traditionally valued...The Fed can change how things look. It can’t change the way things are.”
—Jim Grant

2017

ANNUAL REPORT

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February 6, 2018

Dear Client:

As highlighted in last February's letter, we as absolute-return value investors found it more and more difficult to find bargains in a seemingly endless bull market. Using the S&P 500 as proxy, what was expensive as 2016 ended was marked up another 17.3% (19.5%, including dividends), gaining momentum as the year progressed. Normally we don't peek ahead into the new year in our annual letter, but with nearly a year's worth of increasingly exponential gains—7.5% (through January 26, the cutoff date for this communiqué)—compressed into the first month of 2018 alone, a case could be made for annual reports getting supplanted by monthly updates!

Prediction is risky business most the time, but in high-adrenaline eras like the present it is downright foolhardy. Rather, our all-consuming preoccupation is with preparedness. Toward that end, we wound down both of our onshore and offshore Hummingbird Funds effective May 31, 2017, and all money originally invested, plus gains, has been returned to investors. Although the earliest lockup didn't expire until late September, we saw no reason to continue charging the higher fund fees, with few compelling investment prospects on the near-term horizon.

As an expression of our gratitude, we offered all Hummingbird investors help in finding a new home. Many chose to return to the safe haven of MCM's separately managed accounts. To demonstrate—in a tangible and personally sacrificial way—our concern about the lack of legitimate opportunities, we reduced our base fee to 50 basis points for all MCM clients.

Preparedness also extended to the means by which we communicate with you. The industry standard is typically three formulaic quarterly letters, as well as a longer perfunctory annual report. Knowing that most of you are inundated with reading material, particularly at year end, on May 31, 2017, we began serving up our missives more frequently and in teaspoon rather than tablespoon portions. The steady infusion of eclectic biweekly postings to my blog, "Patient & Principled in the Pursuit of Value"—which we hope you make time to read as they arrive in your inbox—means this annual report is more easily digested at 12 pages rather than 20. ☺ As the rest of this letter should make clear, we believe that in the not terribly distant future the quiescent times of the present will give way to their antithesis, and you may actually find solace in hearing from us more frequently.

Beyond the administrative and organizational changes, we restructured portfolios so that when value opportunities once again proliferate, we will have both the capital and the courage to step into the batter's box. Selling many of our equities was a bittersweet experiences. We forwent any gains going forward in exchange for the opportunity to buy them back at much lower levels in the future. Given the substantial coverage of our remaining equities in the 2017 quarterly letters, we won't repeat ourselves here.

In December, we moved a significant portion of money-market funds and short-term U.S. Treasuries out into the 2-year Treasury note. Trading for a yield of less than $\frac{1}{4}$ of 1% as recently as 2013, they "spiked"—everything is relative!—to over 1.8% by year's end. We're pleased that they've risen further as we have more money to invest, and "riding down the yield curve" will allow us to actively manage the Treasury portfolio. Because we serve two masters—one desires yield and the other liquidity without market-price risk—we felt we found our sweet spot. The 35 basis-points greater yield on the 5-year was not adequate to compensate us for market-price declines in the event rates keep rising.

Finally, in further preparation of your portfolio for the day when bargains abound and today's euphoria is replaced by fear, we are systematically purchasing plain-vanilla, asymmetrical-payoff derivatives. Annual

premiums will be between 1% and 2% of the portfolio's value. It has been said, "When someone isn't afraid of losing small amounts of money, they're almost invincible." Such comparatively low cost insurance may be the only compelling bargain in today's market, despite having a potentially enormous asymmetric payoff.

'Genius Is Before the Fall'

Harvard economist and prolific writer, John Kenneth Galbraith, penned *A Short History of Financial Euphoria: Financial Genius Is Before the Fall*, in 1990, and it's a fitting preamble to this year's annual letter. In cautioning readers against the allure of financial euphoria, Galbraith, like John Maynard Keynes before him, explains the cost of speaking out. "There are ... few matters on which such a warning is less welcomed," he wrote. "In the short run, it will be said to be an attack, motivated by either deficient understanding or uncontrolled envy, on the wonderful process of enrichment. More durably, it will be thought to demonstrate a lack of faith in the inherent wisdom of the market itself." Despite sound reasoning, any victory against such judgments is sure to be Pyrrhic.

Galbraith recounts how Paul Warburg, a founder of the Federal Reserve System, and investment author Roger Babson were vehemently criticized in the 1920s; the reactions from the investment public toward Warburg's and Babson's warnings of ultimate collapse and depression if the speculation continued unabated were bitter, even vicious. We shall attend further to that era later in this report.

Galbraith warns that investors must resist two compelling forces if they are to avoid falling victim to speculative manias: "One, the powerful personal interest that develops in the euphoric belief." Portfolio gains create a positive feedback loop reinforcing the desire for more. This is an internal phenomenon. The second force is external: "[Two], the pressure of public and seemingly superior financial opinion that is brought to bear on behalf of such belief." Both stand as proof of the dictum from 18th-century German literary figure Johann Christoph Friedrich von Schiller. "The crowd converts the individual from reasonably good sense to the stupidity against which ... the very [g]ods [t]hemselves contend in vain."

Continues Galbraith:

History may not repeat itself, but some of its lessons are inescapable. One is that in the world of high and confident finance little is ever really new. The controlling fact is not the tendency to brilliant invention; the controlling fact is the shortness of the public memory, especially when it contends with a euphoric desire to forget. The rule is that financial operations do not lend themselves to innovation. What is currently so described and celebrated is, without exception, a small variation on an established design, one that owes its distinctive character to the aforementioned brevity of the financial memory. The world of finance hails the invention of the wheel over and over again, often a slightly more unstable version. All financial innovation involves, in one form or another, the creation of debt secured in greater or lesser adequacy by real assets.

Grabbing for the Brass Ring?

As testament to Galbraith's interpretation of financial history, the changing of the political guard in 2016 saw a bull market in complacency get itself some legs. It has surged since on the expectation that new tax laws will finally ignite stronger economic growth. In the wake of such legislative innovation, caution is in order. Instead, the market became a devil-may-care grab for the brass ring on the carousel to riches. Snatch the ring and you earn another ride on a pony that goes up and down in a dizzying circle, only to stop precisely where it started. The quaintness of the analogy highlights the quickening pace of everything in modern times—and the almost childish desire of some to keep riding the market merry-go-round. Markets are more compressed, frenetic, and complicated than ever, almost universally predicated on growing quantities of debt, and much less in touch with the whys of market movements and the underlying value of the companies involved.

This late if not final stage in defiance began in the early hours of Wednesday, November 9, 2016, as Asian markets tanked on the unexpected election outcome. The Dow futures made headlines by opening down over 3%. By the end of the day, though, agony had turned to ecstasy as the Dow closed up 257 points despite the earlier knee-jerk reaction. The next day it reached a record high, a feat replicated a record 95 times since. In the weeks following, as the president formed his pro-business cabinet, the Dow flirted with 20,000. By year-end 2017, it was approaching 25,000 (at the time of this writing, it is 26,370, the fastest 1,000-point advance in its history). To consummate the market's lofty expectations, Congress passed a pro-business \$1.5 trillion tax cut only days before the end of the year.

The S&P 500 also has been reaching new highs. Amid all the fanfare and bravado, however, the index also broke another record, this one dating back 88 years. Using the Shiller CAPE (cyclically adjusted price-earnings ratio) as the benchmark, in December the PE ratio, using inflation-adjusted 10-year average earnings, reached 32.4, nearing the high of 32.6 recorded in September 1929. As of today, that metric is 34.5. The extent of overvaluation is corroborated by two further valuation measurement tools: Tobin's Q, as well as the market cap to GDP ratio, Warren Buffett's favorite. Those records never make the headlines. As in other market manias, valuation appears irrelevant.

A legitimate cautionary addendum to such arguments, though, is that ours is a market of stocks, not a stock market. Proponents cite the bifurcation between popular stocks and wallflowers during the 1972 "nifty 50" craze. The same occurred in the late-1990s dot.com bubble. Might there also be a portfolio's worth of cheap stocks today?

Looking through the NASDAQ composite and the S&P 500, a universe of over 3,000 companies, that does not seem to be the case. While PE ratios are high, and the Shiller CAPE is higher, cyclically adjusted PE ratios on individual companies are higher still. This metric better accounts for the cyclicity of earnings during the oscillations of the economy. When earnings are trending upward, the trailing 10-year moving average will understandably be less than earnings of the previous 12 months, providing a governor on excessive expectations of boom times. It works just as well to mitigate pessimism during downturns.

Many NASDAQ companies sport basic PE ratios in the 30s. When calculated with average earnings over 10 years, those ratios are much higher, routinely exceeding 60. Costco, a remarkable business, is not impervious to competition. It currently sells at 32 times annual earnings. It sells for 47 times its 10-year earnings. This valuation is despite massive shifts and intense threats in basic consumer products. Amazon continues new forays into grocery and is growing its dominance in home goods. Walmart has brushed up the appearance of its stores and moved to revitalize its grocery game. Perhaps most importantly, Aldi is drawing cost-conscious millennial consumers just starting their families with a pared-down Costco model that requires no membership fee. Meanwhile, valuations of the company don't seem to take such threats into account.

Toro, a company one-10th the value of Costco, demonstrates the valuation trend in smaller companies. The manufacturer of lawn-care equipment currently trades with at a ratio of 26.5 times current earnings. That is half the 51 times its 10-year average earnings. Without a foreseeable surge in lawn-care maintenance and irrigation needs, and given that the company itself expects revenue growth of only 5% next year, the 26.5 times is simply unsustainable. Again, a 10-year perspective reminds us of the cyclicity of earnings, warning that future returns should be limited.

We acknowledge there have been *relative* bargains in this market. The recovery in oil, from which our choices appreciated nicely, is a case in point. The summer pessimism over brick-and-mortar retail was oversold. Still, when we analyzed the S&P 500 giving each company equal weight, we found that the PE ratio from 10-year average earnings was 47. In looking for bargains, we found only 30 companies trading below 15 times 10-year earnings. Notable among them were General Electric, Hewlett Packard, IBM, and Macy's. Most others were oil extractors and electricity producers. Each has its own story, but all are well-covered and their challenges

well-known. In this market, there are good reasons they trade so low. Although they are cheap, we aren't convinced they are bargains.

Most of the time, thanks to arbitrage, the market is reasonable efficient. More importantly, none of these examples demonstrates a bifurcated market. Rather, it is broadly and highly overvalued. As it rises, the storm clouds grow darker, and only the briefest of sunrays highlight momentary undervaluation. It isn't the time to be at the carnival, brass ring or not.

Is the Past Prologue?

Ninety-three years ago, at the quarter-century mark, 1925, a great bull market was under way, and Benjamin Graham, then 31, had enjoyed impressive success as an investor in the challenging years since 1915. During an early-1929 conversation with business associate Bernard Baruch, both agreed that the market had advanced to “inordinate heights, that the speculators had gone crazy, that respected investment bankers were indulging in inexcusable high jinx, and that the whole thing would have to end up one day in a major crash.”

Years later Graham lamented, “What seems really strange now is that I could make a prediction of that kind in all seriousness, yet not have the sense to realize the dangers to which I continued to subject the account's capital [money he managed for clients, family, and friends],” which, by 1932, had shrunk to 15% of its 1929 value. Graham was not alone in having at least a vague notion in the mid- to late '20s that things would end badly. What he and others lacked was not so much the conviction as the moral courage and temerity to say “No” when everyone else was saying “Yes.”

In examining the 1929 event, its roots can be traced to the depression of 1921, just as today's asset boom is an outgrowth of the financial crisis and Great Recession of 2007–09. In important respects, these two preparatory economic contractions, along with the public policy responses to them, could not be more different.

When World War I ended in 1919, unexpected inflation was soon followed by the aforementioned depression. As James Grant wrote and I paraphrase, in 1920–21 Woodrow Wilson and Warren G. Harding met the deep economic slump by seeming to ignore it, implementing policies that most 21st-century economists would call backward.¹ Confronted with plunging prices, wages, and employment, the government balanced the budget and, through the Federal Reserve, raised interest rates. No “stimulus” was administered, and a robust, job-filled recovery was under way by late 1921. Grant dubs it “America's last governmentally unmedicated depression,” noting that “the government didn't socialize the risk of financial failure or attempt to steer and guide the national economy by manipulating either the rate of federal spending or the value of the dollar.” It seems governmental passivity did not so much destroy confidence as enhance it.

By contrast, the federal government's response to the dual threats of 2008 was decidedly reactive and anything but *laissez-faire*. Neither Presidents Bush nor Obama, neither Treasury Secretaries Paulson nor Geithner, were remotely prepared academically or experientially to cope with the failure of a complex system that, to their untrained eyes, appeared out of the blue with the terrifying roar of an avalanche. In a word, they panicked. And the only person in the room with credentials was Federal Reserve Board Chairman Ben Bernanke. His doctoral thesis had been a postmortem on the Great Depression and had preprogrammed him for only one course of action: Economic management via the U.S. central bank. The following quotation of uncertain origin was apropos in describing his reaction: “To a man with a hammer, everything looks like a nail.”

¹ James Grant, *The Forgotten Depression* (Simon & Schuster, 2014).

Based on the results, Bernanke's meddling fell short of expectations.² Austrian-school economist F. A. Hayek foresaw just such an outcome in his 1974 Nobel Prize acceptance speech. The complexity of economics, essentially a social system with billions of daily decisions made by billions of people, dwarfs that of the physical sciences. The best of intentions notwithstanding, no one can or should attempt to master such systems. And humility should restrain them from becoming "... an accomplice in man's fatal striving to control society." The title of his speech: "The Pretense of Knowledge."

Consequentially, the 2008 response, followed the spirit if not the letter of the interventionist regime imposed first by Herbert Hoover immediately following the first crash in 1929 and then Franklin Roosevelt in March 1932, just months before the end of the second³ crash. To my knowledge, no U.S. policymaker invoked the extraordinary events of 1920–21 as a potentially relevant precedent during the crisis of 2008; the collapse of 1929–33 rather monopolized the "market" in historical analogy.

One can anticipate the arguments in defense of this choice. In 1920–21, the economy was much smaller than it is today. The political environment was wholly different than ours, and the statistics produced to measure the expansion and contraction of economic activity were, at best, crude. Besides, there was no federal safety net and no easily accessible credit, either of the personal or mortgage variety. All this is true, yet each objection might be applied with nearly equal force to the Great Depression itself.

There is something else to consider. Following the 1929 Crash, President Hoover and Treasury Secretary Andrew Mellon, veterans of the 1920–21 depression, embarked on a whirlwind of intervention to "stop a depression before it could start," language virtually identical to the rhetoric of 2008. At the president's insistence, every faction in business, industry, and labor convened in Washington on November 21, 1929, agreeing under varying degrees of duress to strike a bargain to forestall depression: Companies would not cut wages, nor would unions seek increases. Stabilization, an idea that gathered steam among economic luminaries, including Keynes, during the mid-'20s—not disorderly 1921-style wage and price deflation—was to be the order of the day. While these interventions (the "First New Deal," some called them) were an undisputed failure, the non-intervention of Wilson and Harding constitutes an uncelebrated success.

The fiscal and monetary policy remedies that began in 2008 to prevent a repeat of the 1930s achieved their stopgap measures, at least temporarily. The subsequent compounding of mispricings, malinvestments, and other distortions—to say nothing of substandard economic performance and growing instability—leaves us wondering whether the tin can of inevitable consequences was simply kicked down the road. Returning to Hayek, we think it not totally unreasonable that the post-2008 intervention may ultimately be remembered as an "undisputed failure."

² The efficacy of counterfactual arguments holding that the economy would have slipped into a bottomless depression without intervention must be weighed against those who contend the ship would've eventually righted itself. No one knows which would've caused the greater cost to society. Ex-post rationalization is a water bucket riddled with holes.

³ The "first" crash began with the Dow's peak at 381.17 on September 3, 1929, from which point daily price volatility and trading volume convulsed into spasms of fear and relief. The freefall, which began as "The Crash" on October 24 ("Black Thursday"), ended three weeks later on November 13, during which time the Dow plummeted 198.60 points, an overall decline of 47.9%. During the seemingly eternal, somnolent *five months* between November 14, 1929, and April 17, 1930, the panic subsided, and the Dow marched back to 294.07, recovering 48% of the ground lost during the crisis. The "second" crash followed, this time investors suffering a death-by-a-thousand-cuts, as the Dow slipped into the black hole of ignominy, shredding all hope as it faded from 209.4 to 41, losing 81% of its value over the next 26 relentlessly excruciating months.

The divergent responses to the 1921 and 2008 downturns created substantially different contexts for the bull runs that followed. The importance of this comparison is that the policy response to the 1921 crash resulted in a healthy economic recovery. As the decade drew to a close, however, dramatic growth created an investor euphoria that pushed prices far ahead of the fundamental underpinnings. The S&P composite rose 4.3-fold by September 1929 and achieved a record valuation of 32.6 times 10-year earnings. With the Fed tightening monetary policy early in the year, the groundwork was in place for an abrupt reversal in fortunes.

By contrast, the interventionist policy regime in 2008 yielded a far less robust recovery. The poisonous medicine of easy money and staggering debt, both public and private, courtesy of the Federal Reserve, left the economy much weaker even as it inflated asset prices to levels remarkably similar to those of 1929. The inflation in common stocks, despite a lack of sustainable⁴ real growth in intrinsic value, has generated paper returns that have spurred investor confidence that the recent past is the new normal. The S&P 500 has risen 3.8 times since 2008, a similar proportion as it did in the years following the '21 depression, and the CAPE ratio now stands at 34.5 times. Further, the Fed plans to continue rate hikes.

Like the 1920s, profit margins are high and reported earnings are rising, but at a rate that pales by comparison to the rate of appreciation in assets. Even the deregulation of late is in some sense analogous to the paucity of regulation in the '20s. In addition, we currently have a social, political, financial and economic fragility quite unlike that of 1929. The re-emergence with a vengeance of populism on the political landscape demonstrates more discontent than exuberance. Such restlessness is no doubt the result of diminished economic opportunity, especially for middle-aged and older white males, evidenced by extremes in inequality in wealth equaling that of 1928⁵ and persistently low growth in productivity.⁶

These realities are in part the consequence of high levels of public and private debt, about which we have written extensively (see footnoting below).⁷ Regardless of reported earnings growth—itsself a metric easily manipulated by the myriad machinations of corporate accounting miscreants—the backdrop of today's market is on many levels impoverished vis-à-vis the '20s.⁸ That makes current asset prices all the more perplexing. Not only is the S&P index more highly valued than on the eve of the Great Depression, the economy of the United States is saddled with challenges—financial in the form of debt and monetary policy, social and political in the form of any number of divisions—that the nation of the 1920s did not share to the same degree.

⁴ Paraphrasing Nassim Taleb in *Antifragile*, growing GDP can be achieved by loading future generations with debt—and the future economy may well falter when it comes time to repay such debt. Economic growth built upon such fragilities is not to be called growth, a hard truth not yet been understood by most governments.

⁵ Thomas Piketty. *Capital in the Twenty-First Century*, 2013 (p. 295), Harvard University Press: "... Capital gains in the United States reached unprecedented heights during the Internet bubble in 2000 and again in 2007: in both cases, capital gains alone accounted for about five additional points of national income for the upper decile, which is an enormous amount. The previous record, set in 1928 on the eve of the 1929 stock market crash, was roughly 3 points of national income."

⁶ December 29, 2017, blog post (excerpt): "Growth in productivity, the amount of goods and services produced compared to the number of labor hours used in producing them, is the wellspring of economic prosperity. During the current expansion cycle, productivity has grown at a dispiriting 1.1% annually, less than half the 70-year average of 2.3% and lower than any prior cycle. Lower growth in productivity means low growth in income to labor, capital (in corporate profits), and in public-sector revenue."

⁷ See footnote 4.

⁸ When physical capacity is underutilized—as it is in U.S. manufacturing—cash flow otherwise used for capital spending is redirected toward activities that give only the illusion of growing prosperity. Inflation of per-share earnings and dividends, through stock repurchases and rising dividends, ultimately leading to higher stock prices and *creates no systemwide gain in prosperity*.

The Demons of Today

We will not attempt to identify *the* catalyst for a market reversal. That would constitute hubris and speculation. We can, however, identify seriously worrisome weaknesses that the 1920s did not share.

It has been well-publicized that consumer confidence is nearing all-time highs and is well above 2007, even after a significant drop in December. Many frame this metric as a leading bullish indicator, especially given how reliant our economy is on consumer spending. It is, therefore, essential to see how this sentiment plays out in the real economy.

As evidence of public sentiment toward the economic future—assuming it's not actually an indication of financial distress—the personal savings rate has hit a 10-year low of 2.4% of disposable income. The decline in savings fuels purchases today, but it creates a consumer less resilient in the face of reversed fortunes.

Further, while consumers are spending more, they also are spending more than they have! Federal Bureau of Labor Statistics data show that the average U.S. household spent 94% of its 2017 annual income on consumer goods (including medical expenses) and spent another 10% servicing debt—mortgage and consumer. The math looks odd, because the resulting expenditures (104%) exceed total income. Considering the 2.4% savings rate, households outspent their incomes by 6.4%. (Does this sound like any federal government you know?!) That excess was satisfied by consumer-credit expansion of \$551 billion. Comparatively, GDP grew by \$513 billion. Positive consumer sentiment can only drive sustainable economic growth if consumers have sufficient funds to maintain spending. Whatever growth we see in consumer spending today has largely been bought on credit that must be repaid tomorrow. Sadly, as noted parenthetically above, profligate Uncle Sam has not set a good example.

Tomorrow is of special concern due to the global credit-tightening cycle that seems to be under way. With a strong labor market and signs of inflation becoming more and more apparent, there's good reason to believe the Fed when it projects raising rates throughout 2018. In fact, the bond market seems well out ahead of the Fed. The 2-year Treasury has rallied 75 basis points since the central bank's last 25-basis-point increase in the Fed Funds rate. This is good news for savers and good news for us, since we delayed entering a portfolio of laddered treasuries until late this fall, locking in higher real yields.

It is not good news, however, for debt-laden consumers. Their only recourse will be to limit consumption. This is a painful corrective in the U.S. economy, which is, like that of 1929, heavily reliant on consumer spending.

Such economic circumstances have market implications. Consumer behavior impacts corporate profits and ultimately equity valuations. Additionally, David Swensen, iconic author and Yale University's longtime chief investment officer, is openly worried about the lack of volatility concurrent with high valuations in the security markets in the presence of mushrooming fundamental risks he sees all around the globe. He wonders if we're not setting ourselves up for another market crisis.

Consider, for example, the earnings yield (i.e., earnings divided by price or the reciprocal of the P/E ratio) on the S&P. Based on the CAPE, it is 3%. The nominal yield on the 10-year Treasury is in excess of 2.75%, having been just over 2% as recently as September.

The "equity-risk premium," the excess return that common stocks should provide to compensate for the extra risk is, using this back-of-the-envelope approach, *de minimus*. There are any number of methods to guesstimate the premium and how it's derived, but, suffice it to say, when we eyeball the totality of the environment in

which we find ourselves, we're hard-pressed to argue with those who believe the premium should be nearer to 5% than .25%. Understandably, Swensen knows that however the equity-risk premium is right-sized, it will be acutely painful.

That Which Is Hidden from Plain Sight

Due to the shortness of the financial memory, insidious threats to stability have arisen beyond the fragile economy and pricey markets. Electronically traded funds (ETFs) are a key example of excesses in “innovation” characteristic of late-stage bull markets. They are hardly a new class of products—the first ETF of the S&P 500 was launched in 1993. They allow a basket of securities (equities, bonds, futures) to be traded on an exchange like a stock. With minimal management fees, basic ETFs are an important investment vehicle for many investors. They have been on the forefront of the movement toward passive investing approaches.

The number of such financial vehicles has ballooned since the Great Recession, however. Regulatory restrictions and the shift to passive have numerous consequences, among them lower profits for investment-bank trading desks. Consequently, banks have turned to ETFs as an important source of revenue. Such revenue is generated in two ways. First, in an effort to diversify and market new ETFs, the underlying investment thesis of each new product has become increasingly specialized and specific, supposedly justifying higher management fees. The Global X Lithium ETF, a play intended to capitalize on the growth in batteries and electric vehicles, commands a 0.76% management fee. That is 76 times the fee of an early S&P 500 fund.

The second way banks profit from ETFs is as authorized participants (APs). The APs are agents that convert the underlying equities the ETF tracks into ETF shares. Essentially, the APs arbitrage the difference between the ETF basket of securities and the actual underlying securities. The small profits from bundling and unbundling the shares keep the ETF in line with the index or other assortment of securities it tracks.

ETFs in many ways are nothing new. Management fees and arbitrage have been the playground of the major Wall Street houses since the stock market began. Since there's money to be made in the mechanics of the product, the more products the better. The market is now so inundated with ETFs that, believe it or not, there are more exchange-traded products currently than there are individual stocks.

In other ways, however, ETFs are quite new, and the innovation is not entirely for the better. So long as the fund flows are positive, the migration of investors from active to passive investing results in a constant bid to the underlying equities. This is most markedly the case in the most popular ETFs. When an S&P 500 ETF is purchased, its underlying securities are not bought for their individual value, earnings potential, financial health, or any other metric. Those securities are purchased simply because they are on the ETF's shopping list. This process is without regard to the price/value relationship. As a result, serious distortions in price have accumulated.

While much attention is given to the FANG stocks—tech growth stocks, specifically, Facebook, Amazon, Netflix, and Google—little attention is given to their similarly expensive large-cap brethren that share space in their indexes. Netflix is expensive because investors expect its earnings to dramatically increase over time. It's a young company. When an ETF buys the S&P, it buys Netflix, but it also buys McDonald's in similar proportion. The latter is also extremely expensive, in addition to being highly leveraged and slow growing. Longtime money manager and erudite blogger Jesse Felder calls McDonald's, 3M, Boeing, and Caterpillar the “Fantastic Four,” as they have far outperformed the FANGs since 2016. Their success doesn't rest on their independent merits but on the constant bid courtesy of ETFs (they are held 23.8%, 28.7%, 21.5%, and 22.5% by ETFs, respectively). Therefore, they trade at twice their 20-year average enterprise-to-sales ratios. Somewhat

reminiscent of mortgage-backed securities during the housing boom, a poor long-term investment when repackaged as a new and seemingly diversified financial product is still a sow's ear.

Diversification is another ETF pitfall. The plethora of options available aims to help you target your investment goals. However, it is liquidity, not diversification, that is the primary determinant of many underlying securities. For APs to efficiently create and redeem ETF shares, liquid stocks are preferred. Thus, large-cap companies predominate. The Fantastic Four are, not surprisingly, routinely included in numerous ETFs, all with various investment objectives. Investors frequently use ETFs to gain passive diversification. Often, they get nothing of the sort.

The Fed's quantitative-easing policy has pushed down the yield on bonds at the very moment when retiring Baby Boomers have been attempting to shift their holdings away from equities. As a result, an abundance of junk-bond issues have stepped into the gap offering higher yields. The ETF industry was quick to securitize them for the convenience of retail investors and lazy financial managers.

The Wall Street Journal recently offered some color to the generally dry domain of international bond finance.⁹ A \$500 million issue by the corrupt government of Tajikistan to finish construction on a hydroelectric dam first begun by the Soviet Union in 1974 and a \$1.14 billion issue for a thrice-stalled mega mall begun in 2003 and still striving despite the current retail environment, are two examples of high-yield junk bonds issued in 2017. Any number of very real risks—say, an environment of rising interest rates; war in Afghanistan, India, or Pakistan, all Tajikistan's neighbors, not to mention a geopolitical power struggle among China, Russia, and the U.S. over the former Soviet Pact states; pressure on U.S. consumer spending from inflation or recession; or the continued retail onslaught of Amazon—could all derail such bonds.

Bond ETFs do not enjoy, due to the nature of their holdings, the liquidity of their equity counterparts. In situations like those above, the bid evaporates. APs have nothing to arbitrage if no one is buying. They will buy a portion of the ETF's shares and hold its constituent components in inventory, but until a buyer appears for the underlying bonds or there are new investors interested in ETF shares already bundled, the current ETF holders will be unable to sell.

These are just samples of the problems in the universe of exchange-traded products, but even more complicated versions exist. Exchange traded notes (ETNs), for example, are packaged derivatives on futures contracts, wholly reliant on the solvency of the issuer. They are massively leveraged products used to short volatility, a profitable trade of late, but whose value can disappear overnight should volatility return anywhere close to historical levels. Such trades were typically the domain of sophisticated investors at specialty hedge funds. They are now freely available to any investor with a smartphone. This is the exchange-traded product universe.

Today's financial markets are quite unlike those from even 10 years past. The current environment has spurred legion new products, many of which have never encountered a bear market. Quite likely, the weaknesses on the horizon portend greater flaws still out of sight.

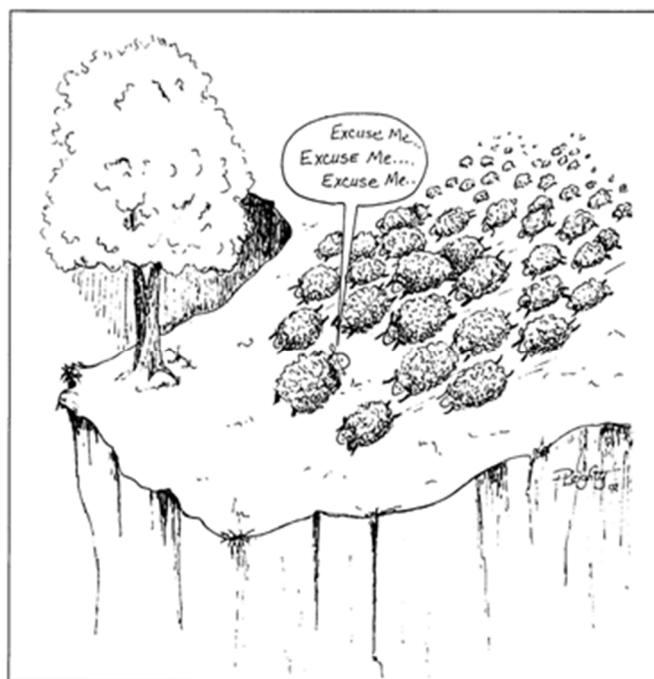
⁹ <https://www.wsj.com/articles/decade-of-easy-cash-turns-bond-market-upside-down-1517308201>

The Practitioner's Dilemma

On January 3, 2018, the highly regarded Jeremy Grantham, founder of \$77 billion GMO,¹⁰ wrote an essay “Bracing Yourself for a Possible Near-Term Melt-Up.” Although peppered with disclaimers, the siren call to readers is Grantham’s beguiling possibility that the market will make a final assault on a bubble peak comparable with its forebears, an enticing further gain of 60% from today’s levels over the next 21 months.

By his own admission, though, Grantham’s firm, GMO, paints a far darker long-term picture, recently forecasting that the annualized total return of the S&P 500 seven years hence will be -3.9%, that is to say, \$1 million invested today will have shrunk to \$750,000, including dividends, in seven years. The very reason Grantham stoops to tempting us with the apparent dilemma—staying at the party till the last drop of liquor is spilled or quietly slipping away before the cops break up the revelry and haul the inebriates off to the hoosegow—is likely to camouflage a very real problem every investment manager faces in heady times like these. Doing right by the client (invoking your asymmetrical information advantage to tell him what he doesn’t want to hear) risks driving the client you’re intent on protecting into the clutches of the proliferation of compromised “The client is always right” competitors. Investors are at their vulnerable worst when markets are detached from value. Sagely stated by Warren Buffett: “Nothing sedates rationality like large doses of effortless money.”

Digging deeper still, we find the crux of the practitioner’s dilemma. In the long-forgotten GMO Quarterly Letter of April 2012, Grantham spells it out: “The central truth of the investment business is that investment behavior is driven by career risk.” The primal instinct is, above all, to keep your job. And to do so, Grantham paraphrases Keynes in advising: “You must never, ever be wrong on your own.” This, logically, leads to herding, which, given the appropriate, but rarely anticipated, negative or positive stimulus, becomes a stampede.¹¹



¹⁰ Grantham knows of that which he writes all too well. Not too many years ago, GMO’s assets under management purportedly exceeded \$150 billion.

¹¹ A local artist was commissioned to draw the cartoon below during the dot.com bust. It appeared again in writings in early 2007. It made its most recent appearance in the closing chapter of *A Decade of Delusions*. It seems apropos that it appears here at this moment in history.

In the meantime, investors' time horizons have become progressively shorter as confirmed by the high and rising rates of share turnover over the longer term. Missing a big move, like the one Grantham sees as a possibility over the next year and a half—no matter how fundamentally absurd—is a sure way to get the pink slip. The industry's harsh reality is that the market's irrationality can outlive the client's capacity to remain patient. As an aside, the clients of institutions are often unwittingly complicit. When popular acronyms like TINA (There Is No Alternative) or FOMO (Fear of Missing Out) rule the day, danger is invariably close at hand.

In this context, the melt-up scenario is much more plausible. Even though a record number of professional investors believe the market is overvalued, they know they're on a short leash if they underperform for very long.

Lest we forget, despite the current cultural prominence of Wall Street, it has not always been so. In the aggregate, Wall Street has always been a negative value-added proposition. And yet the Street cycles in and out of fashion. Today, like the '20s, the investment management industry's star is shining brightly while the societal toll has never been greater. Preserving the purveyor's McMansions takes precedence over everything else, including their clients—whose financial well-being, ironically, is the ultimate source of their wealth. Deserved or otherwise, no one wants to simply give up the good life.

The masters deserve the last word. Warren Buffett quoting Ben Graham: “‘You can get in way more trouble with a good idea than a bad idea,’ because you forget that the good idea has limits.”

Final thoughts ...

The tragedy of arbitrary and unsettled immigration rules is no stranger to MCM. Several months after Hummingbird was launched, Peter Wong and Cecilia Hung were returning to the U.S. after a short visit with family in Hong Kong. Because of a technicality, Cecilia, upon landing at O'Hare, was not allowed to enter the United States and was summarily sent back to Hong Kong on the next flight. Peter, who is also a citizen of Canada, was allowed to stay in the States. However, not long after this they were married, and it would have been cruel to ask Peter and his bride to live half a world apart. Instead, Skype became our lifeline. Because we had adequate bandwidth, video and audio quality was so good that we felt we were in the same room—almost. Given the 12- and sometimes 13-hour time difference, Peter and Cecilia became nocturnal. In order to function in our time zone, they slept during the day and worked all night. Since it was uncertain whether Cecilia would ever be allowed back in the U.S., our stopgap solution eventually took its toll.

Immigration setbacks did not stop with Peter and Cecilia, however. Ho Jun Yang, a gifted summer intern from Brown University, came to work for us full time after graduating in the summer of 2016. He and three other Brown students followed the standard protocol for renewing their student visas last summer. All were rejected on technicalities. The university has interceded, but resolution is still in limbo.

Fortunately, for every loss there seems to be an offsetting gain. I worked extensively with Lane Miller during his one-year internship, which ended in May 2017. Immediately thereafter I asked him to join us full time, researching alongside Ho Jun until the visa issue derailed our plans. For those of you who have had deep conversations with Lane, know that hyperbole is not necessary in describing my understudy. Suffice it to say, because we share a commonality of views on the most critical subjects germane to our profession, almost everything I write is now done in collaboration with him.

Finally, and most importantly, is a sense of gratitude I feel toward you, our clients. Few investors would have passed the Stanford marshmallow test with flying colors the way our clients have, even in spite of me putting them through the most extreme test of deferred gratification. In the essay, “Why 1925?,” we quoted Ben Graham as saying that unless an investor had the fierce independence and temerity to step away from the

madness in 1925, the chances of surviving the debacle of the Crash¹² and the subsequent Great Depression were 1 in 100. Whatever storms may lie ahead, we ardently believe that our clients will be among those who survive *and* thrive. In the greater social context, they will be the ones through their eventual bid who might prevent a downward market spiral devoid of buyers from disintegrating into social and political chaos.

Very truly yours,
Frank K. Martin, CFA

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Past performance is no guarantee of future returns; performance may be volatile and the investment may involve a high degree of risk.

¹² See footnote 3. Graham avoided the first crash in 1929, but fell victim to the second. Quoting from *A Decade of Delusions*: “Graham observed that the ‘new era’ commencing in 1927 involved at bottom the abandonment of the analytical approach; and while emphasis was still seemingly placed on facts and figures, these were manipulated by a sort of pseudo-analysis to support the delusions of the period. The market collapse in October 1929 was no surprise to such analysts as had kept their heads, but the extent of the business collapse which later developed, with its devastating effects on established earning power, again threw their calculations out of gear. Hence the ultimate result was that serious analysis suffered a double discrediting: the first—prior to the crash—due to the persistence of imaginary values, and the second—after the crash—due to the disappearance of real values.”