May 2017

"I never allow myself to have an opinion on anything that I don't know the other side's argument better than they do."

"It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent."

"Develop into a lifelong self-learner through voracious reading; cultivate curiosity and strive to become a little wiser every day."

— Charlie Munger

Off to the Races… Or Traces?

In the opening months of the first quarter of 2017 the S&P 500 continued its post-election rally, rising 7.4% by March 1. The enthusiasm waned during the euphemistic Ides of March as the index backtracked 1.2% during the final month of the quarter. Those industries and companies presumed to be the beneficiaries of the seismic shift in governing ideology took a breather as high expectations grudgingly yielded to harsh reality. A dispassionate appraisal of the state of things as they actually exist hearkens us back to this precept from Benjamin Graham via Warren Buffett in 2005:

> *"You're neither right nor wrong because other people agree with you. You're right because your facts are right and your reasoning is right—and that's the only thing that makes you right. And if your facts and reasoning are right, you don't have to worry about anybody else."*

In this communiqué, as well as in those preceding it, we begin with a focus on facts. We collect them … examining them, turning them over in our minds, seeking patterns with precedents in the past—mean reversion, investors' behavioral responses, contextual conditions—all to educate ourselves on predictable outcomes.

With such study at hand, we can be reasonably confident if a given outcome is likely, despite our uncertainty *when* it might occur. Estimating the magnitude of such outcomes is a critical corollary to the process, and exogenous factors (see our discussion of debt below) complexify the analysis. In the face of these difficulties many managers give way to the most popular consensus peddled in the press. We hold still more resolutely to what we know. It is the foundation of our investment decisions.

Gresham's Law Revisited

In an attempt to understand the subtly evolving state of affairs in the soft science of behavioral economics, we resurrect a principle perhaps vaguely familiar to a number of our readers. It is a monetary concept known as Gresham's Law, which claims that "bad money drives out good." Although named after the 16th-century English financier, Sir Thomas Gresham, its origins can be traced back to the Greek comic dramatist, Aristophanes, in the 5th century BC.

The proposition applies to the debasing of coinage, that is, the intentional reduction of precious metal content in a coin during the minting process. Old and new coins had equal face value in the market, so the old were hoarded out of existence.

As systems and institutions have become more complex over the millennia, the application of Gresham's Law has morphed beyond coinage to include all manner of economic, social, and political endeavors in which the prevalence of the bad affects the presence of the good.

As a more recent example, here's what iconoclast Charlie Munger said in a 1984 letter to shareholders, in which he applied Gresham's Law to the debasement of standards of conduct in the savings-and-loan industry of the 1980s (at the time Buffett's partner-to-be was Wesco Financial Corporation chairman):

> *Although interest rates have subsided from the 1981–82 peak … an agency of the U.S. Government continues to insure savings accounts in the savings and loan industry, just as it did before. The result may well be bolder and bolder conduct by many savings and loan associations. A sort of Gresham's Law ("bad loan practice drives out good") may take effect … through increased copying by cautious institutions of whatever apparent-high-yield loan and investment strategies seem to allow competitors to bid away their savings accounts and yet report substantial earnings. If so, if "bold conduct drives out conservative conduct," there eventually could be widespread insolvencies caused by bold credit extensions come to grief.*

Exactly 1,043 out of 3,234 savings and loan associations in the U.S. failed between 1986 and 1995. In *The Best Way to Rob a Bank Is to Own One: How Corporate Executives and Politicians Looted the S&L Industry*, former bank regulator William K. Black tells how compromised "bold" CEOs, abetted by complicit politicians and regulators, engaged in "control" fraud—using illegal accounting—that ultimately resulted in catastrophic failure.

Munger's warning in 1984 saw the handwriting on the wall. The S&L debacle is a gripping prequel to the Enron collapse in 2002, the subprime crisis in the mid-2000s, Lehman et al. in 2008, and the next, yet-to-be-exposed, fraudulent scheme-in-the-making. If significant financial deregulation becomes the new standard, Black's exposé will serve as a primer for the next generation of miscreants. In each circumstance, "bold" behavior," just like debased currency, left "conservative conduct" and responsible investment managers in a conundrum: Lower your standards in order to compete or lose market share and eventually go out of business.

Once bad behavior has taken hold, it is difficult to uproot. Think of Darwin's law of natural selection. If the deeply embedded obsession with short-term performance does not give way to more sustainable investment philosophies, value investors and their commitment to rational long-term behavior, may find themselves an endangered species.

In what now seems like a voice from antiquity, John Maynard Keynes in 1936 argued that the social object of skilled investment is to "defeat the dark forces of time and ignorance which envelope our future." He went on to say: "The actual private object of the most skilled investment to-day[1] is 'to beat the gun,' as the Americans so well express it, to outwit the crowd and pass the bad, or depreciating, half-crown to the other fellow."

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[1] John Maynard Keynes, *The General Theory of Employment, Interest, and Money*, 1936.

Through the Depression years and decades beyond, chastised speculators, contrite and repentant, took Keynes' words to heart. Like a noxious weed, however, the behavior known as "beat the gun" and "pass the bad, or depreciating, half-crown to the other fellow" has taken root again.

Industries and professions with this regressive tendency—entities that offer no inclination toward self-regulation—must be subject to third-party oversight for the sake of consumers and clients. In a sad testimony to the state of ethics in our profession, the Department of Labor recently proposed a rule to minimize conflicts of interest between those giving financial advice and the retirees they counsel, proposing that the former act as "fiduciaries."

The DOL has thus far received more than 400,000 comments, the majority of which were submitted by aggrieved advisors and their lobbyists, rather than ill-advised clients. Originally slated for implementation mid-April, the rule has been delayed because of post-election political posturing. When a profession as susceptible to moral drift as ours so successfully lobbies against such consumer protections, the state of affairs is dire indeed.

Moral duty, rather than law or regulation, cements our commitment to putting our clients' interests above our own. We firmly believe that anyone entrusted with the money of others ought to be a fiduciary, the prime standard in both law and equity. We always seek to prudently grow client capital, but as guardians in the face of exuberant markets and nosebleed valuations, we will do our best to ensure that if we err, it is on the side of caution.

Even our own career aspirations—our jobs and livelihoods—must be subordinated to the safety of our clients' principal. The siren song of mature bull markets beguiles firms and clients alike toward complacency and the illusory returns of overvalued shares. But our course (and conscience) is clear. Lashed of our own volition to the mast of rationality and responsibility, we intend for the wealth of clients to weather the storms intact and stand poised at the threshold of the satisfying and sustainable growth that is the joyous recompense of the patient.

Such commitment becomes a rarity in these times when bad behavior, increasingly and sadly, is the norm. While the 2008–09 financial crisis was Gresham's Law writ large, the script being written and performed by our central bank today is a less discussed iteration of the phenomenon. Low interest rates have encouraged bold and reckless behavior. Sensible practices have largely devolved into a Hobson's choice between low, high-risk returns[2] or none at all.

We need look no farther for confirmation than to the record-high commitment of 97% of equity mutual funds' assets to low-return common stocks—this despite a late-March survey of fund managers by Bank of America Merrill Lynch that found 81% of respondents believed stocks are the most overvalued since 2000. If this contradiction between current asset allocations and overpriced equities strikes you as counterintuitive, read on.

Low Treasury yields are a precipitating cause of low expected returns from common stocks

The current value of any economic asset is the present value of its future cash flows. Treasury bond yields are a

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[2] The current return from common stocks, the dividend yield, is knowable. Expected total returns, which include future price appreciation or depreciation, are not. What we do know is the S&P 500 dividend yield is 1.97%, roughly its average since 2009, yet one-half of the 4.03% average as recently as from 1970 to 1990. And today's less than 2% yield is in spite of a 9.2% annual growth rate of the dollar amount of dividends paid ($2.8 trillion in total) from 2010 through 2017(e) and the contribution to the per-share dividend yield calculation by shrinking the denominator as $4.3 trillion in shares were repurchased. The two principal explanations given for the collapse in dividend yields are (1) Federal Reserve policy since 1987 and (2) the growing weight of technology stocks in the S&P that focused on growth over dividends. We wholly agree with the effect of Fed policy on dividend yields, but we think the technology argument is dated. In fact, of the 12 largest-cap technology companies, only Alphabet (#2) and Facebook (#4) pay no cash dividend, and the weighted average dividend yield of the other 10 is greater than the S&P.

principal factor in determining the rate at which those cash flows are discounted. Please note the while the Federal Reserve sets the Fed funds rate, its effect on Treasury yields is only indirect.

With the 10-year U.S. Treasury bond as proxy, and beginning with the new millennium in January of 2000, its yield, then 6.5%, has been in an irregular[3] but unmistakable downtrend. Having fallen to as low as 3.5% by 2003, it rose to 5% as the equity market was peaking in October 2007.

During the eight years of the Fed essentially keeping short-term interest rates at zero, the yield on the 10-year Treasury fell to a low of 1.5% in mid-2012, rebounded at 3% at year-end 2013, and returned to 1.5% in July 2016. It is currently 2.4%.

The cash-flow discounting mechanism is applied to the valuation of common stocks. For the sake of familiarity and simplicity—though not because of airtight accuracy—let's assume reported earnings per share (EPS) is a proximate substitute for "cash flow." Holding all other fundamental variables constant, the price-to-earnings ratio (e.g., how many dollars one is willing to pay for $1 in earnings per share?) should be higher when interest rates are low and vice versa. What seems like an obvious correlation is not nearly so clear in real life.

The other variables—the cyclical ups and downs of the economy and the far more turbulent subset, corporate profits (expressed here as S&P 500 earnings per share)—defy being held constant.

To make outcomes even more unpredictable, one must also factor in the market's often amplified emotional reactions to the perceived or actual changes in fundamentals —rendering it nearly impossible to test what seems like the simple intuitive hypothesis that lower interest rates matter-of-factly mean higher P/E ratios.

Since each episode must be evaluated in the context of both historical precedent and current events, the post-Great Recession one-off bull market certainly piques our curiosity.

First, the 10-year Treasury yield has taken at least a temporary respite from the swoon dating back to the early 1980s when it broke through the then unimaginable 15% level. For those of us who remember those days vividly, the last six years constitute a study in contrasts. Since mid-2011, the yield on the 10-year Treasury bond has languished in the low single digits, as enumerated several paragraphs above. The average yield: 2.1%.

Second, despite the lack of impetus from falling bond yields, the P/E ratio, based on trailing 12-month EPS, rose from 11.3 times in August 2012 to 18.3 times currently. If falling Treasury bond yields weren't the driver, perhaps earnings were? The facts, rather indisputably, say otherwise. Like a maxed-out bungee cord, the deepest postwar S&P earnings recession was followed by a proportionate snapback. After S&P earnings per share peaked at $89.50 in August 2007, they collapsed to $42.50 by the end of 2009, returning to their prior records two years later.

But for the last four years, beginning in 2012—and in spite of the financial-engineering benefit of $4.3 trillion in corporate-share repurchases—nominal S&P EPS growth has been lackluster at 1.9%, half the rate of nominal GDP.

[3] For the statistically curious, the periodic fluctuations were contained within two standard deviations—or 1.1% of the best-fit, downward-sloping trend line.

Barrels of ink have been spilled in attempting to explain the continuing rise in stocks in the face of dormant earnings. A thimbleful from us will add little. What we do know is that by any reputable valuation metric,[4] common stocks are priced at levels that now rival the most extreme levels in U.S. history.

With a little help from an inviolate investment truism, the tendency toward mean reversion, history unequivocally suggests that expected returns from the S&P 500 will be *de minimis* for the next decade or more unless (1) future S&P earnings grow at a much faster pace than their 6% historical average[5] and (2) the P/E ratio sets new all-time highs.

Worse yet, a gut-wrenching drawdown of, say, 50% should not be ruled out. The S&P has never mean-reverted from these extreme valuation levels in an orderly, linear fashion. Of course, such outcomes are unpredictable. But our inability to quantify or time the risk does not mean we should ignore it.

Circling back to interest rates, yes, in a rather imprecise manner they factor into the determination of the discount rate used to price stocks. And, along with other variables, Treasury bond yields in the low single digits have done their bidding. That in no small measure helps to explain why stocks are so expensive and, *conversely*, why expected total returns are so abysmally low relative to the long-term historical average of roughly 10%.

Surging Consumer Confidence: a Good or Bad Omen?

Such elevated valuations have traditionally presaged eventual bear markets—but with such imprecision with regard to timing, magnitude, and duration that the warning has generally been disregarded. It was Keynes who observed that "Markets can remain irrational longer than you can remain solvent."

What qualifies a warning light in statistically expensive markets or episodes of buoyant consumer confidence, is subject to interpretation. Today's environment is a telling example. Where we see red, others see amber… or even green. Since surging consumer confidence (and talk of resurgent "animal spirits") has been making the headlines, let's take a deeper look into consumer confidence and try to interpret its predictive power. The widely referenced Conference Board's Consumer Confidence Index, along with the University of Michigan's Surveys of Consumers,[6] are the leading sources.

The investor's adage "buy low, sell high" easily passes the grade-school commonsense test, but the "Buy on bad news, sell on good" corollary requires a somewhat more abstract mode of comprehension. It presumes the observer understands that when consumer confidence is high, the scent of optimism is in the air. Stocks are selling at very high valuations in no small measure because people are feeling good.

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[4] Price/earnings, price/forward earnings, price/book, price/dividends, enterprise value/EBITDA, the Fed Model, Tobin's Q, market cap/GDP, the NIPA profits cyclically-adjusted P/E (CAPE), the Shiller CAPE, to name some of the more prominent. Please e-mail us for the details.

[5] A possibility if not a probability, according to Trump proponents. We consider such an outcome an improbable unknowable.

[6] We have direct contact with the Surveys of Consumers chief economist, Richard Curtin. We have found his insights on the behavioral side of economic behavior to be invaluable.

At such times we must be more concerned, with Will Rogers, about "the return *of* my principal than the return *on* my principal." History shows clearly that consumer confidence goes hand in hand with overvalued markets, just as undervalued markets coincide with low consumer confidence. Some may opine that high consumer confidence portends future economic growth and thus higher stock prices. That makes intuitive sense, but the facts simply don't support it. Consumer confidence is a coincidental indicator, not a leading one. (Not surprisingly, consumer confidence is positively correlated with both equity prices and year-over-year rate of change in real GDP.)

In other words, by the time consumers finally become optimistic, the economy is usually late in an expansion cycle. Conversely, consumer confidence plunges during recessions. Both give credence to the admonition "Sell on good news" (i.e., when consumers are confident) and buy on bad news, when they're despondent. Note the incongruity in the media today. At the same time that concerns are being expressed about overpriced markets, high consumer confidence is being celebrated as a harbinger of better times to come.

With just three notable exceptions, the Conference Board's Index has been range-bound between 112 and 60 since it was first introduced in 1967 (1985 = 100). On the low side, it briefly fell below a record-low 30 during the worst of the financial crisis in 2007–09. As for the upside of the confidence index, it levitated in the vicinity of a record 145 as the dot.com bubble inexorably filled to its bursting point in early 2000.

With the data released on March 28, 2017, the index stands at 126, its third-highest level ever. We do not mean to misrepresent the index's implications. Like the valuation metrics, the confidence indices are not predictive in terms of timing, magnitude, or duration. There is no doubt, however, that a self-reinforcing feedback loop exists between consumer confidence and the equity markets.

That said, the economic and financial facts we regularly examine show an unnerving amount of information that is characteristically late-cycle (this just as the Fed may be turning toward monetary restraint). Since 1987, an ever-more-intrusive policy of cheap and easy credit has been affecting virtually all economic activity. The financial crisis was ground zero of the Fed's unintended consequences. Since then, however, the Fed has doubled down. This is doubly troubling. Another financial crisis could soon be center stage during the next economic contraction, in what would be a central bank-engineered disaster of epic proportions. That's simply an inference based on observation, not a prediction.

The Two Sides of Debt

As every reader knows, there are dramatically different feelings associated with the incurring of debt than with paying the borrowed money back. Borrowing is usually undertaken with buoyant expectations regarding current and future returns, whether economic or psychic. Many people are prone to an overconfidence bias, which often translates to depression given the obligation to pony up hard-earned income for years to come toward, perhaps, unfulfilled dreams.

Institutions are not immune to the bias, and they often have the capacity to do damage on a grander scale. By some estimates the total cost thus far related to the conflicts in Afghanistan and Iraq, a not insignificant portion of which was funded through the sale of Treasury securities, is between $4 trillion and $6 trillion. When the time comes to pay the piper, debt is like the skunk at the garden party; its odor is not only pervasive, you can't get rid of it.

Because macroeconomic training focuses primarily on components of the national income statement, and because the debt crisis was so deftly managed (postponed?), few economists have spent time examining the relationship between debt and economic activity. Could it be that aggregate debt has surreptitiously become the 600-pound gorilla in the room, simultaneously impeding growth and threatening financial stability?

Due to limited space in this quarterly letter, we'll attempt to hit only the high points, leaving the details for missives that follow. Instead of contracting (euphemistically "deleveraging") following the 2007–09 financial crisis and recession,[7] total domestic nonfinancial debt—excluding such off-balance-sheet liabilities as leases and staggeringly underfunded pension liabilities—continued to grow modestly, reaching a record of 254.8% of GDP in 2016 (compared with 249.2% in 2009). The average since 1945 has been 169.4%.

Though this phenomenon was discussed at length in the 2016 annual letter, we believe it's important to remind readers that the productivity of debt continues to decline alarmingly. By productivity we mean the ratio between an increase of $1 in aggregate debt and a corresponding $1 increase in GDP. The ratio from 1952 to 1999 was 1.7 (i.e., it took $1.70 in debt to create $1 in GDP growth); from 2000 to 2015 it was 3.3; and from 2015 to 2016 it reached 4.3.

Returning to the moral of the preceding paragraph, debt that doesn't earn its keep is much more difficult to retire than that which does. The $1.3 trillion in student loans outstanding (with 10% delinquent), consumer debt that just crossed the $1 trillion threshold, and $1.1 trillion in auto debt ($290 billion of which is subprime) will take a large bite out of consumers' discretionary income in its repayment—and that's before considering any increases in interest costs.

As for the public sector, due in part to financing the Middle East conflicts mentioned above, the federal government seems to be in no position to undertake fiscal policy stimulus that isn't revenue-neutral. States are understandably nervous about their role in the on-again, off-again changes proposed to the Affordable Care Act. Further, unfunded pension obligations, both public and private, have officially risen to $1.9 trillion from $292 billion in 2007. That number likely understates the true liability, however.[8] This is more than the tip of the iceberg, it's a floating mountain. More on that development next quarter.

If This Is the Beginning of a Credit-Contraction Cycle …

For the record, if the Fed is indeed embarking on the 15th tightening cycle since 1945, it is worth mentioning that 80% were followed by recessions. We may be especially vulnerable during this atypically late-stage expansion. Monetary restraint is being imposed at a time of (1) low and slowing economic growth and (2) record levels of debt. By most measures, credit in the form of bank loans, plus nonfinancial commercial paper, is contracting, approaching levels often seen *during* recessions.

More germane to us as investors, the last 10 tightening cycles all triggered bear markets. The continuing degradation of behavioral standards, extended equity valuations, ebullient consumer confidence, unprecedented levels of debt relative to the GDP engine that ultimately services it, and the contraction in credit growth are all patterns marking the later stages of business and market cycles. We can state with some degree of confidence that the complex system just described is both increasingly fragile and in a critical state, though admittedly it has been able to remain relatively unperturbed for some time. We cannot predict the catalyst that might trigger an implosion, nor can we predict the potential damage. If there's a risk that I might drown swimming in stormy seas, whether the water's depth is 10 feet or 1,000 feet seems irrelevant.

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[7] Carmen Reinhart and Kenneth Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*, 2009.

[8] Federal Reserve data show that in 1952 the average pension had 96% of its portfolio invested in bonds and cash equivalents. Assets matched future liabilities. But a loosening of state laws in the 1980s open the door to riskier investments. In 1992 fixed income and cash had fallen to an average of 47% of holdings. By 2016 the so-called safe investments had declined to 27%. It's no coincidence that pensions' flight from safety has coincided with the drop in interest rates.

Is It a Market of Stocks, or Is It a Stock Market?

In the last two chairman's letters in the Berkshire Hathaway annual report, Warren Buffett gave this question plenty of ink, yet mostly left us in the dark. While there are many tangential issues, not least of which are the fees charged by hedge funds, the question of whether it's better to buy stocks or the market remains perplexing. It's a hot and relevant topic, and we'll use some of our own ink to offer our own two cents.

Buffett has always been a buyer of stocks, and, increasingly, companies, yet he advocates that the masses buy the market—index funds. He has an uncommon talent and temperament that placed him at the pinnacle of investment prowess, and only a handful of individuals have the capacity to purchase a portfolio of wholly owned businesses.

Presuming we meet the minimum thresholds for talent and temperament, we can implement one or more of the edges Buffett has by narrowing our focus to a comparative handful of carefully selected investments in a generally expensive market. In practice, though, the conditions that value investors face today are not particularly accommodating.

In recent years the increasingly frenzied scramble for return by growing hordes of investors has left rather slim pickings for disciplined, absolute-return value investors. In this highly competitive environment for ideas, alpha—excess returns above that of an index fund—is found only in the least likely places. Some are neglected or overlooked wallflowers, as we described in several earlier letters. Even that turf, however, is well-worn.

Increasingly, we find it necessary to attempt to assess our counterparties' behavior. To be sure, we might gain an alpha edge with a divergent view of the future or with a portfolio construct that allows cash to be a major portfolio component.

Consistent with the predictability of human behavior, when active managers fall short of the performance of passive index funds, money migrates in that direction. When managers like ourselves were unable to find value in the shares of dot.com companies as prices advanced to the theretofore unmatched levels, assets moved in the direction of index funds that, by design, are indifferent to the prices paid to mimic the index.

Today, like then, many people have reverted to investing in the stock market through index funds, and the latest rage of do-it-yourself madness, ETFs (exchange traded funds)—embracing the stock market, not a market of stocks. Bull markets seem to induce amnesia. In time, investors forget that while the performance of index funds precisely replicates the underlying index on the way up, it inflicts a proportional amount of pain on the way down. Broad diversification provides no protection whatsoever against market risk.

We can, however, forecast with precision that if the S&P declines 50%, index funds based on the S&P will also fall by precisely that percentage. So far, our capacity to hold a large percentage of our assets in cash has resulted in us trailing the unthinking index. Only if markets never fall will we continue as a negative value-added proposition.

Another defining, and perhaps momentous, edge we enjoy over index funds—and what are known as index-hugging managers—is the willingness to hold copious amounts of cash in reserve when markets are expensive. Just as cash has truncated our gains when markets became even more expensive, it will buffer our losses when they inevitably mean-revert. More importantly, though, it will then provide us with options when few others have them. The hands of fully committed institutions are tied when they are blindsided by the inevitable bear markets. Their common lament to clients as they ride out the storm is "At least we're all in the same boat."

Because of our cash and the optionality it provides, we don't fear market storms. On the contrary, because of the acute shortage of competing buyers, bear markets provide unmatched opportunities. This deferral of gratification—patiently forgoing the limited opportunities of the present for the greater opportunities of the future—is one of the surest, yet most difficult, ways of achieving alpha.

Buffett's criticism of typical hedge fund fees is hard to dispute, but his advocacy for all-in indexing in a particularly expensive market perplexes us. When he stepped out of the shadows of anonymity in 1999, he warned that long-term future returns from extravagantly expensive markets would be disappointingly low. Enigmatically, he remains silent today. In our continuing quest for alpha, we will keep following the adage, "To win, first you must not lose."

Very truly yours,

Frank K. Martin, CFA

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