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QUARTERLY
CAPITAL MARKETS REVIEW

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The Coming Bear Market?

Those words were not mine. They were uttered September 21 by a first-class equivocator, 2013 Nobel laureate in economics, Bob Shiller. Even in this bold stroke, the "?" makes the phrase rhetorical, not predictive. Shiller, of whom I'm an unabashed admirer, came by his public ambiguity honestly.

The reigning master of obfuscation, Alan Greenspan, summoned Shiller before the Fed in 1997 so that the august body might hear from the vaunted Yale professor on his outlook for the stock market. You see, in December 1996 Greenspan had uttered a phrase that ricocheted 'round the investment world: "irrational exuberance."

Greenspan, initially emboldened by similar warnings from Warren Buffett, who had recently advised *against* purchasing soon-to-be-issued Berkshire Hathaway class B shares on account of their being overpriced, became nervous as the market continued its meteoric trajectory. Greenspan called for reinforcements. Shiller, no sycophant, cut to the chase. The man who had developed the CAPE (cyclically adjusted price-earnings ratio) and later the Case-Shiller House Price Index during the housing bubble, forthrightly stated that the S&P 500 was selling for twice what it was worth, which was fundamentally true. That was not enough to dissuade tech-smitten investors, however. They didn't stop buying until the decade drew to a close, the index doubling even from the '97 level over the next three years.

His early warning unheeded, Shiller has suffered under the "once burned, twice shy" syndrome in public ever since. Still, he finds a way to get his thoughts across to those who can see through the fog of his absent-minded-professor demeanor. His academic work, though, has been unbowed by the experience with the Fed. In March 2000, at the very crest of the dot-com wave, Shiller published the first edition of *Irrational Exuberance*. The book was right on the money and, perhaps more importantly, for the right reasons.

A second edition came out in 2005, echoing many of the same concerns about equity markets, but with a compelling new section devoted to the bubble in real estate. The same curiosity that led Shiller to conceive of a methodology to test for under/overvaluation of the equity markets (CAPE), led him to concoct a house price index where one had not existed before. Though the book was published two years before the peak, those who understood Shiller's data-driven conclusion that a housing bubble was in full flower, went on to make billions on the long side of the CDS market. The naked sellers of the CDS, like AIG, went broke. The real tragedy, however, is that nobody at the Fed, apparently, ever read Shiller's prophetic book.

The third edition of *Irrational Exuberance* appeared in bookstores one year ago. Its opening "salvo" was the equivalent of pouring cold water on a raging fire of euphoria.

> One might think that years after the bursting of the speculative bubbles that led to the 2007–09 world financial crisis, we should be living in a distinctly different post-bubble world. One might think people would have "learned their lesson" and would not again pile into expanding markets, as so many did before the crisis, thereby worsening incipient bubbles. But evidence of bubbles has accelerated since the crisis. Valuations in the stock and bond markets have reached high levels in the United States and some other countries, and valuations in the housing market have been increasing rapidly in many countries. All this has been occurring despite a disappointing world recovery from the financial crisis, an increasingly tense international situation—with deadly wars in Gaza, Iraq, Israel, Syria, and Ukraine—and a wave of potentially disruptive nationalist sentiment and political polarization in the United States, Europe, and Asia.

With that preamble, and a year later, we turn to Shiller's September 2017 musings. I have included the link for readers to check and see if I've taken excessive liberties in my interpretation. To begin, as an apparent concession to conventionality, Shiller selected a 20% or greater decline as an indication of a bear market, despite seeing no fundamental basis beyond tradition. By that metric, he identified 13 bear markets in the U.S. since 1871. The peak months preceeding the bear markets he identified were in 1892, 1895, 1902, 1906, 1916, 1929, 1934, 1937, 1946, 1961, 1987, 2000, and 2007. Because they were more protracted, according to Shiller, 1968–70 and 1973–74 were not included.

Shiller contends that a high CAPE implies potential vulnerability to a bear market but is by no means a perfect predictor. Since 1881, the CAPE has averaged 16.8%, but it tended to rise prior to the 13 bear markets, averaging 22.1. He notes, as we also have with some regularity, that it is currently above 30, a high-water mark exceeded only twice: in 1929 and then 1997–2002.

Interestingly, what is seen by many as a bullish indication, Shiller sees otherwise. Real S&P earnings growth spiked to 13.3% compounded from Q2 2016 to Q2 2017, compared with an average growth rate of 1.8% since 1981. In point of fact, in the peak months before past bear markets, real earnings growth also was well above average, rising at 13.3% per year, on average, for all 13 episodes.

Another snippet of ostensibly good news is that average stock-price volatility, which Shiller measures using his database as the standard deviation of monthly percentage changes in real stock prices for the preceding year, is an extremely low 1.2%, one-third of the 3.5% average since 1872. While the difference is not as extreme as the pre-bear-market real-earnings growth, volatility averaged 3.1% during the year preceding the peak month before the prior 13 bear markets. It was 2.8% before the crash of 1929. (Parenthetically, the currently popular indicator of volatility, VIX, dates back only to 1993.)

In short, the U.S. stock market has many of the telltale signs that appeared before the 13 previous bear markets. It is irrationality, often born out of collective amnesia, that leads to unsustainable bull-market excesses, along with something indiscernible in the collective investor psyche that precipitates the bear markets that inevitably follow. As we have written on more than one occasion, predicting the timing of bear markets is impossible, whereas preparing for them is only nearly impossible, for in so doing one must frequently act in ways contrary to human nature itself. After all, we are social animals who thrive on belonging, acceptance, and—ideally—affirmation. We receive none of those rewards for early preparation.

Speaking from decades of personal experience, if I'm not doubted, criticized, and often rejected, I'm probably not doing my job. It's not that clients find our writing uncredible, it's when we actually get off the gravy train—selling the appreciated shares of companies that we like and thus foreclosing on any possibilities of future gain—that tends to sow the seeds of discontent. I know only one person who sold his overvalued house during the housing bubble. In his case, although he was confident he was doing the right thing, uneasiness preceded tranquility.

There are structural factors that lay the foundation for bear markets, conditions that move from stable and safe toward unstable and risky. The transition is often exacerbated by positive-feedback loops. As events escalate, they often go way too far, ultimately producing painful consequences. While the presence of those factors is of no predictive value in the short run, they are quite indicative of the long run. Specifically, a CAPE of 30 almost guarantees that the return from equities over the next 7–10 years will be negative.[1] With history as our guide, we also can confidently say that the experience will not be linear but rather like a roller-coaster ride, which almost certainly will have passengers terrified from time to time.

With limited upside[2] and potentially disastrous downside—the CAPE sank to the mid–upper single digits during the terminal phase of the major secular bear markets of the past[3]—it certainly appears that fully committed speculators are violating a cardinal rule in gambling: Never bet against the house. It also defies a basic rule of the stewardship of wealth: Don't allow yourself to be put in a position where your wealth brings you greater angst than peace of mind (supposed to be a universal attribute of wealth) and thrusts you unwittingly into a *state* of mind out of which irrational decisions too often germinate.

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[1] Though our own work led us to this conclusion, citing the work of others—with appropriate caveats—may help our readers broaden their understanding of the subject. The GMO white paper, "The S&P 500: Just Say No" by Matt Kadnar and James Montier, is a good place to start. It is not Montier's first rodeo writing about an overvalued S&P 500. I am as familiar with his work as he is with mine. We can provide links to his earlier analyses for those who might be interested. Also, note that I do not have links to credible sources that take the opposing point of view. I couldn't find any. In the event I have overlooked some gem that a client could send, I will gladly publish bona fide counter perspectives.

[2] Perpetually low interest rates are often cited as a reason why stocks will maintain their upward trajectory indefinitely. Another is the broad range of economic benefits that will be derived from tax cuts and the simplification of the tax code. Historical evidence, however, would suggest that unchecked belief that either or both will be a panacea simply does not stand up to careful scrutiny.

[3] As a student of market history, I would certainly not rule out such unfathomable levels appearing in the future.

Finally, only a small percentage of investors at a time can step out of the investment game. In the aggregate, all shares of stock must be owned by somebody all the time. It's a truism, but it bears repeating: Most investors must be in the game through good times and bad. By being the iconoclastic loner and saying an emphatic "no" to the ever-solicitous croupier, and thus sit out a hand with lousy odds, the virtues of optionality will in time become apparent.

It is, after all, only by truncating the upside, that you protect on the downside. One thus avoids being victimized by this irrefutable law: If you lose 50%, you must gain 100% just to get back to even, not to mention the years of compounding time squandered. Of course, those like the undersigned, who leave the party early, will be accused of squandering gains. My comeback: If you don't know precisely when to quit, Russian roulette is a fatal game.

If you are an opportunistic value investor and can stand the possibility of losing a little with the expectation of making a lot, you may well find yourself among the very few who have significant capital (in fungible, liquid form) to invest in equities when they are selling at giveaway bargain prices. Coming back to the table at that point will not be easy, but imagine the difficulty faced by the one whose portfolio is hemorrhaging red ink. Your reentrance at that moment of anxiety means you become the house and the odds will be stacked decidedly in your favor.

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Third-Quarter 2017 Portfolio Review

Our two largest holdings, Gentex and Berkshire Hathaway, followed the market's lead this quarter. Despite its 5.5% dividend yield, Helmerich & Payne will not likely attract much attention from investors until earnings return to the black.

Gentex (GNTX)

Gentex, which we have long admired, has returned 12% since our last quarterly communication. Soon after that letter was completed, a fund well known for attempting to identify candidates ripe for shorting, issued a thesis arguing that Gentex harbored unacknowledged downside. We spent considerable time examining the fund's arguments. Some of its main concerns were precisely those features of the company we like. For example, the thesis took issue with the large cash balance Gentex maintains. Surely, went the argument, there must be some financial impropriety hidden below such an abnormally healthy balance sheet. We believe that cash reserves in this environment are a valuable advantage, not a red flag.

At the annual analyst meeting in August, COO Steve Downing took the thesis to task. Throughout the Q&A,

Downing showed clear command of the business. We were satisfied with his answers to the critiques the thesis raised, and he reaffirmed our optimism in the future of Gentex's business.

Gentex released its operating results for Q3. Sales were up 2%, and earnings per share were down 3%. The results seemed to track with our opinion of the company and the markets it supplies. Though North American light-vehicle production was down 8% for the quarter, international shipments moderated the effect on Gentex's sales.

The company's full-display mirror system, a combination of its core technology and multiple external cameras that stitch together a rear view free of blind spots, also saw wider adoption. This suite of features fetches higher margins, which helps offset the pricing pressure OEMs (original equipment manufacturers) exert over its more common legacy offering.

The current automotive down cycle is not finished. We expect North American demand to contract further and production to swoon. This is why we value the hoard of cash Gentex has stored. Since the amount is well in excess of working-capital needs, the redundancy is available for product development, adding manufacturing capacity, and share repurchases. The company will be all the more valuable when automotive demand eventually is resurgent.

Helmerich & Payne (HP)

Helmerich & Payne continues to take market share with its superior rigs and to make technological investments, all while maintaining a clean balance sheet. Despite an overall choppy oil and gas environment, the market kept showing additional demand for the super-spec Flex Rigs.

From the beginning of the fiscal year to the end of the third quarter, HP had maintained industry-leading upgrade patterns, increasing the active fleet by 98 rigs during the fiscal year, of which 86 were super-spec upgrades (eight rigs per month). It also has continued to upgrade standard Flex3s, a rig that's increasingly used in oil and gas drilling operations.

Since Q2, the company has been able to put 17 Flex Rigs back to work and gained seven new customers. Through early October, HP maintained U.S. land market share at around 19%, but it increased active AC rig market share to 30%. Ultimately, the quarter ended strongly, as HP exited the period with 190 contracted rigs, improving total quarterly revenue days by 26%.

Despite changes in the price of oil and rig counts, the increased efficiencies of these technological investments have resulted in steady day rates. Current prices are already considered to be on the low end of the spectrum based on the value they provide. Even if there were a pullback of 100–150 rigs in the U.S., these would likely be the less-efficient, lower-quality rigs.

Therefore, HP believes that it can provide enough of a value proposition to keep supporting some price increases. By delivering the well more quickly, the customer can pay a higher day rate and still save money on the well overall. HP's services help customers lower total well cost through drilling-productivity gains, resulting in higher-quality wellbores. Consequently, HP continues to invest in its potential to improve day rates and capture market share through efficient operation that delivers significant value to customers.

HP also completed the acquisition of MOTIVE Drilling Technologies during the third quarter. With its 14 patents, MOTIVE has developed the Bit Guidance System, which uses cognitive computing to improve directional drilling, decision automation, and optimization. MOTIVE will allow HP to produce still higher-quality wellbores through more accurate placements of bits. This acquisition adds more advanced rigs, further increasing operating capacity, while also creating a new service offering. Such an acquisition illustrates that, even in a challenging environment, HP continues its strategic initiatives to be a technological leader.

In addition to operational gains, HP has maintained the financial strength of its balance sheet. Some analysts were concerned about the increased rate of its declining cash balance. This allowed us to purchase more shares at a lower price than reported in our previous letter. HP, however, is still financially sound. Its cash balance is $612.7M, with a net cash position of $120M. Further, it also has $261.2M of unused line of credit. Although it still has a negative net income, that is mostly due to high non-cash depreciation expenses. With a healthy EBITDA/interest coverage ratio of 18.39, producing positive cash flow from operations, it remains in a position of financial strength.

Although dividends remain high with a yield of 5.50%, HP's balance sheet allows it the financial freedom to continue paying dividends. In addition, the business has flexibility in its CapEx, which can be adjusted to the market environment. With a base maintenance CapEx of $100M—roughly a third of its annual CapEx—it can continue offering dividends to shareholders should industry conditions worsen. This is bolstered by management's dedication to maintaining cash distributions to its shareholders, and we consider HP's dividend remains safe, creating a certain floor for the price of the stock.

Some analysts are concerned about the scheduled retirement of the CFO, Juan Pablo Tardio, in June of next year. Despite this impending transition, we're confident that management will continue to maintain fiscal discipline.

Ultimately, Helmerich & Payne is a strong business that has the financial strength to continue supporting its business and dividends. Even as the oil and gas environment remains uncertain, we believe that, barring another severe and prolonged downturn, HP will not only survive but thrive.

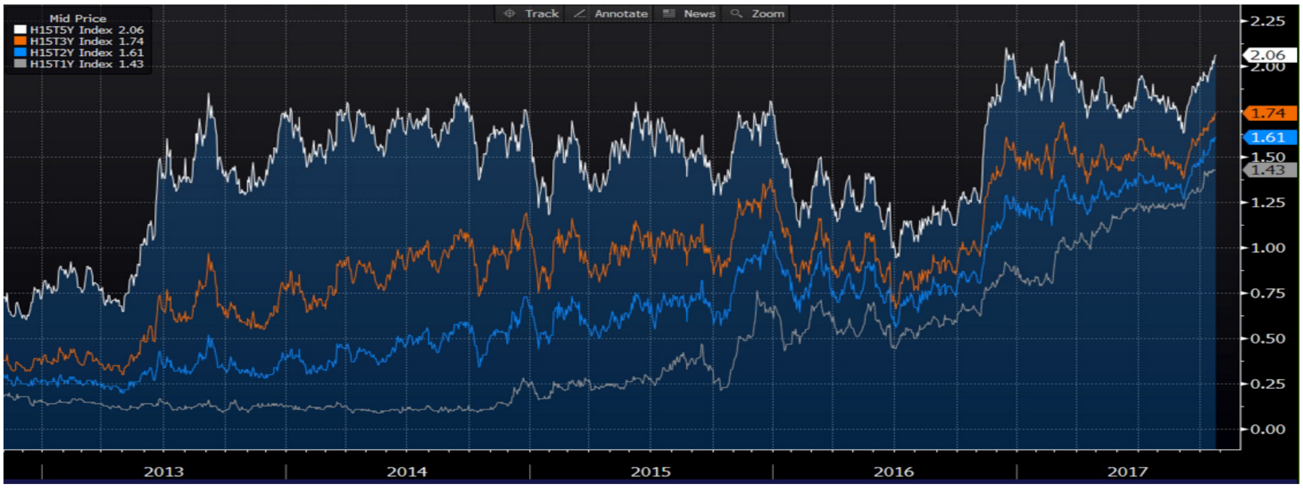
Fixed Income Assets

Over the last year and a half we have played a game of cat and mouse with the Treasury market. We keep asking ourselves when we should pounce; i.e., purchase somewhat longer short-term Treasuries to lock in prevailing yields.

After keeping rates near zero for 7 years, on December 16, 2015 the Fed nudged its benchmark rate up a smidgen from .25% to .50%. The five-year graphical presentation below displays the uptrend since in one-year Treasury yields (gray highlight in right margin); two-year, blue; three-year, orange; and five-year, white. Note the five-year yield (white) doubled from 1% to 2% in the last two years. Interestingly, spreads between the one-year and the five-year since 2014 have narrowed significantly. Historically, when the yield curve inverts (e.g., the yield on the one-year Treasury exceeds that on the five-year), a Fed-engineered recession—intentional or otherwise—is often in the cards. That outcome, in turn, invariably leads to lower interest rates.

As mentioned in our email of May 2017, we will soon be doing some rebalancing of durations among our Treasury holdings. Will provide a more thorough explanation in our annual report to you.

Five-Year History of One, Two, Three, and Five-Year U.S. Treasury Security Yields



A Few Thoughts on Our Investment Management Process

Though our equity portfolio is the smallest it has ever been, we are, as Mississippians like to say, busier than a one-armed paper hanger as we look for tomorrow's ideas. This short addendum to our quarterly letter highlights a few of the factors we take into account as we manage our inventory of ideas, as well as the self-discipline we impose in buying and selling the companies therein. In both cases, we emphasize the importance of having an "edge."

A few discussed below are the importance of understanding the businesses we buy, our concentration on small cyclical companies, along with holding a contrarian, and presumably advantageous, perspective on the market. When initiating or disposing of a position, we aim to place ourselves in a position of strength relative to our counterparty.

Without an edge, our long-term returns are destined to be average or worse. The most conspicuous edge is an uncharacteristically long view in an investment field currently consumed with short-term returns. Indicative of that perspective, 10 years ago Citigroup CEO Chuck Prince became infamous for arguing, "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." Prince acknowledged the risks but nonetheless lingered for the last dance—and a costly dance it was. Today Citigroup languishes at a price little more than 10% of the lofty levels achieved in its heyday.

Whenever we identify a company that we consider cheap enough to be worth twice its current value five years hence, we'll be as patient owning it as we are in waiting to buy it. Bear markets are the ideal occasion for using this edge to the fullest. In the meantime, we are looking at companies, almost always smaller ones, where, through our research, we discover some unique advantage that the company possesses that's not widely understood.

Therefore, we seek a deep understanding of the companies we buy. Further, we covet business models that are anti-fragile—companies that actually get stronger during bouts of adversity. They employ operating and capital-allocation practices that position them for outlasting weaker competitors, enabling them to gain market share during a downturn.

On an ongoing basis, we prune our existing inventory of investable candidates as their circumstances change. Some are removed automatically when they've been acquired or if they've made an acquisition that indicates a less-than-compelling capital-allocation strategy. Any number of companies have been removed due to their utilization of financial engineering that is destructive to shareholder value. Others, like the recent victims of the e-commerce onslaught, have business models that give us little confidence that they will find a way back to robust profitability.

We sometimes define what we like by defining what we avoid. Popular consumer companies, like the FANGs (Facebook, Amazon, Netflix, and Google), are priced for perfection, which is a perishable commodity. Back in 2000, five other favorites that are still very much in business today—Microsoft, Cisco, Intel, Oracle, and IBM—were priced similarly. Their returns to investors, however (with the exception of Microsoft), have fallen dramatically below the expectations of those heady days.

Counterintuitively, we lean toward high-quality companies with cyclical end markets, rather than those perceived as pure growth stories. The market prices for cyclical companies tends to be more predictably volatile than non-cyclicals. Though unachievable in ideal form, this dynamic creates the opportunity to buy a cyclical company's shares near their lows in bear markets and sell in proximity of subsequent bull-market peaks. Embracing volatility is a huge "edge" (though it makes periods of non-volatility, like the present, somewhat difficult to "bear").

As alluded to above, our research leads us to companies that will sell for less than 50% of today's prices in the next bear market. Purchased and sold reasonably well, their holding-period returns (annualized rate of return from the price on the date of purchase to the price on the date of sale, plus dividends) typically greatly outpace the growth in intrinsic value. To be sure, we risk selling a "portfolio maker" prematurely. On the flipside, portfolio breakers, such as Valeant, might be avoided.

We strongly believe that the smallish manager has an undeniable edge of which few seem to avail themselves: the ease and low cost of trading positions. Selling when future returns look unpromising and then turning around and buying when the returns from the same company, due to stock price depreciation, are mouthwatering is the key to solid returns.

Competition for ideas is intense in this late-stage bull market. There are few bargains to be had, and we are not content to purchase today what will be on sale tomorrow. The number of public companies has declined 37% in the last 20 years. Meanwhile, the population of analysts and financial advisors has grown steadily. More people buying fewer things has certainly raised prices—and well beyond the intrinsic value of most shares.

As you might surmise, however, total employment in the financial-services industry is a reliable contrary indicator. It's hard to get an accurate count on the number of analysts in the 1930s because the few who survived thought it in their own best interests to remain inconspicuous. Like the Shiller CAPE mentioned elsewhere in this letter, or today's record-high margin debt, or the record number of acquisitions on the back of cheap financing that have depleted the number of public companies, the burgeoning masses in the financial services industry is a symptom of extremes, not a predictor of short-term outcomes. Our investment strategy is honed for the long term. It will outlast—and, we expect, outperform—other less-durable strategies through such periods of irrationality.

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