Our politics, religion, news, athletics, education and commerce have been transformed into congenial adjuncts of show business, largely without protest or even much popular notice. The result is that we are a people on the verge of amusing ourselves to death.

–Neil Postman

At no point in history have so many non-risk-takers, that is, those with no personal exposure, exerted so much control.

–Nassim Nicholas Taleb

Why is it that leverage crises occur frequently in financial markets, but not in the broader business world? The reason is that the very ability to liquidate—a clearly desirable attribute of an investment portfolio—is, ironically, the root of the liquidity crisis cycle.

–Richard Bookstaber

The human brain is a complex organ with the wonderful power of enabling man to find reasons for continuing to believe whatever it is that he wants to believe.

–Voltaire
Dear Client:

The S&P 500 rose a roaring 29% in 2019. The market was nearly indomitable but for a few pullbacks that were both moderate and brief. Maintaining portfolios almost entirely in cash, MCM did not participate in this rally. Here is why.

**Portfolio Management: The Buy Decision Is Paramount**

For more than 30 years MCM has been committed to growing wealth by purchasing marketable securities at prices that minimize risk to client capital. That means we buy fractional interests in companies with established operating histories, strong balance sheets, and, critically, when we believe they are temporarily trading at a risk-adjusted discount to their intrinsic value. Even a mediocre company can be a good purchase if it’s bought at a compelling price. By buying shares of businesses essential to a functioning economy when they are—because of transitory shocks—on the bargain rack, we effectively mitigate the downside risk of owning them. We buy with a “margin of safety”—the three most important words in investing.

Many investment advisors take a different, and seemingly more sophisticated, route. Known as modern portfolio theory (MPT), it does offer the allure of mathematical complexity and intrigue. MPT is no stranger to me or my fellow CFA charter holders and partners Eric Cinnamond and Jayme Wiggins at Palm Valley. MPT practitioners offer a broadly diversified portfolio of hundreds of securities. Theoretically, the securities selected offer the best risk/return mix, along what is known as an “efficient frontier.” Where we as value investors part company is in how we manage the two principal risks that investors face: unsystematic (company-specific) and systematic (pervasive bear markets).

Since we feel comfortable with our approach to managing company-specific risk by insisting on an appropriate margin of safety at the time of purchase (implying that no purchase or purchases are made unless or until those conditions are met), the amount of cash or hedges we hold also explains how we assiduously attempt to contemporaneously avoid systematic risk. That imperative is non-negotiable. In contrast, investors who sailed directly into the bursting dot-com bubble of 2000 and the financial crisis of 2007–08 on the assurance that MPT would safeguard their wealth learned a hard lesson.

Albert Einstein dubbed compound interest the eighth wonder of the world. Warren Buffett, who has lived out Einstein’s adage, is worth $90 billion today. Since 1965, the book value of Berkshire Hathaway, in which almost 100% of his wealth resides, has compounded at 18.7% per year. Given the casual banter at cocktail parties, one would think everyone earns returns above 20%. And yet, in point of fact, as a diversified investor Buffett has no equals over such a lengthy time period. What Buffett and Einstein knew is that big losses ruin your compounded returns in two ways: first, and most obvious, is that a 50% loss requires a 100% gain just to get back to where you started and, second, the loss of time while your portfolio is still working its way out of the hole.

Because of the corporate construct of Berkshire Hathaway, which is a conglomeration of wholly-owned businesses and marketable securities, it is not easily comparable to an actively managed portfolio. There are, however, lessons to be learned. If you divide the compounded annual growth in book value of Berkshire over the 53 years from 1965 to 2018 into three distinct periods—1965 to 1974, 1975 to 1998, and 1999 to 2018—a telling picture emerges. Synchronous with the ebb and floodtide metaphors from our 2018 annual report, the first of these three began with an overvalued market, the terminal phase of a flood tide. Buffett’s returns were substantially lower, at 13.94%, than his overall average. In 1975, following the worst recession and bear market since the 1930s, stocks remained historically undervalued for the next 15 years, before concluding with the technology bubble ending in the late 1990s. These were the halcyon days for Buffett as he achieved an average annual rate of 29.73%. Since 2000, Berkshire has grown at a significantly slower rate of 9.49%.
during the first period, the current cycle has seen a similar dearth of opportunities. Therefore, it is of no surprise that, like MCM and Palm Valley, Buffett holds record levels of cash today.

Stock Markets: Less Than Meets the Eye

The arduous process of bargain-purchase-price-dependent portfolio management is currently confounded by the broadest and longest case of asset inflation in modern history. While we avoid marquee names that garner public attention (Google, Amazon, Uber) on account of their routine overpricing, and thus not uncommon extreme corrections at the end of the cycle, there have typically been smaller companies often ignored by the major indexes that continue to offer potential gains. This drove our outperformance through the dot-com bubble. Since the unconventional policies of the Federal Reserve in the wake of the Great Recession, however, the prices of all manner of assets (tangible and securities, primarily common stocks and bonds) have soared to levels thoroughly untethered from their real earning potential.

To avoid overpaying, our portfolios have often carried an outsized position in cash, an asset valued for its optionality rather than its returns. We’re well aware of how psychologically difficult it is to maintain this position, both for clients and ourselves. We trust, however, the patterns of history. They have invariably seen such overvaluation in the markets revert with equal and opposite force. In the aftermath of the reckoning, opportunities have been abundant and future profits well worth the wait. In the meantime, we’ve turned to practicing patience, remembering that it is when the cognitive dissonance of the markets most tests investor abstinence that the end is nigh.

Talk is cheap, though, so we will dispense with platitudes. Here are some numbers to illustrate the state of equity markets today.

The performance of the S&P 500 appears breathtaking. Surely the doomsayers who warn against recession or worse economic calamity have been found wanting.

These gains are indeed impressive, but the aggregate data hide a disturbing trend. The headline number is frightfully disingenuous. It is conveniently forgotten that the end of 2018 saw a dramatic 20% fall in the market. Since the September 2018 high, the market is up only 12.78%. The market spent much of 2018 regaining the ground lost in February after the volatility complex blew up. Since the peak in January 2018, the index has returned 6.4% annually. This puts the S&P 500 return for 2019 into context.
Under the hood, the components of the index are disquieting. Much of its growth in 2019 came from the tech sector. If we look at more traditional businesses in the S&P, we see that the index isn’t firing on all cylinders. The chart below shows the S&P, excluding the tech sector. Its return since January 2018 has been 3.42% annually, half the full index and far below the 15.69% annual rate the S&P, excluding tech, boasted the two years prior (2016–17).

Essentially, and quite similarly to 2000, the S&P 500 is breaking records on the backs of tech companies. The drama of this tech bubble 2.0 is well illustrated by Apple. Its market capitalization increased some 90% throughout 2019. Again, this headline-grabbing figure forgets to remind readers that the company lost some 40% of its value in the fourth quarter of 2018. Context.

Still, since the September 2018 peak, the stock is up a very healthy 30%. Despite trade wars with China, Apple shares—which derive 10–20% of their sales from China—have increased significantly. This is despite flat revenues, earnings, and cash on hand. To put its surge in perspective, the market cap of this one company is now greater than the entire energy sector.

That is, this manufacturer (namely, Apple) of Veblenian discretionary consumer goods is being valued higher than all the drilling equipment, distribution capacity, and still untapped reserves of all the oil and natural gas companies listed on the S&P 500. While the world undoubtedly will continue turning from petroleum products to other forms of energy, the oil and gas industry is a necessary part of the immediate energy future.
As iPhones compose over 60% of Apple revenues, it isn’t an exaggeration to say that Apple’s product offerings are substantially more discretionary than oil and gas. This doesn’t seem like rational pricing to us.

Another telling example is Tesla. While its market capitalization would typically include it in the S&P 500, it lacks a key feature required for inclusion: sustained earnings. Despite its valuation, it cannot consistently make a profit. Investors have rewarded Tesla, though, with a 132% increase in share price since this past May! The company blurs the line, through fact and fiction, between information technology and the traditional economy. It builds cars, the archetype of industrial capitalism, with modest self-driving technology, the holy grail of the AI (artificial intelligence) revolution. It seems that techno-optimism has bled into adjacent sectors. Tesla, which still cannot turn a consistent profit, has a market capitalization 50% higher than General Motors and is in desperate need of operating capital.

Cracks in techno-optimism may be emerging as IPOs (initial public offerings) for hyped tech stocks have dramatically underperformed expectations recently. We’ll return to that narrative below as it relates to a parallel story in the valuation of bonds.

First, however, we must mention the impact recent Fed actions have had on stocks. In September of 2019, short-term funding prices spiked. These are the interest rates that banks pay to borrow money from each other. Banks routinely lend to one another at day’s end when they find their accounts in either excess or deficit due to cash-flow exigencies. The Fed attempts to establish a range in which that lending happens. In September 2019 the rate in the overnight repo market—one of the markets that satisfies end-of-day liquidity needs—jumped from just over 2% to north of 8%. This dislocation is extreme and reminds us of funding oddities in 2007. In attempting to bring rates back into range, the Fed opened a repo facility. This is a program in which banks can lend U.S. Treasuries to the Fed for, say, two weeks, at an established low rate.

Since that facility began, the Fed has increased its balance sheet nearly $500 billion. By the end of January, if the current pace continues, it will exceed its level at the height of the quantitative-easing programs. This geyser of liquidity has had a very bullish impact on equity markets.

![Figure 4: (Top) S&P, excluding technology, vs. Fed balance sheet (note: S&P value is indexed), (Bottom) S&P index vs. Fed balance sheet](image)

The Fed only really began shrinking its balance sheet in January of 2018. It was quite possibly an underlying contributor to the volatility in the first quarter of that year. As shown in the top chart above, the S&P,
excluding technology, essentially didn’t grow from the January 2018 peak until this past September when Fed liquidity again entered the market. The bottom chart shows the entire index performance from January 2018 up until Fed easing. The market didn’t even keep pace with nominal GDP growth (3.9%)! The Fed promises its intervention is not permanent. We place little stock in Fed commitments, but it seems clear to us that the stock market is, fundamentally, not a story of strength if it needs Fed life-support.

**Corporate Debt: Both Buyer and Seller Beware**

When equities are overpriced, classical investment wisdom would have investors turn to debt products. Debt markets, however, are also at unprecedented valuations and volumes.

Using numbers provided by the Federal Reserve, the amount of corporate debt has surpassed the 2008 level of 44% of GDP, now reaching 48%. This is an increase, but perhaps not a greatly alarming one. Remember that the last crisis (just over a decade ago) was caused mostly by housing debt, not that of corporations. If those businesses could survive the financial crisis intact, surely a modest increase in debt without a mortgage crisis is more manageable.

**Nonfinancial Corporate Debt as Percentage of GDP**

![Chart](image)

Such an assertion seems to be the opinion of multiple commentators, but details complicate the picture. The Fed’s sum of corporate debt excludes the debts of businesses not publicly listed. When those other totals are included, the corporate-debt burden jumps to $15.5 trillion, or 74% of GDP. That is versus 68% in 2008. Again, the rise (6 points in this case) is significant, but perhaps it isn’t a serious matter. So what drives our concern?

**Rates Have Consequences**

The low interest rates since the last crisis, courtesy of the Fed, were intended to stimulate investment spending by encouraging borrowers to take on new debt. Corporations borrowed but with two undesirable outcomes.

First, the funds they borrowed were rarely used for capital spending. They more often repurchased shares (which frequently were reissued to executives)¹ or paid out as dividends. This restructured the balance

¹ [https://www.hussmanfunds.com/comment/mc191111/](https://www.hussmanfunds.com/comment/mc191111/)
sheet—euphemistically known as “financial engineering”—but it didn’t increase productivity in the real economy. Therefore, growth in GDP remained anemic. On this count, Fed policy failed to achieve its objective.

Second, the low rates led investors, long accustomed to yields that exceed the underlying inflation rate, on a desperate search for investment income. To earn something above the U.S. Treasury rate, the Fed’s policy left them no alternative but to buy riskier and riskier assets. This demand has allowed companies with uncompetitive business models, colloquially known as zombies, to continue limping along—literally on borrowed time. It also has opened the door to companies with unproven business models to hype their stories to win the dollars of managers eager to enhance returns on unproductive cash. These are the famous (rapidly becoming infamous), unicorns—unlisted businesses with market capitalizations over $1 billion.

Some consequences of this situation are well known. Toys-R-Us was one such zombie company. It was overleveraged and unable to adapt to the changing retail climate. We’ve examined that story before. Below we’ll return to the current saga unfolding around untested business models. Before getting granular, however, we must examine the consequences of the aggregate.

The Ugliness of Grade Inflation

When bonds are issued, they’re given a rating regarding their quality (AAA, AA, A, BBB, BB, B, CCC, CC, C, D)2 The four bolded varieties are considered investment grade. In our 2018 annual report, we warned that the volume of BBB bonds, the lowest rung of the investment-grade ladder, had grown disproportionately in relation to the whole.

Pouring money into BBB bonds represents investors’ seeming willingness to accept escalating risk in exchange for yields approaching pre-crisis levels. This dynamic also hasn’t been ignored by the news cycle. Major financial publications now openly admit that, in a downturn, the BBB bonds could be downgraded in quality, automatically triggering various kinds of fire sales; many financial intermediaries have limitations on the ownership of below-investment-grade debt. This would cause the highly illiquid below-investment-grade

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2 Standard & Poor’s rating system

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market to swell. It’s unclear who would step up to buy in that market and at what price. As long as interest rates remain low, however, and corporate profit margins don’t contract too much, all will be well. Or so the argument goes.

While the premises of that optimistic assessment are themselves uncertain, there’s a further wrinkle in the BBB sector not widely discussed. That is the inflated ratings these bonds are assigned already. In 2000 the net leverage of a BBB bond was, on average, 1.7x, as derived below:

\[
\frac{(\text{Total debt} - \text{cash} - \text{short-term investment})}{\text{EBITDA}^3}
\]

This is basically a measure of a company’s financial capacity to service its debt. Cash and short-term investments easily convertible to cash are subtracted from gross debt to arrive at net debt. The funds available would include earnings before deducting interest, taxes, and non-cash charges of depreciation and amortization. By 2017 the average leverage was 2.9x. That means ratings agencies have seen fit to assign the same rating to a bond with 70% higher leverage than allowed just 17 years ago. Essentially, while the volume of BBB bonds, as an absolute amount and as a percentage of corporate debt, is unprecedented historically, it is also of lower quality than the same grade of bond in the past. This willful negligence by the rating agencies, driven by the competition for market share, was one the precipitating causes of the mortgage-backed security (MBS) meltdown, which itself played a major part in the financial crisis of a dozen years ago. The aggregate is uglier than ever.

**Coming to Terms**

The debt markets may finally be coming to terms with the risks in the bond complex. While BBB, BB, and B-rated bonds continue to trade in tandem, the yield on CCC bonds has been rising since the equity market sell-off of the fourth quarter of 2018.

The average BBB bond yields just 1.45% more than a Treasury. That is essentially unchanged since September 2018’s 1.43%. However, a CCC bond, which offered 6.62% more than a Treasury last year, must give investors just under 10% today. We’ll keep a close eye on these spreads. It’s invariably the lower quality

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3 Earnings before interest, taxes, depreciation, and amortization

4 Warren Buffett has no interest in companies that report results using EBITDA. He says, “… They are either trying to con you or they are conning themselves.”

issues that begin to move first. This is also why we continue to feel uncomfortable with allocating money to corporate bonds, even though that means we must sacrifice yield for clients. There’s far more risk in the low-grade bond space than meets the (untrained) eye.

Under the Microscope

Malinvestments became increasingly common during this ever easier credit cycle. The spate of IPOs over the last two years has pulled the curtain back on some truly dismal investments, typically those with unproven business models. Lyft is down 50% from its IPO price. Pinterest is down 33% and Uber 25%. What these companies share is negative earnings. Despite multi-billion-dollar valuations (Uber is over $50B), they are not yet profitable. Their declining valuations mean that private investors who purchased equity soon before the IPOs likely overpaid. The tepid reception of these newly public companies indicates, at a minimum, that some investors are now requiring their equity investments to turn a profit. This seems reasonable of course, but profit has been harder to come by the last decade. It is, in fact, why equity markets are valued so highly.

Yields on bonds are, in many cases, negative, especially until recently. The 10-year Treasury, that nominally yields 1.5%, actually has a “negative real yield” as inflation is typically closer to 2%. Further, we have reason to believe that inflation is actually outpacing the official CPI print. A still more bizarre phenomenon, however, is “negative nominal yield.” Throughout the bulk of 2019 much of the bond market in Europe has been trading with yields below 0%, before inflation and currency hedges were factored in.

When rates are so low, such that an investor is guaranteed to lose money if holding the bond to maturity, the prospect of a real yielding asset can be transfixing. Equities are that asset as many offer minimal dividends, though far less so than historically. Thus, equity valuations have continued to rise.

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6 Rosenberg, David A. Breakfast with Dave. 11/25/2019.
7 Readers may be curious why anyone buys these instruments. Two reasons among many are that some investors, namely managers of pension funds, are required to buy government paper. Another is that while the yield may be negative, if you expect rates to decline further, the price of the bond could still rise. This is investors treating bonds like stocks, holding them temporarily before trading out of the instrument. Given the positive yield on U.S. bonds, one would think everyone would rush into the Treasury market. That market is denominated, however, in dollars. Prudent investors hedge the risk of currency fluctuations when they purchase foreign-denominated bonds. The cost to hedge dollar risk is currently so high that yields to foreign investors with hedged positions is comparatively negative to European rates.


WeWork ... Didn’t

The enthusiasm of investors for equities resulted in much pomp around the expected listing (see below) of WeWork in the fourth quarter of 2019.

WeWork is a real estate company that leases work space to companies and freelancers in major global cities. You can rent a spot at a table, an individual office and conference room, or even a whole floor from which to run your enterprise. In exchange for your dues, you receive a coffee bar, printer access, and other office amenities. Ostensibly, you also have the opportunity to network and participate vicariously in the hip, laid-back, creative office space for which Silicon Valley titans are renown. That is to say, WeWork has Ping-Pong.

Its concept isn’t bad. It’s a good thing for people to spend more time connecting and less time absorbed in their desktop screen. It makes them better people and also better workers. Further, WeWork supplies workspace to major corporations like IBM and Samsung. Outsourcing office space is a major trend. The problem is that the business simply isn’t worth $47 billion, at least today. But that was the valuation given the company by outside private-placement players. The “tech startup,” which does a lot more leasing of office space than technological innovation, was one of the hottest businesses of the last two years. Its locations have ballooned, not just across the U.S., but in Europe and Asia as well. A Wall Street analyst preaching the prowess of WeWork could be forgiven. It leases more than 5.3 million square feet in Manhattan alone, an increase of 3 million since 2017. Since analysts typically don’t have Ping-Pong in-house, their fascination is perhaps understandable.

But WeWork has never been profitable. Beyond that, even if it were to become profitable, real estate-management companies are not high-margin businesses. Just because you house nascent tech startups doesn’t mean you have the margins of successful tech companies! As the IPO neared, investors balked—and WeWork withdrew its offering. Suddenly, the darling was facing a cash crunch. Without the cash infusion from going public, it looked like WeWork would need to borrow more from banks or through bonds. With earnings negative, there is no guarantee that further growth will make the company profitable. This affects two industry participants: bondholders and equity holders.

In reverse order, investors like pension funds, and insurance companies require an actuarily mandated return on their investments. They employ various strategies to meet their return targets. We have discussed some of them previously, like selling volatility—a trade that first blew up in February 2018 and likely will do so again. Since the last recession, private placements have been one of the hottest markets for these investors. With equity valuations at record highs and dividend yields near the risk-free rate, these large funds have instead looked to investments in which either multiple expansion can be expected or earnings have an opportunity to rise materially. This is the private-equity and venture-capital space. These investors provided the funding that satisfied the equity side of the company’s balance sheet. The point is that fund returns, unfortunately for pensioners, could be seriously less than required if all assets are fairly priced.

Those equity haircuts, though, are not directly destabilizing economically except insofar as they affect consumer confidence. The equity markets, however, are not independent from the debt markets, no matter how much the conventional wisdom would seemingly indicate. They’re intwined in complex and unexpected ways. It’s in the debt complex, that murky space in which interconnectedness and its corresponding fragility reign, that the real threat lies.

In the End, Earnings Pay Coupons

WeWork also has debt holders. Its bonds were rated B before the IPO. They are currently at CCC+, trading at a 27% discount to par. To stabilize itself, the company needed cash. SoftBank, already a major investor,
agreed to provide more capital after U.S. banks balked. That infusion, though, valued the company at only $4.6 billion, more than a 90% reduction since January 2019. It posted a $1.6 billion loss last year. Ultimately, a company must pay the coupons on its bonds from earnings (after all, debt is intended to increase earnings). WeWork, however, lacks earnings. Until it becomes profitable, if it ever does, it must finance its coupons by reducing expenditures, fast, and focus on profits rather than growth. Complicating matters, the company has received $2.8 billion in unearned revenues—a billion more than its current cash. These are prepayments by customers it would be obligated to repay if it didn’t deliver the contracted services.

WeWork understandably is now selling off its non-core businesses to raise more cash. It has halted its growth plans and will likely attempt to exit some of its current locations. It has had an enormous impact on the commercial real estate market, though, leasing fully 2% of all office space in both New York and San Francisco.9 Its demand for space has pushed up property values in those areas.

Landlord financing is based on property values. Building owners generally finance their purchases with commercial mortgages, which are based on the value of the underlying asset. WeWork’s landlords often paid for leasehold improvements or suspended the first year of rent to incentivize the company to set up shop there. Should WeWork exit its contracts, or go broke entirely, the serviceability of its landlords’ liabilities could be affected, especially if the underlying property value were to decline. This is a worst-case scenario, but it goes to show how markets are interconnected. Debt is chained to other debt. Overvaluation in one space can mutate to stress in another.

**The Poorly Engineered Structure of Debt**

WeWork is a microcosm of a much larger story. Junk debt yields more than the debt issued by companies with strong and stable cash flows. WeWork has no free cash flow and so falls into the former category, but it’s by no means alone. What’s startling is how many well-known U.S. stalwarts find themselves bordering on a junk rating, including GE, AT&T, and Anheuser-Busch. This puts the scope of the problem in perspective.10 A recent IMF report says a recession half as severe as 2008 would see companies that owe some 40% of total global corporate debt—about $17 trillion, or 90% of U.S. GDP—unable to meet interest payments from earnings alone.

Remember, debt needs to be productive enough to repay itself, or it’s a drag on the business. If it cannot sufficiently do so when earnings decline and margins contract, the borrower is left without the funds needed to service it. With the financial condition of these borrowers already compromised, as the standards for BBB bonds illustrated earlier, they simply don’t have the cushion necessary to easily weather tough times. To raise cash, they, like WeWork today, will be looking to sell assets. If one borrower is in trouble, though, it’s likely not alone. One of the abiding aphorisms in our profession goes like this: “There is never just one cockroach in the kitchen.”

Financial intermediaries—pension-fund managers and insurers—are aware of the problems in the corporate debt world. They’re conflicted, though, because of the pressure they feel to meet their actually determined required rates of return. The conundrum in which they find themselves is certainly not without recent and admittedly unnerving precedent. Chuck Prince, the former Citigroup chief executive, infamously said in July 2007 (referring to the firm’s leveraged lending practices): “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.”

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10 This is not to suggest that we think AT&T is in any danger of insolvency—merely that the problem of poorly rated debt could require companies to rearrange their balance sheets at a time most disadvantageous to equity investors.
They’ll try to clean up the credit quality in their portfolios when the sustainability of the return becomes questioned, but at that point willing buyers will be in short supply. Someone must hold these instruments at all times. Not everyone can run for cover. The credit quality of the bonds, however, along with the deterioration of standards, suggest that cover will likely be required eventually.

In the 2011 film on the Great Financial Crisis, “Margin Call,” Kevin Spacey lines up his traders in the morning and informs them the firm needs to liquidate its holding of mortgage-backed securities (MBS). “For those of you who’ve never been through this before, this is what the beginning of a fire sale looks like,” he says. By the end of day, demand has evaporated, markets have locked up, and no one wants MBS. That is Hollywood drama. The real action plays out somewhat slower—and is actually far scarier.

That’s because a movie cannot convey within the limits of its story-telling genre the complexity that is the fuel for the fire. Popular retellings of the last crisis have left almost no one with a comprehensive understanding of the real mechanisms that crippled markets. When the Great Financial Crisis is truly probed, it becomes difficult to fully comprehend and articulate how a small minority of mortgages across suburbia caused, for example, Apple’s stock price to halve.

The answer is leverage in portfolio construction. As was true of MBS (and could prove hugely destabilizing in the corporate-bond world), so it is with the leveraged holding of fixed-income securities. In 2008 investors funded their purchase of MBS with borrowed funds. When the lender refused to renew the loan, they had no choice but to sell.

Today bond positions are still financed with borrowed funds. This is the very basis for the risk-parity strategy of the famed Bridgewater Associates (BA) fund. Since the volatility of bonds has been historically lower than that of equities and the two assets have often been inversely correlated, BA leverages its bond holdings so it can commit less capital to them while maintaining greater theoretical protection against an equity decline. If that description sounds, well, incomprehensible, simply know that leveraged positions in anything carry greater risk and force an investor to unwind a holding more quickly, making that sale largely immune to price.

This strategy has gained wide popularity, but most investors don’t realize that stocks and bonds aren’t always inversely correlated. In market crashes, as in 2008–09, panic supersedes reason, and correlation coefficients often approach 1.0; investors with leveraged portfolios will again find their lenders issuing a margin call. Unable to pay back their loan, they will be forced to sell something, anything. Therefore, stocks, bonds, and all other assets are affected.¹¹

All this is emblematic of a complex system. Each part is connected to some other part until some new stressor is introduced to the equation and the many relationships begin to break. This is not a tangled web; that has flexibility in the network of connections. This is a rigid bridge of brittle and irregular trusses spanning the abyss of required return. Unsupported, its ties inevitably crack under the weight of investor sentiment turning to head in the other direction.

* * *

**Value Investing in a Late-Stage Economic Expansion and Bull Market**

Whenever asset prices become untethered from value in late-stage economic expansions and accompanying bull markets, Ben Graham’s 85-year-old classic, the 1934 edition of *Security Analysis*, has, sadly, faded into

¹¹ This dynamic is not the sole province of a grand market crash either. From 1971 to 1975 bonds declined in price. Stocks had a major crash and ended the period flat. The same was the case from 1968 to 1970. Other examples would simply detail more fully the fact that stocks and bonds can share the same fate and wreak havoc on a portfolio unprepared for that fate.
irrelevancy. Now is one of those periods. Not coincidentally, previous episodes included the final stages of the 20th-century bull markets that ended in 1929, 1965, 1999, and the current run yet to be concluded.\textsuperscript{12}

Today’s market bears mention for its remarkable similarities to 1999 and 1929, certainly in terms of valuation, as well as other resemblances discussed below. Only at those two peaks did the cyclically adjusted price-earnings ratio (CAPE) exceed today’s level.\textsuperscript{13} By the dot-com peak, that metric levitated in the stratosphere for an excruciating 51 months. Regardless of how interminable a trend may appear in the moment, over time its relationship to the historical average is clear. Measured monthly, the index has traded at this level only 4.32\% of the time. The dot-com bubble accounts for 3 full percentage points of that number. To make the point visually, the following chart shows the CAPE range into which each month of S&P valuation falls since 1880.

![Percentage of Months in S&P 500 (1880–2019) per CAPE Range](chart)

The dot-com bubble boasted especially egregious valuations, unprecedented throughout market history at nearly three standard deviations. By comparison, levels before the crash of 2008–09 were rather tame. In fact, only for 15 months (including all of 2007) did the market trade above the first standard deviation of the CAPE ratio. That is still historically dangerous territory and we pared our equity holdings significantly during that period in the name of capital preservation. But the drama of the episode is so vivid, thanks to continuous news coverage, Hollywood adaptations, and the very real economic pain inflicted on our home region in Indiana, it is often forgotten that in historical context, the market movements were brief.

During the Great Recession—out of which was born what may be posthumously called the Great Bull Market of the 2010s, to which it lays legitimate claim—the S&P 500 shed 57\% of its value, 875 points. One year later, it had already regained 60\% of that loss. That pronounced bounce was followed by a story of dramatic gains (and unprecedented monetary policy). From the 2009 low to the 2019 high, the market, on average, returned 17.1\% annually. It would’ve been a misnomer to dub what happened the Great Recovery,

\textsuperscript{12} We remain unconvinced that 2007 represented a secular peak anywhere approaching the magnitude of its predecessors. It was a bubble in financial speculation where nothing new and sustainable was created. The mid-1960s constituted the culmination of the great postwar economic boom. Likewise, the transformative digital age so stirred the imaginations for its endless possibilities that a bubble was virtually inevitable.

\textsuperscript{13} Robert Shiller has recently offered an updated version of the ratio that now takes profit margins into account. It’s Shiller’s new metric that we’re using in this annual report. The average of the new ratio throughout market history is 20.4.

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however, as the U.S. economy didn’t come close to mirroring the vibrancy of the market. That said, as Donald Trump makes clear while rallying the faithful, the two are often misleadingly promoted as one and the same.

The lackluster economy has left a nettlesome question perplexing us for much of the current expansion. Despite the angst among policymakers during the heat of the crisis, was the so-called Great Recession an event so devastating, like the Great Depression, that its name need be memorialized in caps? Did the bear market of 2008–09 resemble in some fashion the 1929 free-fall—or its plunge in the early 1930s, which led valuations back to cyclically historical lows? When the bottom fell out, it altered attitudes and behaviors toward risk for multiple generations. Did the Great Recession, like its notorious forbear, expose the extent of ill-conceived investments and allow for these malinvestments to be expunged? Did it earn its distinction because it was profoundly cathartic?

In terms of the toll exacted on everyday Americans, one metric alone starkly contrasts the ’30s with today. Compared with a peak unemployment rate of just under 10% in 2010, by 1931 the unemployment rate had reached 15.9% and peaked at 24.9% in 1933. As the country remained mired in economic depression, unemployment stubbornly held in the mid-to upper teens until 1941, when America’s industrial might was finally harnessed to aid our World War II allies in Europe.

So, we argue, “no.” No, the Great Recession was not profoundly cathartic. While social safety nets spared most economically damaged households from acute physical suffering, the pain endured by investors was short lived and insufficient to instill the necessary discipline needed for rational allocation of capital during the recovery. Without feeling the consequences of malinvestment, there is little incentive to repent. Our examinations of the debt and equity markets above make clear that investors, indeed, have neither relented nor repented.

Worse is the reason the painful lesson was avoided. The ad hoc, intermittent, fiscal stimulus and a pedal-to-the-metal monetary policy through 2015 truncated the downturn and fostered an anemic recovery that was heralded as preferable to facing the consequences of years, if not decades, of accumulated excesses. While GDP growth has been poor, 10 years of a synthetic, managed expansion, wrestled the headline unemployment rate down from 9.9% at the nadir of 2009 to 3.9% in 2018, the lowest since 1969. Although the rate is technically the same, the “quality” or satisfaction level of employment today is a mere shadow of what it was 50 years ago.14

In terms of the engine that drives the economy in real terms, GDP declined 0.1% in 2008 and fell another 2.5% in 2009. It has stumbled along, averaging just over 2% growth since. The comparison with the 1930s could not be more revealing. After four consecutive years of a savaging decline in business activity, economic Darwinism left only the strongest standing. Like a forest ravaged by fire or the devastation of post-World War II Japan and Germany, the ground was cleared for the green shoots of recovery. For GDP growth, “The harder you fall, the higher you bounce.” In contrast to the 2010s, the 1930s saw outstanding GDP growth once the economy bottomed out.

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14 One of the biggest changes is the dramatic increase in women in the workforce, who now outnumber men. To the extent women are working out of economic necessity, the impact on the family structure can be negative. In quantitative terms, inflation-adjusted wages since 1969 have been flat. In fact, workers have been decidedly unsatisfied with the recovery as wealth disparity explodes, the gig economy hijacks the security of long-term employment, and all manner of costs rise faster than the wages of the bottom 50% of income earners.
A challenge of historical comparisons dating back to 1920 is the paucity of aggregate economic data. Stitching together conclusions from sources such as the *Historical Statistics of the United States*, financial historian James Grant, whom we have long held in high esteem (in part because he admits to the practical necessity of treading lightly on mushy statistical ground), writes on the ‘forgotten depression’ from January 1920 to July 1921. During those 18 months, precisely the same duration as the 2007 to 2009 contraction, Grant estimates that nominal GDP declined 23.9% in 1920–21. After adjusting for price deflation, that fall moderates to an 8.7% drop. Unimaginable today, producer prices fell by 40.8%. Further, he suggests that a crude measure of unemployment was 19%. Far more persuasive but obviously less verifiable are his anecdotes about the events that led up to the century-ago contraction and the toll it took on business in general.

While there were many causes that led to the economic expansion and stock market bubble of the 1920s, it’s our view that the springboard from which it was launched can be traced to the 1920–21 depression itself. A false sense of confidence arose out of the seeming ease by which the economy righted itself. The dark fears that almost overwhelmed business owners became the tinder that flamed the economic and market exuberance of the Roaring ’20s. In the managed economy of today, the recent recovery was not primarily predicated on confidence in unfettered resilience of businesses, households, and investors but the guarantee of our central bank to shore up markets. Accordingly, the 2010s lacked the zeitgeist that characterized the 1920s. It may end up the same, but it won’t be due to the kind of widespread euphoria that swept the U.S. nearly a century ago.

The post-1934 economic recovery (within an ongoing business depression) was of a bottoms-up, “pull-yourself-up-by-your-own-bootstraps” variety. Corporations with strong enough capital structures, liquidity, viable business models, and products or services still needed or desired by consumers, would, with Great Depression-honed introspection, put the pieces back together to be even more competitive. That wasn’t the story of the 2010s.

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Interestingly, one of the principal reasons the current managed expansion has raised relatively few red flags can be traced to the stubbornly low rate of consumer price inflation. The implicit assumption, among pundits and the Fed alike, is that we needn’t worry until inflation begins to stir, like a sleeping bear that has been poked. Inflation’s absence, in other words, is no cause for alarm.

Historical analogs argue to the contrary. It appears that today’s Fed leadership is not as conversant with lessons of the 1930s as was its former chairman, Ben Bernanke. We suspect even our readers will be surprised to learn that monetarist historian Milton Friedman, in the seminal *A Monetary History of the United States, 1867–1960*, published in 1963, named deflation as the specter of the 1920s.16

The economic collapse from 1929 to 1933 has produced much misunderstanding of the twenties. The widespread belief that what goes up must come down and hence also that what comes down must do so because it earlier went up, plus the dramatic stock market boom, have led many to suppose that the United States experienced severe inflation before 1929 and the Reserve System served as an engine of it. Nothing could be further from the truth. By 1923, wholesale prices had recovered only a sixth of their 1920–21 decline. From then until 1929, they fell on the average of 1 per cent per year. The cyclical expansion from 1927 to 1929 is one of the very few in our record during which prices were a shade lower at the three months centered on the peak than at the three months centered on the initial trough. The stock of money, too, failed to rise and even fell slightly during most of the expansion—a phenomenon not matched in any prior or subsequent cyclical expansion. Far from being an inflationary decade, the twenties were the reverse.

In referring to the “stock of money” at the end of the block quote, Friedman, an empiricist, did not mention the concept of money velocity because he felt it was stable. New evidence over the last 50 years has called into question Friedman’s conclusion. The definition of velocity is the number of times the money supply turns over during a period of time divided into GDP. Without getting unnecessarily granular, it is now generally believed that high and rising velocity is inflationary and vice versa. In the short run, hyperactive money is more likely to affect prices than the quantity of goods produced. A shortcut to understanding the importance of money (M) velocity (V) can be found in a simple formula: \( V = \frac{\text{GDP}}{M} \). Disaggregating, GDP also can be expressed \( \text{GDP} = \text{PQ} \) (price times quantity).

What we know now is that the velocity of money peaked in 1918 at 2.0 and declined during the 1920s, signaling the future trouble to come. Those monetary decelerations led to slower economic growth, lower inflation, and lower interest rates. Bond yields declined before the Great Depression started. This also reflected the surge in indebtedness, which weakened economic potential before the Great Depression erupted. We doubt that very few investors, both then and now, were or are even aware of the movement of these aggregates. Such behind-the-scenes similarities between the 1920s and the 2010s have worried us greatly as the current decade continues down the parallel track. Certainly, the Fed must know, and yet it remains mute. We offer the FRED chart below from the St. Louis Federal Reserve Bank, simply as one corroborating data point, without comment.

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While the list of dissimilarities between the 1920s and the 2010s is long, overlooking the parallels is perilous. Both periods were marked by unexpectedly low consumer price inflation while concurrently experiencing extraordinary asset price inflation.

Returning to today’s economy … While there are any number of plausible explanations for the subpar recovery, one important factor is incredibly elementary: the “marginal propensity to consume” (MPC). In 2019 the poverty level of income for a household of four was $25,750. For that family, an additional dollar earned is a dollar spent. But in this age when the disparity in income between the haves and have-nots is the greatest since 1928—in no small part because of the quintupling of stock prices since 2009, from which the haves have benefited disproportionately—the MPC calculation for the haves is much different. A multibillionaire simply cannot physically consume his or her income. Even in terms of McMansions and Maseratis, there’s a finite limit on how many one can own. For that cohort (small in number but huge in wealth), what isn’t consumed is usually reinvested … driving asset prices even higher, in a presumably ever upward feedback loop.

As one of many examples, the market for famous paintings, especially old master works done before 1830, has risen impressively over the last decade on the strength of money in search of something to do. That “something” is made conspicuous by the absence of utilitarian underpinnings. In 2017 Leonardo da Vinci’s Salvator Mundi sold for a record $450 million. From 1985 to 2010, the average price paid for the paintings by artists such as van Gogh, Picasso, Warhol, and Rothko was about $100 million. Prices paid and volume of activity have risen since.

Lacking a foundation of profoundly diminished expectations, the current economic expansion was doomed to mediocrity from the beginning. Further, while politics and economics have never been good bedfellows, the Fed succumbed in the crisis (and routinely since) to do something when economic performance fell short of its expectations. Nearly exhausting its policy responses, the Fed, complicit since the 2000 bubble with perpetuating the status quo for the sake of appearances, has been punching from its heels ever since.

As we write elsewhere in this report, the fragile house of cards that has been built upon the illusion that the fact that it still stands is reason enough to believe that it will do so indefinitely. At one point the morals embedded in the fable about the Three Little Pigs were indigenous to Western culture. Apparently no longer … The Big Bad Wolf can take many forms, but the ultimate destiny of the house poorly built on a flimsy foundation is foreordained.
Value Investing Is Least Popular When It's Most Needed

By our measures and observations, the synchronic nature of economic, market, and credit cycles would suggest that they are all late-term as we have consistently noted throughout our writings. In 1999, during a rare but propitious moment of peering into the future, Warren Buffett observed that investor expectations were seriously detached from reality, just as they were in the mid to late 1960s in the final throes of the great postwar bull market. In my 2011 book, I wrote:

Even though experienced investors expect annual returns of almost 13% over the next 10 years—and novices believe they will get nearly 23%—in the opinion of the greatest investor living today, common stocks in the aggregate will be lucky to return 6%, or 4% after inflation, in the years ahead.17

We believe first of all that the case for discouragingly low returns for equities between now and, say, 2030 is even more compelling. For the several reasons cited above, the risks to the trend in nominal GDP growth certainly appear to be weighted to the downside, not the upside. Second, we’ve depleted the valuation bank account that counted on falling interest rates to drive equity valuations to nosebleed levels. It’s a naive if not reckless assumption to contend that profit margins will increase further from near all-time-record levels when topline volume and productivity, themselves dependent on investment spending, remain stuck in the doldrums. To be sure, in 2018 corporate earnings were juiced by the December 2017 tax break. But what the 2017 Congress giveth, a more left-leaning Congress in the future could taketh away.

Perhaps It’s in How One Defines Value?

One must dust off Ben Graham’s classic, Security Analysis, to gain an appreciation for his brilliance in defining value.

First, he wrote that the attractiveness of an investment should be viewed in absolute, not relative, terms. Following that line of reasoning, the continuum of appealing investments, at least theoretically, could range from thousands to none. Of course, if the real mandate is to avoid the unwanted attention from tracking below the increasingly ubiquitous index funds, being fully invested is likely the only practical alternative. An investor cannot wholly commit to chasing an index while at the same time adhering to Graham’s insistence on viewing every investment in absolute terms. Then the manager is slave to the winds of fortune, hoping to eke out enough excess return to justify more expensive fees versus the cheaper, passive behemoth.

Second, in his famous metaphor, “In the short run, the market is a voting machine, but in the long run, it is a weighing machine,” Graham emphasized that in the near term the connection between price and value is like a bungee cord, always under strain, one way or the other, from the vicissitudes of mass psychology. Most of the time the psychology of the multitudes, absent energizing causes, is benign.

Something Strange Happened on the Way to the Future

In recent decades, though, our religious, political, and social beliefs, in which our way of life is rooted, have come under siege. While not assuming causation, we see modern innovations in technology—the latest being the ubiquitous smartphone and its innumerable apps—have created entirely new conditions of thought and existence. The surreal election, presidency, and impeachment (what’s next?) of Donald Trump is sometimes referred to as a constitutional crisis. Few would lay the blame at the feet of technology. And yet one could argue, as Neil Postman18 did in 1992, that a bygone era was, indeed, trampled under technology’s foot.

“America was the first nation ever to be argued into existence in print.” He cites Paine’s Common Sense and

The Rights of Man, Jefferson’s Declaration of Independence, and the Federalist Papers as documents written and printed to make the “American experiment appear reasonable to the people, which to the eighteenth-century mind was both necessary and sufficient. To any people whose politics were the politics of the printed page, as Tocqueville said of America, reason and printing were inseparable.”

Those thought leaders and framers of the Constitution lived in the world of the printed word with its emphasis on logic, sequence, history, exposition, objectivity, detachment, and discipline.

With the advent of television, and its predecessors including the telegraph, public discourse was dumbed down with its emphasis on imagery, narrative, presentness, simultaneity, intimacy, immediate gratification, and quick emotional response; i.e., the ideal medium for Trump’s message.

Since Postman, the Internet has spawned social-media platforms. This is the epoch of the synthetic crowd, strangers coalescing in virtual space around any number of proliferating causes. While Graham could not have predicted the current forces impacting mass psychology, he knew they would creep into the picture from time to time. So did French polymath Gustave Le Bon, whose short masterpiece about crowd behavior during the French Revolution, *The Crowd: Study of the Popular Mind,* was so persuasive that more than a century later it unwittingly captured the imagination of both Hitler and Mussolini. According to Le Bon:

> The most striking peculiarity presented by a psychological crowd is the following: Whoever be the individuals who compose it, however like or unlike be their mode of life, their occupations, their character, or their intelligence, the fact that they have been transformed into a crowd puts them in possession of a sort of collective mind that makes them feel, think, and act in a manner quite different from what each individual would feel, think, and act were they in a state of isolation. There are certain ideas and feelings that don’t come into being, or don’t transform themselves into acts, except in the case of individuals forming a crowd.

Moreover, Le Bon observed that crowds exhibited the psychological characteristics of “impulsiveness, irritability, incapacity to reason, the absence of judgment of the critical spirit, the exaggeration of the sentiments, and others.”

Empowered by today’s technologies, Trump (as a metaphor) and the behavior of the capital markets resemble, in certain respects, the mass-psychology characteristics of which Le Bon wrote. Whether they (one political, one financial) represent a mass mania are stories yet to be revealed.

Qualitative analysis of such crowds is a most imprecise endeavor. Historically, however, they have routinely ignored the advice of Graham to “be fearful when others are greedy and greedy when others are fearful.” Like any overused warning, it loses its potency and eventually becomes cliché as indifference grows. That is all the more reason, though, to heed its message. Many investors are inclined to extrapolate and see the future as an extension of the past. Why? Because it works … most of the time.

Graham was of the chronically curious camp, unlikely to be lulled into complacency as virtually every question he asked was preceded by the word “why.” To avoid the extrapolation trap and the dangers of the crowd’s psyche, Graham believed that the best way to view the future is by looking for repeating patterns in the past. He remixed himself, as history does so readily, that for everything there is a season, that cyclical and mean reversion are fundamental to the laws that govern almost everything.

**What Warren Buffett Was Leery of Saying in 1999 …**

… was that capital market trends aren’t linear. While he is the embodiment of the best in American capitalism, both preaching and living it throughout his life, he hasn’t been blind to the often whimsical nature
of crowd psychology. At the Berkshire Hathaway shareholders meeting on May 5, 2007, I put this rhetorical question to the chairman:

Warren, having read and reread your (2006) chairman’s letter, I was particularly struck by your “help wanted” ad for an eventual successor to you and Lou Simpson to oversee Berkshire’s investments in marketable securities.

Instead of advertising for a Ted Williams, the Hall of Famer to whom you often refer because of his rational approach to becoming a hitting legend, you proposed to recruit the consummate defensive player. Here are your words, and I quote: “We therefore need someone genetically programmed to recognize and avoid serious risks, including those never before encountered. Certain perils that lurk in investment strategies cannot be spotted by use of the models commonly employed today by financial institutions.” In a world where everyone’s talking about return, you talk about risk.

What I inferred from this job description, your warnings on derivatives, the dollar, executive compensation, the Gotrocks family and its “handlers,” your preference for private deals over publicly traded stocks, among others, is that in general since 1999 your assessment of the investment environment in marketable securities does not appear to be radically different from how you felt exactly 30 years ago, when you more or less took a multi-year hiatus from marketable securities because you simply didn’t like the odds. Am I reading you correctly? I would hope that Charlie might give his two cents’ worth as well.\(^{19}\)

His spoken response was understandably obtuse compared to his written word. After all, a whisper of warning from Warren packs such a wallop that it can ricochet ‘round the investment world. He has never been in the business of moving markets. Given the subpar record of the managers he hired (before Todd Combs in October 2010 and Ted Wechsler in 2012), along with Buffett’s own behavior during the bear market, it’s unclear of how seriously he took his own warning.

**‘Crash’: the Investment World’s Leper**

The word “crash” is, with few exceptions, an untouchable in the lexicon of professional investors. It connotes images of chaotic environments in which panic gains the upper hand, and the risk of permanent loss of wealth rises to an intolerable level. If an advisor wants to stay employed, some boilerplate speech about how 10-year expected returns will likely be uninspiring, delivered with funeral-parlor solemnity, may be more effective in retaining clients than recommending they leave the theater before someone yells fire. John Hussman (whose investment record, it might be noted, does not square with his scholarly macro market research) is a man who pulls no punches. He draws on a careful study of historical relationships in stating matter-of-factly that the current bull market will end with the S&P losing enough of its value that even a seasoned mortician will not be able to fake it. For investors focused on 2020 and beyond, Hussman quotes a man intimately familiar with the 1930s:

> There are three principal phases of a bear market: the first represents the abandonment of the hopes upon which stocks were purchased at inflated prices; the second reflects selling due to decreased business and earnings, and the third is caused by distress selling of sound securities, regardless of their value, by those who must find a cash market for at least a portion of their assets.

> —Robert Rhea, *The Dow Theory, 1932*\(^{20}\)

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\(^{20}\) [https://www.hussmanfunds.com/comment/mc191230/](https://www.hussmanfunds.com/comment/mc191230/)
Marching to a Different Drummer

Our affiliate, Palm Valley, embraces a purposely traditional Graham-esque, portfolio-management approach. Disinclined to give much weight to chronically optimistic Wall Street forecasts (when was the last time you saw a downbeat one?), Eric Cinnamond and Jayme Wiggins study the performance of often cyclical underlying businesses over multiple economic cycles while simultaneously making note of the range of earnings or cash-flow multiples that applied then. Based on their historical work and being increasingly suspicious of the growing chasm or “gap” in GAAP (generally accepted accounting principles) earnings, they “normalize” earnings and cash flow in good times and bad so as to avoid multiples that misrepresent reality.

Their approach is far from the fixation of many in the analytical community on what’s trending at leading technology companies. Because their work is so tedious, it requires incredible self-discipline. The monotonous but necessary reading of the transcripts of quarterly earnings calls on 200 companies, quarter after quarter, and then documenting their observations in the hope of discerning patterns, both within companies (micro analysis) and among companies for the economy as a whole (macro), is a competitive advantage with a moat a mile wide.

Many value managers are desperately trying to cope with the rapid pace of disruption in the digital age and how people live, work, and spend their money in its gig-economy offspring. Palm Valley’s mandate effectively leads them away from the popular, and therefore heavily trafficked, sectors and securities in the market, toward mundane businesses unlikely to be crushed underfoot by disruptors like Amazon, Google, or Facebook. Inverting Palm Valley’s approach to portfolio management, the do-or-die question arises: Is there enough price volatility in the shares of comparatively inconspicuous and often cyclical businesses, on average, that buying them when they are out of favor (and therefore at prices offering a compelling risk-adjusted margin of safety) and then selling them when the opposite occurs produce an adequate annual risk-adjusted absolute return?

Currently the answer is no. Companies on Palm Valley’s buy list are, almost without exception, selling at prices that offer the unacceptable combination of high risks and low expected returns. Despite its minimal yield, cash is the default alternative because of its optionality. As Warren Buffett implied above, the return from equities is anything but linear. If one waits patiently for two years—neither making, nor most importantly, losing any money—and then purchases an out-of-favor business for 50% of its intrinsic value, which then doubles over the next five years, the compounded annual holding period return would be 10.3%.21 Given that our expected return over, say, the next seven years for the S&P as a whole is less than 5%, and quite possibly markedly so, Palm Valley’s disciplined, patient, and low-risk approach has great appeal to us. Like farmers cut from the same cloth, their perspicacity will not become apparent until harvest time.

Final Thoughts …

Sometimes progress is incremental, while at other times it’s like a racehorse in full stride. The aforementioned Palm Valley Capital Management was “easy on the bit” as the starter stood ready to drop his flag. Unbeknownst to the competition, Palm Valley principals were, in an earlier incarnation and speaking figuratively, a “dark horse” thoroughbred that exhibited an instinct to navigate the elements, the track and the competition to make it ’round the oval and to the home stretch with energy to spare—a horse that, given its head, ran with a keen awareness of the primacy that to win, first you must not lose.

Since Palm Valley was founded in October 2018 but not registered with the SEC until February 1, 2019—an unwitting victim of the government shutdown—we were limited as to how much we could say about the

21 Rule of 72s: In order to determine how many years it will take for an asset to double in price, divide 72 by the annual rate of return. To determine the return necessary for an asset to double in price, divide 72 by the number of years available.

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organization in the Final Thoughts section of last year’s report. Fortunately, we were able to write at length about the character, competence and sense of urgent commitment of Eric Cinnamond and Jayme Wiggins, its cofounders and metaphorical jockeys.

Soon after registration, Palm Valley’s website was up and running. By April 30, 2019, the Palm Valley Capital Fund was registered with the SEC (symbol PVCMX). Quarterly letters to shareholders began in Q2 of 2019, written by Jayme, and posts to the firm’s blog site, starting March 5, 2019, are the handiwork of Eric. Compared with MCM, their perspective tends to be more bottoms-up. A quotation that we might well have included on the cover page of this report applies to Eric and Jayme: “One cannot eschew studying the microcosm if one wants to understand properly the macrocosm of a developed country.”

The three of us share the same awareness of the importance of preparedness, as well as the business conundrum it presents. In order to inspire confidence in potential investors by exhibiting steadfast patience in our commitment to our clearly stated goals and process in an investment world rife with temptation, we must be open for business even if business doesn’t appear to be open for us. In the mutual-fund industry, the meter runs whether you have a fare or not.

Moreover, the calling card of an absolute-return value firm with the preponderance of its assets in cash stands little chance of making it past the receptionist in this short-termism phase of a late-cycle bull market. Even if we “should” be able to elbow our way past the gatekeeper, we have no answer that will be well received when the question is “How did you do in 2019?” In fact, if that’s the question, we know we’re in the wrong place and talking to the wrong person. Given our long-term perspective, we’re looking to do business with people who will still be around after the next bear market.

Fortunately, knock on enough doors, and you’ll find that rare individual who is honest and humble enough to admit that he knows how much he doesn’t know. As we alluded to in this and earlier reports, smart selling in a market seemingly without upper limit is, in a phrase, depressingly unsatisfying. To make our point, we invert the meaning of the 1977 hit single, “You Light Up My Life,” vocalized by Pat Boone’s winsome daughter, Debby: How can it be good, when it feels so bad? Whether it’s Palm Valley or MCM, since substantially all the money we invest is safe-harbored in the repository we euphemistically call the “optionality of cash,” any agony imposed on others by selling before the top is yesterday’s misery. While clients may be understandably unsatisfied with de minimis returns today, it’s hard to deny that we represent two of the few clean slates among most active managers and, most certainly, all passive managers.

Of no less importance, the aforementioned rare bird is no doubt equally aware of the enormity of the reciprocal challenge in stepping up to the proverbial plate when panic is omnipresent.

Rudyard Kipling’s poem “If—” comes to mind:

If you can keep your head when all about you
Are losing theirs and blaming it on you;
If you can trust yourself when all men doubt you,
But make allowance for their doubting too:
If you can wait and not be tired by waiting,
Or being lied about, don’t deal in lies, …

The final two lines provided a resolution to all the conditional “if” statements:

Yours is the Earth and everything that’s in it,
And—which is more—you’ll be a Man, my son!

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Mark Skousen. The Making of Modern Economics: The Lives and Ideas of the Great Thinkers
In the deepest sense, we aspire to be the men of whom Kipling writes. Toward that end, Lane Miller and I, as well as Eric and Jayme, live day to day by the first six lines in the poem. Importantly, we go to great lengths to make allowance for the doubting of others. Carefully reviewing disconfirming evidence is the only sure way to test the credulity of ours. We are all students of heuristics, those biases that tend to operate at a subconscious level. Only the future will tell whether we kept them at bay.

Reinforcing what I wrote last year at this time, Kristen Smith-Myers and Lane Miller have risen to the occasion, running the MCM operations seamlessly, as measured by responses from clients. Lane and I have overseen research and portfolio management with relative ease given the generally simple construct of our portfolios. When the opportunity to begin aggressively buying businesses for the portfolio arises, the significance of our affiliation with Palm Valley will become immediately apparent.

Lane, intellectually gifted as he is, has taken to investment management with breathtaking speed and acumen. His curiosity is insatiable, a reality that quashed my initial inclination to fall back on glib answers. Challenge and opportunity lie in wait for his future!

Finally, whether we’re on the cusp of the long-awaited chance to manifest our mettle to our incredibly patient clients is yet unknown. As was the case with Eric and Jayme before Palm Valley was formed, asset attrition is the “price” of being an absolute-return value investor in a market such as the one described in this report.

Who knows, despite the volatility over the last two years, the market’s mid-single-digit performance since 2018 may be the largely unseen hesitation of the grand floodtide that has lifted all boats. Like a pendulum that briefly pauses at its arc’s extreme, could it be signaling that the tide is about to turn? Wealth that was illusory would become loss that is real. Value investors who put clients before careers will be transformed from dunces to geniuses. In reality, though, neither sobriquet applies to those who strive to know history so as to avoid its snares and traps—or to those who are open-minded enough to see the opportunities that lie ahead.

Very truly yours,
Frank K. Martin, CFA
Lane K. Miller

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