Pecaut & Company

Our Mission: To Be Our Clients' Most Trusted Financial Advisor

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Market Update

From our September newsletter:

"Rates can go up as well as down. And it can happen suddenly…….A seemingly small increase in interest rates could send very large ripples through world markets."

And so they have. In 1745, during the Jacobite Rebellion, English government bond yields jumped from 3% to 4% and sparked a 25% decline in bond values. This time around, the U.S. 10-year treasury yield jumped from 1.8% to 2.4% in the month of November and world bond markets declined $1.7 trillion in value in short order. While folks continue to wring hands about a Fed rate hike before year-end, bond markets have taken matters into their own hands. After seven years of zero-based interest rates, it appears that the lowest interest rate regime in 5000 years is finally reversing.

The trigger event, of course, was the surprising outcome of the U.S. presidential election. While many prognosticators predicted a market collapse should Trump win, just the opposite has happened. As attention has shifted from personalities to polices, the stock market has rallied sharply. Expectations for increases in fiscal stimulus, more moderate regulation, and normalizing interest rates have sparked sharp up moves for financials, industrials, and other previously neglected sectors. Sharp price reductions occurred for bonds and high yield stocks such as utilities (see our Sept. letter warning) and global consumer goods stocks. As with 1745 and with each sudden shift since, it is always so surprising how quickly these repricings can occur.

Our timeless advice: Pay off your debts. Keep a couple years' worth of living expenses in cash reserves. Invest the balance in great companies at reasonable prices. In particular, we like owner-operated companies with captive capital and long histories of intelligent capital allocation. As rates move up, opportunities will no doubt arise in unexpected places.

Our Two Cents

"You only find out who is swimming naked when the tide goes out."

- *Warren Buffett*

The tide is going out and we should pay careful attention. All of us have been swimming in the sea of assumptions that go with three decades of declining interest rates. We're so immersed in the thinking patterns that follow this 30-year trend, we may only see them clearly after some unpleasant recoil. To the degree our entire economic system is geared to this underlying trend, a shift to a rising rate environment will almost certainly reveal a substantial amount of skinny-dipping.

One way to prepare for such times is to get clear on what is. The dizzying rhetoric of the political campaigns and the frenzied media spin at each turn has created a cloud of confusion for nearly everyone. As Garrett Hardin pointed out in Filters Against Folly, words are as often used to obfuscate as to

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illuminate. That has certainly been the case this year. So, in an attempt to bring more clarity, we offer our two cents on a few issues.

Will the Fed raise rates?

Our two cents: Irrelevant. Rates are already up sharply (1.8% to 2.4% on the 10-year is a 33% increase). The Fed is well behind current events.

Will jobs return to America?

Our two cents: Mostly irrelevant. While some jobs may relocate to the U.S. from foreign locations, the bigger issue for employment is obsolescence by technology. For example, how many more jobs would you guess there are in the semiconductor industry today than in the year 1999? Answer: There are *50% fewer* jobs. Even in the technology industry (or, perhaps, especially in the technology industry) innovations are more often eliminating rather than creating jobs. Consider this: manufacturing output is at an all-time high while manufacturing employment is at a post-industrialization low. Try this one: What is the most common job in Iowa? Answer: Truck driver. This is also true in over half of our 50 states. What happens to those jobs as self-driving vehicles come on stream? You get the picture. Technology and innovation are changing how we get things done. Technological obsolescence of jobs is the elephant in the room. (As past chair of Goodwill of the Great Plains, Dan has had a front row seat on the challenges of training the workforce for a world of accelerating change.)

Who has been taxed most heavily over the past 7 years?

Our two cents: Savers. Here's our thinking. There is currently some $11.4 trillion of savings in the banking system. Those savings have earned nearly nothing during this seven year zero-based interest rate experiment. Without heavy-handed central bank interventions, let's say a modest interest rate of 2% would have prevailed for the period. If so, savers would have earned $1.6 trillion in interest. While these numbers are rough, of course, it is fair to say savers have been very heavily "taxed" during this zero-based interest rate regime.

After all these machinations, have regulators at last solved the "too big to fail" banking issue?

Our two cents: No. In fact, the big are getting bigger at an accelerating rate. The top 4 banks (Bank of America, Citigroup, JP Morgan, Wells Fargo) have 36% of deposits - $4.1 trillion - and grew deposits by 5.5% in the last quarter, an increase of $213 billion that, according to bankstocks.com, would equate to the ninth largest U.S. bank by total deposits! However, to the extent these banks are well-run and solvent, the system is well served. As an investor, these banks are attractive selling at moderate valuations, well capitalized, more conservative in their underwriting, and beneficiaries of widening interest rate margins as interest rates rise.

<u>A Few Thoughts About the Index Craze</u>

"Ships will sail around the world but the Flat Earth Society will flourish. There will continue to be wide discrepancies between price and value in the marketplace, and those who read their Graham & Dodd will continue to prosper."

- *Warren Buffett*

Over the past 8 years, over $1 trillion has flooded into index funds and EFTs while some $800 billion exited actively managed funds. Over one third of all fund assets are now in indexed products. The thought that indexing is the way to go has become universal and institutionalized. Pension and endowment committees are moving to indexing in droves. What self-respecting fiduciary wants to buck the tide and risk ridicule? Recent Department of Labor regulations nearly make it illegal to do other than index.

At its core, indexing says that it does not pay to think about price and value. Own the index and all will be well. This absence of needing to think lowers costs, so that's good. But here's the problem – if everyone continuously buys the same set of assets over time, eventually that asset set will become overpriced. *There is no mechanism in indexing to handle overvaluation or overconcentration.* When people

want to buy an index, the index fund managers must dutifully buy the large, liquid securities in the index *regardless of price*. When those same people panic to get out, index fund managers must dutifully sell those same securities *regardless of price*; thus institutionalizing the phenomena of buying high and selling low. We know what happens when everyone is buying. Stocks go up. The second part, when everyone is selling, is yet to be tested on this scale of indexing.

While indexing in a general way makes good sense, anything done in the extreme will create its own problems. We believe that is the current state of affairs. Media headlines are famous for being Wrong-Way Corrigan's, calling the trend just when the trend is over. A recent *Wall Street Journal* article, "The Dying Art of Stock Picking", most likely just called the turn.

So, *as value investors, we are thankful for the indexing mania.* For one, bargain-hunting is a very competitive activity, so it helps enormously to thin the competition. The rise of indexing is significantly reducing employment in the active management world (our competition) and replacing it with "Flat Earth" (doesn't pay to think) index managers. For another, to find discrepancies in price and value, it helps to have non-economic players in the markets. For example, an institution may by rule not be allowed to own a non-dividend paying stock. So, should a company eliminate its dividend, that institution must then immediately sell that stock, regardless of the price/value relationship. That creates opportunity for the value investor. Likewise, indexing, as we described above, creates a non-thinking process in the purchase and sale of securities, which, in turn, will necessarily create more price/value discrepancies over time. *In essence, the indexing mania is creating an ideal competitive environment for years to come for our little value oriented investment shop.*

More Index Thoughts

One very interesting problem we see afoot is the observer's dilemma: The massive indexation of the markets has turned the measuring stick (the index) into a product – so what are we measuring anymore? In physics the term for this is called the "observer effect" which refers to the changes that the act of the observation will make on a phenomenon being observed. A simple example would be checking the air pressure on your car tires. In doing the checking, some air leaks out of the tire, thereby changing the pressure – which was the very thing you were trying to measure.

In a similar vein, "portfolio insurance" was all the rage with institutional investors back in the 1980's. The "portfolio" part was to remain fully invested in the stock market at all times. The "insurance" part was to engage in program trading and dynamic hedging to minimize downside risk. And - voila! - nearly all the return of the market with virtually none of the risk! It worked fine until people actually needed it to work. Black Monday, Oct. 19, 1987 saw a 23% one-day decline as all the computers tried to sell at the same time.

Large scale indexing has yet to be tested on the downside. But the observer's dilemma holds. If everyone is continuously buying index funds, then, of course, the index will rise. This will work until it doesn't. In the meantime, the waves of buying into index funds have distorted the measuring stick, so what is it that we are measuring?

One last thought. The idea of the mutual fund is to spread risk. We believe large scale indexing may be *concentrating risk* rather than spreading it. Only highly liquid securities qualify for the large dollars the indexers seek to put to work. Securities that fit into neat categories are also required. So the list of suitable candidates for an index is limited, perhaps more limited than many suspect. In addition, this concentration of risk has likely been intensified due to the remarkable shrinkage of shares over the last two decades. In 1995, there were 7487 companies listed. Today there are less than 4400, a decline of over 40%. At the same time, the number of funds has mushroomed. In 1995 there were 526 mutual funds. Today there are 2005. This is wild. A stock to fund ratio of 14 has plummeted to 2. *Just 2 listed stocks for every 1 mutual fund.* Prediction – there will eventually be a massive wash out in the index/ETF world. Way too many funds chasing too few liquid stocks.

An Amazon. Com Best Seller

We are surprised and delighted to share that Dan's health story, Beating Bronchiectasis, is an Amazon.com Best Seller! For those of you who have already read the book, thank you so much for your support. For those who haven't read the book as yet, we invite you to do so (99 cents for Kindle, $4 for paperback). If you find the book worthwhile, please write a review and/or pass it along to a friend. What people are saying:

"In this profound and inspiring book, Daniel shows us that it's time for everyone to start embracing this integrative medicine approach….. This book is a healing gift to the world.

- *Jun Po Denis Kelly Roshi, Abbot of Hollow Bones/Mondo Zen*

"I have had bronchiectasis all my life and I was a respiratory therapist for 23 years…..I think his story is valid, valuable, and inspirational."

- *Laurel Shand, Respiratory Therapist*

Sometimes it reminded me [of] a medical thriller, and I didn't want to stop reading.

- *H.B.*

"The greatest lesson in this book is that you need to take responsibility for your own health."

- *Dr. Michael Jung, MD.*

Improving Financial Literacy Update

As we have shared over the years, we are on a mission to increase financial literacy in the world. After 3 decades of newsletters, we finally stepped up in 2015 and condensed all that money wisdom into a book, Save, Spend, Invest, Give. The central theme of the book is that money is a tool to create the world you want, so learn to use the tool. The book has so far sold a few hundred copies (and raised a few hundred dollars for the All Nations Gathering Center at Pine Ridge, SD). A big thank you to our client/grandparents who bought the book for all their grandkids – a perfect holiday gift! We are also thrilled to hear that a few teachers have even used the book in teaching their students. Podcast downloads recently passed the 7400 mark. 68 countries and all 50 states. You can check them out at www.danielpecaut.com. Thanks to all of you for assisting us in our "improving financial literacy" project.

Corey and Dan's The University of Berkshire Hathaway, a compilation of 30 years' worth of Berkshire annual meeting notes, is in the finishing stages. We're hoping for a spring launch and will keep you posted.

Jackson Steele Pecaut, 1935-2016

Uncle Jack passed away peacefully in October. Jack was a founding partner in Pecaut & Company with his brother, Dick, and father, Russell. He loved the stock market, trading his portfolio right up to the day before he died.

Jack had a big, boisterous voice, a hearty laugh, a gift for telling stories, and, every once in a while, a talent for the outrageous. He loved to travel and hold court with his weekly coffee klatch.

We are so grateful that Jack, Dick, and Russell took that risk back in 1960 to start something new. Jack was pleased to know that John, the 4th generation, had joined the firm.

Jack, we miss you already.

Happy Holidays

"To love what you do and feel that it matters. How could anything be more fun?"

- *Kathryn Graham*

It is indeed a great pleasure and privilege to do something we love to do for a living for so many friends and clients. Thank you so much for your support and the trust you place in us.

It feels like this has been a transformational year for us at Pecaut & Company. John rejoined the firm. Shelby performed heroically when Gayle needed to take a sabbatical. Our "internet-ecosystem" and literary efforts are lifting off. And, above all, Corey and Dan became grandfathers. What a year!

Our gratitude especially goes to Shelby, Gayle, and John for their hard work in providing our clients such excellent service throughout the year. We have a great team. Corey and I are grateful for that each and every day.

All of us at Pecaut and Company thank you for your support, mindful that all the success in the world means nothing without loved ones with which to share it. May you and those you love have a happy, healthy, and blessed holiday season.

Dan Pecaut Corey Wrenn