Pecaut & Company

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

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EXECUTIVE SUMMARY

- **Market Update**
- **Investing Outside the Rules**
- **Reaching for Yield**
- **Growing the Team**
- **Pecaut & Company Sponsors Sunrise Fundraiser**

Market Update

With markets around the globe hitting new highs, we are in a worldwide bull market. As value investors, we are allergic to enthusiasm and enthusiasm is running high today. We continue to be of two minds about this market with caution being uppermost in our thoughts.

Warning signals include: sovereign debt levels in the trillions (how will the Central Bankers unwind this mess?); nearly a decade of zero-based interest rates has inflated asset prices around the world; the U.S. stock market to GDP ratio is near its all-time high (about 129% versus the all-time high of 136% from the year 2000); valuations in general are rich; reaching for yield has become extreme (see below); the stampede into index funds continues; record profit margins suggest earnings are overstated.

Positive signals include: The earnings yield / bond yield spread is very wide – stocks are clearly a better value than bonds; at 4.2%, unemployment is the lowest in 16 years; average family income hit a record high, increasing a record 8.5% over the last two years; owners' equity as a share of total real-estate holdings climbed in the second quarter to the highest level in 11 years (healing many of those homeowners who were underwater after the subprime mortgage crash); best of all perhaps - prognosticators are falling all over themselves trying to pick the top of this market – which suggests this rally has a long ways to go.

As always, caution is in order. Pay off your debts. Have your emergency cash in place. Sell to your sleeping point. With the balance, invest for the long run in quality, wealth-compounding stocks, especially non-indexable, well-capitalized, owner/operator companies.

University of Berkshire Hathaway

Our book has wildly exceeded our expectations. Recently Amazon.com showed *UBH* ranking as #1 in Portfolio Management, #8 in Business, and #14 in Investing. Amazing! With over 60 reviews, the book has a 4.7 star rating (out of 5) at Amazon. Corey and I have been interviewed on a number of radio shows and value-oriented websites about the book. Visit our website to check them out.

Thanks to all who have supported the project. If you feel so inclined, please write a review at Amazon. Our intrepid editor, Austin Pierce, continues to say that nothing helps a book along like those reviews.

Investing Outside the Rules

Reality is always more complex than rules can ever be…so invest outside the rules.

- *Murray Stahl, Chairman and CEO of Horizon Kinetics*

Our primary investment concern is the massive amount of sovereign debt in the global financial system. Like a cat in a tree, the central bankers have gotten themselves into a mess and no one knows just how to get down out of that tree.

The next biggest concern in our minds is the indexing stampede. Some $1.4 trillion has flooded into index funds and ETFs over the last 8 years. Indexation has become the rule for pension investors, endowments, and institutional investors of all kinds. The government has even passed regulations that encourage indexing. The logic: the average return of all active managers is the market return. However, active managers charge fees while the index costs next to nothing, so the index will always outperform the average of managed returns over time. Ergo, everyone should simply own index funds. Now the logic has become the rule. And the rule, taken to extremes, is leading to unintended consequences.

For one, since the S&P 500 Index is market cap weighted, mass indexing is leading to a ***concentration of risk***, rather than diversification. In the first half of 2017, just 5 stocks (1% of the index holdings) accounted for one quarter of the S&P's return. In 2016, the top 25 stocks accounted for 50% of the S&P 500's return. In 2015, the 10 best performing stocks accounted for *100%* of the S&P 500's return. Rather than providing diversification, the index is now providing concentration of risk, the opposite of indexation as it was intended.

For another, index fund managers must be agnostic on business value. They simply buy the stocks in the index in proportion to their market weight. Much like the tech bubble of 2000, where the NASDAQ index briefly traded at over 200 times earnings, there is no mechanism with indexing to account for valuation. For this reason, we prefer to reframe the "passive vs. active" debate as "non-thinking vs. thinking." Doing enough thinking to avoid extreme overvaluation makes huge sense to us.

In addition, index managers must be all in all the time to fulfill their mission of indexation. When a shareholder decides to sell an ETF or index fund, the fund manager must dutifully sell a portion of each stock in the portfolio. What if everyone goes to sell at the same time? No doubt we could have something very much like Black Monday, October 19, 1987 where all the "portfolio insurance" programs sold and sold. Portfolio insurance claimed to deliver most of the market's return without as much risk. The idea was that computers would automatically sell out the portfolio on a small dip, so you could never lose too much. But when many institutions bought into the notion, many computers were set to sell on the next downturn. And did they ever. The Dow finished that day down 508 points, a decline of 22.6%.

<u>So What to Do?</u>

We agree with Mr. Stahl. The key is to invest outside the system, outside the predominant rule set of the day. Thus, consider being a ***non-index investor.*** At Pecaut and Company, we have been building our own little universe of non-indexable companies. Many are small, too small to ever be indexed. Some have multiple classes of stock which exempts them from indexation. Some have large inside ownership so the actively traded float is too small to quality for indexation. Some are too complex to fit neatly into an index category. We especially like owner-operator companies where the insiders are excellent allocators of capital, are well funded with captive capital (versus open-ended funds and ETFs where the capital can be taken away by the click of a mouse by the least patient, most frightened shareholder), with a clear path to value creation. Sometimes it's an acquisition. Sometimes it's a large stock buyback. Sometimes it is a restructuring or spin-off. Sometimes it is a combination of these activities. We call them

NICCOO stocks – Non-Indexable, Captive Capital, Owner-Operators.

To be sure, nearly all stocks went down in the 2008-2009 subprime mortgage crash. However, stocks that are well-capitalized will see their way through. Companies with shrewd allocators of capital will do even better, as it is in times of distress that the most compelling bargains often arise.

Reaching for Yield

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

- *Warren Buffett*

One of the items on our checklist for gauging the temperature of the financial markets goes under the heading of "reaching for yield." Next to selling in a panic, reaching for yield is one of the most common and costly investment mistakes we have witnessed. After nearly a decade of zero-based interest rates, reaching for yield has become a global past-time.

This summer Argentina sold $2.75 billion of bonds with a maturity of 100 years – "century bonds" – with a yield of 8%. While 8% sounds pretty juicy, consider that the bond is backed by a country that just defaulted on its debt in 2014 and has defaulted no less than 8 times in its 200-year history. With even a 100-month bond with such a country, one should be circumspect. Loan it money for 100 years? Crazy. But, wait, there's more!

From the September 13, 2017 WSJ: *A 100-Year Bond Is a Hit – Investors lined up Tuesday to buy an Austrian government bond that won't be repaid until September 2117, earning just 2.1% interest along the way. Austria sold $4.2 billion of the bond.*

Lending anyone money for 100 years is a crazy idea in a world with so much change and risk. Lending it to Austria might be less crazy than Argentina. But look at the rate. 2.1% is less than the 10-year Treasury rate of 2.3%! Really? 10 years backed by the full faith and credit of the U.S. of A. requires more yield than a bond of 100 years backed by Austria?

Austria is not alone. It joins Ireland, Belgium, and Mexico in issuing 100-year bonds. The article explains: *The strong demand for ultralong debt is another indication that even as the European Central Bank is preparing to wind down its post-crisis stimulus measures, investors believe interest rates will stay low for a protracted period.*

By the way, Austria also sold $4.8 billion in five-year bonds which yield around ***minus 0.2%.***

Yield is indeed scarce. Investors are clearly reaching for yield. We believe indexing plays a part as well. As funds flow into bond index funds, they must go find things to buy. With no valuation controls (unthinking investing) amidst a global scramble for yield, these funds are paying up for all sorts of risky bonds. However: *You only find out who is swimming naked when the tide goes out.* When interest rates go back up, there could well be a massive amount of skinny dipping revealed in the world of bond investing.

Growing the Team

We are delighted to announce the addition of Ruby Welcher to our Pecaut & Company Team. Ruby will oversee back office operations, bringing a positive attitude, an eye for detail, and a passion for order to the task. Ruby was raised in Siouxland by her Filipino parents. A great story, her folks grew up just miles apart in a suburb of Manilla only to meet and fall in love in Michigan. As her mom puts it, "The love of my life was on the other side of the river, but I had to meet him on the other side of the world." After graduating from Briar Cliff in accounting, Ruby forged a career in the financial industry, including 15 years in employee benefits administration. She, her husband, Steele, and son, Alex, are pleased to call Sioux City home. When she's not analyzing numbers, Ruby likes reading, cooking, yoga, and meditation.

Pecaut & Company Sponsors Sunrise Fundraiser

We are proud to be the Signature Sponsor for the Sunrise Retirement Community Jill Miller Christmas concert being held December 1st at the Orpheum. Sunrise's mission is to care deeply, connect daily, lead boldly, and serve faithfully.

Corey has served on the board for 6 years and is currently the Chairman of the Board. For the last two years, Corey's mother, who is turning 95 next month, has lived in the memory care unit at Sunrise. Corey says "My mom means the world to me and is one of my heroes. I've always been impressed by the compassionate care that she has received and the quality of the people who work there."

We believe the measure of a society is how it cares for those who cannot care for themselves. Sunrise will incur approximately $750,000 in unreimbursed costs serving those who cannot afford their care. Please consider coming out to enjoy a great family outing, after all Santa Clause and the Grinch will be there. Call for free sponsor tickets!

Dan Pecaut | Corey Wrenn | John Pecaut