

February 2018

## EXECUTIVE SUMMARY

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### Market Update

We continue to be of two minds about this nine-year bull market.

On the one hand, things are good. The economy is doing well. Unemployment is near 4%. The banking system has healed and is well capitalized. Public policy, tax policy, and regulation have become less onerous for business. The U.S. recovery has now morphed into a worldwide recovery, something rarely seen. In addition, there is a technology revolution going on which will probably last a couple decades and remake the way goods and services are delivered worldwide. For businesses with strong and growing moats around their business castles, these are very good times.

On the other hand, valuations are elevated. We are at the top range of the market cap to GDP ratio. Enthusiasm is clearly on the rise (see below). The recent tax bill has caused a 7% run in January. 7% is a good **year**. The Fed is clearly looking to take away the punch bowl, as QE fades and interest rates are bumped up. The 10-year Treasury rate has taken notice, rising in 18 months from a low of 1.36% to 2.70% recently. Complacency is high: 2017 was the first year in history where the market declined no more than 3% for the year. Caution is in order.

What to do? If you have needs for cash within a couple years, raise it now. This would also be a good time to make charitable gifts of appreciated stock. With the balance of one's portfolio, know what you own. Many of our owner/operator companies have accumulated cash over the past several years (e.g. Berkshire Hathaway has over \$100 billion in cash). In this way, they have already prepared for days of cheaper prices. Such knowledge reduces the need for "getting out."

Indeed, we believe commentators clamoring to call the market and inciting investors to get in or out do a disservice. This "in/out" thinking undermines the deeper logic that wealth in a capitalistic world is created through business ownership. When you own a stock, you own a business. Over time it is the long-term growth in intrinsic value of those businesses that matters. Taking this long view, investing then is more of an enterprise, an operation to be run over decades not months. To own more of such businesses when prices are low (which will be when fear and uncertainty abound) and to be more cautious when enthusiasm and prices are high just makes common sense. Taking the temperature of the market can be most useful. The current temperature is clearly warming up.

### Enthusiasm is Up

After eight years of nervousness, investors seem to be getting excited about this old bull market.

- *Investors Intelligence*, a 64-year old survey of investment newsletters, in the January 10, 2018 edition, showed a 64.4% bullish reading, near the top of its historic range.
- The NYSE reports **margin levels that are record levels** both on an absolute basis and as a percentage of GDP.

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- **Mutual fund managers are holding the lowest percentage of cash on record.**
- The AAll reports individual investors are holding the least amounts of cash since 2000.
- The total value of the most popular crypto currencies recently topped \$600 billion.

### A Momentum Market

This enthusiasm, coupled with indexation, has resulted in a crowding into a relatively small number of momentum stocks. We've discussed the FAANGs (Facebook, Amazon, Apple, Netflix, Google/Alphabet) in past letters. We'd also note:

- In 2017, the Russell 1000 Pure Growth Index outperformed the Russell 1000 Pure Value index 38% to 4%.
- Technology stocks accounted for 40% of the S&P 500's 2017 return.

### Filters Against Folly

*Beyond communication, language has two functions: to promote thought and to prevent it.*

- Garrett Hardin, *Filters Against Folly*

Every mania has its buzzwords. In the high inflation 1980's, they were "energy and gold." At the end of the millennium, it was "dot.com." Today they are "bitcoin and block chain." Being a literate society, we are attuned to words but can be as often fooled by them as enriched.

Hardin's book, *Filters Against Folly*, is one of our all-time favorites. Dan even purchased copies for each of his children as basic curriculum for life. Hardin suggest three filters:

1. The Literate Filter - What are the words?
2. The Numerate Filter - What are the numbers?
3. The Ecolate Filter - And then what? You can never do just one thing.

While we are a highly literate society, people can be fooled by words. Words are as often used to obfuscate as to illuminate. We are less so a

numerate society, so people are routinely bamboozled by the numbers. As for the Ecolate Filter, we live in a complex web of interconnection, and that is so often forgotten, especially in the realm of public policy. Effects have effects have effects and we should be decidedly humble about thinking we know what those ripples may be.

These three relatively simple filters have been invaluable to us throughout the investment ebbs and flows over the decades. We wrote about speculative oil and gas stocks back in the early 1980's (see below). We wrote similar articles about the "dot.com" bubble back in the late 1990's. People quitting their day jobs to trade dot.com stocks. *These things happen only in times of great enthusiasm.* Today, anecdotally, we've heard of people quitting their day jobs to trade cryptocurrencies. The mania surrounding crypto currencies is providing us with another case study in Hardin's filters.

Long Island Ice Tea recently changed its name to Long Block Chain. The stock went from \$2 to \$9. With 9.1 million shares outstanding, the jump meant an increase of \$64 million in market value. On just an idea and a name change! This comes from naive investors using only the literate filter. With 2016 revenues of \$4.5 million and a net operating loss of \$10.5 million, this company flunks the numerative filter. From the company's website: *"The Company can make no assurances that it will be able to finance the purchase of the mining equipment."* Would you lend to a company selling iced tea one day and trading Bitcoin the next?

To its credit, we would note that the company does seem to be gifted at promotion and fund raising: 2016 financing activities produced net cash of \$9.9 million. This cash, of course, was offset by an operating loss of roughly the same amount. Interesting business model. The ecolate filter - "and then what?" - is most likely eventual bankruptcy. This is not value investing!

Note how similar this story sounds to one we wrote up over two decades ago to illustrate how the literate filter can lead the naive investor astray. From *The Pecaut Newsletter* July, 1993:

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## *All That Glitters*

*To see how the filters may instruct, let us examine Alpha Energy and Gold, a stock that became popular in 1979. A client called to buy some on a hot tip..... He bought some at \$2 per share and would buy more only after I looked at the annual report.*

*In my experience, most investors operate with a strictly literate filter, which was the case with this client. Gold and energy prices were soaring in a period of high inflation. The word “alpha” suggests the beginning, the ground floor. Alpha Energy and Gold – how could it miss?*

*Now let’s apply the numerate filter (6<sup>th</sup> grade math will suffice). The annual report showed that the company had 10 million shares outstanding. The stock was at \$3 per share (yes it was “hot”). And what did you get for \$30 million? Some rights to some land leases and a pickup truck – bought on time! I have seen some great looking trucks, but \$30 million sounds a bit steep. The numerate filter contradicted the literate reading. The only “alpha” here was the beginning of a scam. I told the client to sell immediately. He did so grudgingly and cursed me as the stock rocketed up to 4.*

*With the ecolate filter – “and then what?” – we have the benefit of hindsight. While oil was supposedly en route to \$80 per barrel, the world economy slowed, alternative energy sources were researched and developed, and conservation increased. Inflation subsided. Gold (at \$800 per ounce) and oil (at \$40 per barrel) topped out in the early ‘80’s. Thus, even if Alpha Energy and Gold had exercised its rights to leases, found money to drill/mine for oil/gold, and hit, it had no control over the price of the product. Even if the company had every stroke of luck imaginable, it may still have amounted to little or nothing. Alpha Energy and Gold went bankrupt within two years.*

## **Building Real Business Value**

One of the benefits of experience is that it enables one to see patterns. Long Island Iced Tea fits a

pattern from past cycles of speculation and excitement. Experience tells us to take a wide berth here.

Here’s a thought of more relevance to serious long-term value creation: the middle class of the world is rising. India is on track to pass the U.K. and France and become the world’s #5 economy in 2018. Many Asian countries are moving up the global rankings as well. Well-run global brands have a substantial tailwind that is picking up speed. We continue to prefer a thoughtful approach to investing, with caution against speculation and a focus on excellent companies building real business value.

## **Fourth Generation**

We are very proud to announce that John Pecaut recently became an owner in Pecaut & Company, marking the fourth generation of family ownership in the firm. John has worked hard, especially in the operations area, and now knows the firm’s inner workings very well. He has also been meeting more and more of you, our valued clients. He is a natural for thinking skeptically and strategically, ideal for the value approach that we espouse. In sum, Corey and I could not have found a better junior partner than the one we have in John.

The underlying value here, of course, is family. Russell Pecaut believed in his sons, Richard and Jack, and took the risk of starting a new firm, Pecaut & Company, in 1960. Dan came on board in 1979. Corey joined the firm in 1992. To have the firm prosper for 57 years has been quite remarkable. Even more important, to have loving, healthy family is to be rich beyond measure. Dan says being a grandpa is just fantastic. Corey says he needs to get in shape so he can keep up with the little ones.

We have succession. We have grandkids. We are blessed beyond measure.

All the best,

“Pappa Dan” Pecaut | Corey “Bumpa” Wrenn |  
John “Dada” Pecaut