

May 2017

EXECUTIVE SUMMARY

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Market Update

As is so often the case, we are of two minds.

On the one hand, the massive liquidity infusion in the age of zero based interest rates has created a very levered global economy. How the Central Bankers draw down this massive indebtedness will be key. For the moment, it appears they will move very, very slowly. A hiccup could create above average chaos. Investors should be prepared for a 30% decline at any time. This is always true, of course. Over the last century, the market on average has had a 10% decline every year or so and a 20% plus decline every three to five years. At this moment in time, we are eight years into a bull market, market valuations are higher than average, margin debt recently hit a new record high, and total market value to GDP ratios are higher than average. By these sorts of measure, the "temperature" of the market is "hot." And that favors a more cautious approach to stock market investing.

On the other hand, we significantly prefer owning wonderful, wealth-building businesses to bonds. (Warren Buffett recently said owning bonds at this time is "nuts." Little return, lots of risk.) Cash creates dry powder for future

opportunities, so more cash than average isn't a bad idea. A number of our favorite investees are doing this for you. For example, Berkshire Hathaway's cash hoard has climbed to \$95 billion. White Mountains, when it completes the sale of One Beacon, will have \$3.1 billion in cash. IVA International is over one third cash. In addition, we are in a bit of a winner take all world. Companies that have advantages with their business moats in scale, momentum, capital allocation opportunities, and opportunities to grow are rare and wonderful. It makes no sense to us to dance in and out of them because we will (not might) have a hiccup now and then. This is the patient, long term approach in action.

Tontine Market

We would also note that this has become a "tontine" market in many respects as a number of companies have been buying in huge numbers of shares during this bull market. A tontine is a contract where the last person alive gets the goodies. It started with a government needing money (plus ca change, plus c'est la meme). Louis XIV was looking in 1689 to fund his military operations when he ran out of other sources. This scheme was invented by Lorenzo de Tonti, a Neapolitan banker (ah, those ever-creative bankers...), hence the name "tontine." As originally executed, each investor pays a sum into the tontine. Each investor then receives annual dividends on the capital invested. As each investor dies, his or her share is reallocated among the surviving investors. This process continues until only one

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investor survives. The reason we are labeling this a “tontine” market is that many companies are heading towards buying in all but the last share. White Mountains, for example, had over 8 million shares outstanding in 2010. Today it has a little over 4 million shares. The management recently announced plans to take that to 2 million. Last shareholder standing will own the remaining assets. While White Mountains may be the most extreme example, there are dozens and dozens of companies that have shrunk their shares outstanding by 30% or more during this bull market. This is a value creation (assuming shares are purchased at a discount to intrinsic business value) over and above the day to day operations of these companies. Nearly all the companies in the portfolios we manage have this value creation feature in play. While buying in shares is not new, never to our knowledge has it been so widespread. Many share buybacks have been executed above intrinsic value, destroying shareholder value. Our interest is in the ones that are occurring below intrinsic value.

Value in the Age of Industrial Scale Indexing

In addition, in this age of “industrial scale indexing” (thank you Horizon Kinetics for this term), it is as if the Red Sea parted and a focus on price and value will be rewarded for decades to come. It is a dream scenario for the value investor. Indexing algorithms allocate cash to a weighting of pre-chosen stocks. There is no thought given to price or value. It is the essence of the concept. While this works in general, taken to an extreme, things can get interesting. And they have. The massive flood of assets into indexing has created a two-tier market: there is the ocean of indexable stocks and then there is the lonely back waters of non-indexable stocks. This back water includes numerous companies that will be challenged to

be relevant in this world of relentless change, and so perhaps deserve their lack of attention. However, there are also a number of companies that are well-run, and have a clear path to increasing shareholder value. Some are valued in a way that offers free “options” on future events. Many of these companies have large insider ownership. This is what makes them non-indexable. Indexing requires lots of freely traded shares (or “float”). Closely held owner/operator companies don’t fit the indexing model. We even have an inside-the-office term for this group: NICCOO stocks (non-indexable, captive capital, owner operators). It’s a remarkable time to be a value investor in a world where price and value no longer matter.

What To Do?

As always, pay off your debts and have a couple years’ worth of living expenses in cash. We believe it is essential to position yourself so that you are never forced to sell come what may. Selling into a down market - whether done due to financial pressure or emotional pressure - is the number one value destroyer of investor portfolios in our long experience.

For long-term assets (those with at least 3 to 5 year horizons), we continue to like well-chosen businesses. For us, it’s becoming a bit of a barbell approach. On one end, we own some winner-take-all behemoths (like Apple and Berkshire Hathaway). On the other end, we own some thinly traded, special situations where value creation is uncorrelated or only modestly correlated to the general market (like White Mountains). Reminds us of portfolios we had in the 1990’s. Back to the good old days! Our gratitude to indexers everywhere.

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