Pecaut & Company

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

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EXECUTIVE SUMMARY

- **Market Update**
- **Retirement Cash**
- **Illiquidity**
- **Looking for Value**

Market Update

After a six-year rally, stocks are no longer particularly cheap. In addition, the U.S. stock market has not had a 10% correction in over 3 years. The norm is a 10% correction about every year or so. This suspended animation is in part due to the massive stimulus from the Federal Reserve.

The global experiment by Central Bankers to solve a problem of too much debt by creating evermore debt looks dicey to us. Remarkably, according to the Geneva Report on the World Economy, total debt to GDP ratios are *35% higher* today than at the initiation of the 2008 crisis. The plummet in oil prices and Swiss franc surprise could be the beginning of a series of unusual events as the unexpected consequences of massive stimulus leak out here and there. We like the idea of having some cash around to take advantage of the occasional irrational event.

We remember when U.S. Treasury yields briefly went negative in the fall of 2008. Such was the fear in the market at that time that investors were willing to take *a guaranteed loss* on their money. Warren Buffett even showed an overhead at the 2009 Berkshire Hathaway annual meeting of a confirmation of a Treasury bill sale above par. We remember thinking, "We'll never see that again!" How wrong we were. Today, incredibly, negative yields are becoming commonplace. No less than a dozen sovereign nations sport negative yields. Central Bankers have created a currency race to the bottom to stimulate their moribund economies. It is a "Tragedy of the Commons" sort of process. Each individual Central Bank action makes some sense – if we debase our currency a little, we can export more of our cheaper goods and services and get our economy going. Collectively, however, with everyone doing the same thing, nobody wins and we end up with this very weird world of negative interest rates.

Profitable growth is always valuable. Such growth is getting harder to come by. Sales are flat at many large corporations. Profit margins are at the high end of historic averages, so the trend of improved earnings from increasing margins has largely run its course. Per share earnings have been enhanced by financial engineering such as share buybacks, lowered interest expenses, expense reductions, asset sales, and the like. Much of that has run its course as well. Eventually, companies actually need higher revenues to drive earnings and those revenues may be hard to come by in a world that needs to de-lever.

In sum, caution is in order. Overall, we continue to prefer to own businesses; especially those that have strong competitive moats, are growing those moats, and will benefit over the long run from the continued globalization of the world economy. In

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addition, with increased volatility, shrewd capital allocators may have more bargain opportunities in years ahead.

Going Digital

Through the years, we have seen Pecaut & Company as a learning organism. We are grateful for the terrific teachers and life lessons that have come our way. Along the way, we have attempted to share part of what we've learned through this newsletter. Now we're ready to go digital. We have developed a series of 8 free recordings that we are rolling out to share what we've learned about money and investing. They've been produced especially with the 30-something generation in mind. We invite you to check them out and pass them along to your family and friends. (A book is in the works as well.) Please check out our podcasts at www.danielpecaut.com and let us know what you think.

Thinking About Retirement Cash Flows

Lately we have received a few questions about our investment strategy on funding retirement, particularly in a time of zero-based interest rates. Specifically, "why are we holding any cash when cash pays nothing?" We have also fielded a few questions about investing in junk bonds or higher-yielding securities to generate income. (We warned that yield-chasing can be dangerous, especially after 5 years of zero-based interest rates.) Our approach, while highly rational, may appear unconventional. So please allow us to expand on our thinking.

We begin with timeframes. (In the fourth recording of our podcast series, we discuss the importance of timeframes.) Historically, over 5-year periods, stocks outperform bonds and cash about 67% of the time. Over 10-year periods, stocks outperform about 80% of the time. So the longer the timeframe, the more likely it is that stocks will be the winning strategy.

When the timeframe is less than 5 years, the odds favoring stocks become reduced. Over one or two year periods, the outcomes become fairly random. In addition, some losing years can be quite extreme (as in 2000-02 and 2008—09). (This, of course, sets up the value investor mindset of welcoming declines as opportunities to put long term capital to work – which only works if the short term is not imperiled!)

So for our clients with income needs, we (mentally) set up the account with two buckets. In the first bucket – the withdrawal portion of the account – we invest with a focus on safety and liquidity. We like to have at least 2-3 years of withdrawals covered with safe, liquid assets. (How we loved the old days when we could do this with laddered treasuries.)

This approach frees up the balance of the account – the second bucket – to be invested longer term. This is where equities can be considered. Currently, we still believe them to offer better value than bonds. However, the margin of betterment has shrunk with the upward revaluation of the market after this 6-year bull market. And, where we need to replenish the first bucket, we have been trimming into this rally as we go.

Not only does this approach appear rational, it works. For nearly three decades, including through the two biggest bubble/busts since the Great Depression, this strategy has delivered. Never having to sell when things were in chaos was absolutely key to this success. Let us know if you have additional questions. We appreciate the nudge.

The Temperature of the Market

As we said above, after a six-year rally, stocks are no longer particularly cheap. However, the real signs of increased animal spirits are on the edges of the market and in the world of private equity. We note:

- Restaurant chain Shake Shack Inc. recently came public. At the end of the day, the company had a market value of $1.6 billion, giving each of the 63 existing restaurants a value of $25.4 million.

- According to a recent *Wall Street Journal*, there are now at least 48 venture-capital backed companies with an implied value of over $1 billion each. The number of such companies peaked at 10 during the height of the 2000 dot.com boom.

- Uber has a valuation of $41 billion, even though total taxi revenue in the United States is about $11 billion a year.

- The number of activist funds has grown from just 76 in 2010 to 203 in 2014, according to *Strategas*, and the amount of money under management has tripled. The number of companies targeted by activists rose from 136 in 2010 to 344 in 2014.

Liquidity

In 2009, fear paralyzed the market. Panicked investors liquidated equity funds and poured into bond funds. By 2012, the recovery was clearly underway, but fear still dominated and the mass migration to bond funds and fixed dollar investments continued. (That was the time of our "Value in Stocks" newsletter where we noted *"While much could go wrong, much of that is in the price. What isn't in the price is things going right.")* Today, what's going right is largely in the price. The S&P 500 average PE is now 18 versus a 50-year average of 16, so the market is currently more expensive than average. This is the time investors have chosen to get excited about stocks and, in particular, indexing. A record $242 billion went into index funds and ETFs (Exchange Traded Funds) last year and over $1 trillion during this rally. Such funds are all in all the time and outperformed nearly all actively managed funds last year. Greed has returned.

In a recent interview, Mohamed El Erian suggested that all this indexing has made markets less liquid than people realize. He observed that the indexing craze has led many investors to see ETF's as "safe". However, index funds and ETFs are all in, all the time. If everyone goes to sell at the same time, the index managers must sell index stocks to raise cash, causing such stocks to gap lower.

We have seen this movie before. In general, index funds do a decent job of spreading risk by owning a cross-section of a given market or sector. However, when everyone takes the same position, the effect is *to concentrate risk versus spreading risk*. We first saw this in 1987 with the "portfolio insurance" fad which gave institutions a false sense of security with the thought that computers would automatically sell for them to limit losses. However, when all the computers went to sell at the same time, there were numerous gap openings and the market finished down 508 points or 23% on what infamously became known as "Black Friday". We saw something similar with the telecom and Internet stocks in the 2000-02 period. Every self-respecting manager felt he had to own these stocks to keep his job. We even found shares of Cisco and Intel in junk

bond funds! The public's stampede into everything dot.com once again concentrated risk. When the tide went out, the losses were extreme. The NASDAQ fell 80% over the period.

Valuation Changes

A study of REITs (Real Estate Investment Trust) shows how valuations have evolved over the last 15 years, particularly for yield-oriented securities. During the Internet Bubble, REITs became very cheap. People were systematically selling the "Old Economy" to buy the "New Economy". Tax law changes as well made REITs less compelling to investors. As a result, the REIT Index traded at just 80% of book value. The group was demonstrably cheap and offered very nice yields as well. Flash forward to today, after years of yield-chasing by an interest hungry investing world, we find REITs trading at 3x book value. Worse yet, REITs may be even more overvalued than they look. Research by Horizon Kinetics (our thanks to them for this great insight) shows that some REITs are taking less depreciation than normal to inflate their pay-outs.

So knowing what you own, always important, becomes even more essential in the more advanced stages of a bull market.

Looking for Value

Precision Castparts – Well run consolidator of the aerospace parts and service world. 10-year record of doubling sales and increasing earnings per share by 350%. Stock down 25% on earnings disappointment due, in part, to weakness in the oil patch (only 7% of sales). 10-year average PE 16. Current PE 14, so at the low end of historic valuation.

Leucadia National – Volatility is up. This is good for our holding companies run by excellent capital allocators. Portfolio holding, **Leucadia National**, took advantage of one such event recently. FXCM, a currency trading house, got upside down overnight with the Swiss franc decoupling announcement. LUK swooped in with a rescue package of $300 million at double digit rates and with control elements (in effect, a takeover on the cheap).

We are pleased with value-building developments at our favorite businesses. In particular, the financial sector is extremely well capitalized post crash, has resolved most pre-crash issues, yet still sells at large discounts to fair value due to negative stigmas. Infamous **AIG**, for example, sells at a remarkable 35% discount to its $77 (and rising) book value even as smart people are working to do smart things – improve efficiencies, increase underwriting profitability, and buying back stock ($3.4 billion worth last year).

General Motors, another bad-boy (also derisively called "government motors"), has $20 billion in net cash – over 33% of its market cap! How risky is that? With a strong fourth quarter, it appears that rising auto sales may at last be leading to major earnings growth. In addition, the company announced a dividend increase and a $5 billion buyback program. (Corey had the line of the year with this one: "Why don't they just recall all the cars and start over? Sales would go through the roof!")

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