Pecaut & Company

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

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EXECUTIVE SUMMARY

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Market Update

Nothing succeeds like excess. *- Oscar Wilde*

As we shared in our recent client letter, nine years into a bull market, valuations are full. The stock market cap to GDP ratio is near all-time highs. Insider selling dwarfs insider buying. Government debt and corporate debt have mushroomed in the age of zero-based interest rates. Following the subprime mortgage debacle, Central Bankers around the world have attempted to solve a problem of too much debt by issuing ever more debt. This excess has succeeded in the short run. However, as the Fed shifts from easing to tightening, to think there may be some dislocations and air pockets doesn't take too much imagination. Caution is in order.

Since quarter end, we've had a selling squall as the 10-year Treasury popped from 2.7% to 3.2%. Most likely the suddenness as well as the size of the move is what sparked the selloff. The S&P 500 dropped 6% or so within a week.

The reality is that we're in something of a worldwide bear market. The Dow Jones World Index ex US is down 14% for the year. The NYSE Composite Index is down 7% year to date. 43% of the S&P 500 component stocks are down 20% or more for the year. This does not sound like a bull market. The lion's share of the S&P's return over the past year has come from just one sector – technology. The fever for all things tech has masked the deterioration of the broader market.

At the same time, dislocations and change create opportunity. It is at such times that those companies that choose to think long term and have their balance sheets in order stand to gain market share and to buy distressed assets cheaply. Such times are essential for long term value creation at our favorite owner/operators. Our oft quoted strategy: pay off your debts, have ample cash to cover intermediate needs, and own a selection of well-run owner/operator companies for the long run.

How Soon We Forget

They used to say about the Bourbons that they forgot nothing, and they learned nothing. And I'll say about the Wall Street people, typically, is that they learn nothing, and they forget everything.

- *Benjamin Graham,* The Father of Financial Analysis *by Irving Kahn and Robert Milne*

Our largest concern over the last several years has been debt. As noted above, sovereign nations have taken on trillions of dollars of debt over the last decade. Corporations have followed suit, often using ultra low borrowing rates to fund massive buyback programs. According to *Grant's Interest Rate Observer: In the final quarter of 2007, just before the recession, business debt as a percentage of GDP touched 68.8%, the highest on record since records began in 1945…. Chastened corporate CEOs, hopping aboard the deleveraging bandwagon, reduced the ratio to 64.7% by the middle of 2012. Now it's back to 72.3%.*

72%! Higher than the former record reached in 2007. Seems impossible to believe we'd forget the debt meltdown of 2008-09 so soon, but here we are. Decisions that may make sense for each individual company, collectively have led us to record high debt levels for corporate America during an economic upswing. The US government fiscal policy has done likewise, of course, cutting taxes and running an estimated trillion dollar budget deficit. These are measures normally reserved for recessions. Here we are adding fuel to a nine year recovery.

Unintended Consequences

We also have concerns for the rush of new regulations which are untested and undoubtedly will have unintended consequences. (Remember Garrett Hardin's 3rd Filter Against Folly: *And then what?*) One unintended effect may be increased volatility in bond trading. The conventional banking system is now very well capitalized. The mistakes of the last cycle will not be repeated at the banks. However, since the banks have been severely restricted in market making, the bond markets themselves may be set up for extreme volatility. Bond markets may be far less liquid than most realize. According to GavKal investment research:

*In 2008 the US had about $2.8 trillion of outstanding corporate bonds. Against that, bond dealers kept roughly $260 billion of inventory (a little under 10% of the outstanding). Fast forward to 2018 and a decade of zero and negative interest rate policies has caused the US corporate bond market to almost double in size to $5.3 trillion. Yet a whole raft of regulatory changes has resulted in bond dealers now holding a paltry $40 billion of inventory (**less than 1% of the outstanding**).*

Thinking versus Non-Thinking

Another extreme event we've discussed in past letters has been the massive indexation movement. Over the last 11 years, net flows into index funds and exchange traded funds have totaled $2.5 trillion, while active funds have lost $500 billion. Staley Cates at Longleaf Partners estimates, if you include closet indexers (managers who hug the index), the effective indexing percentage today is approximately ***three-fourths of fund assets***. Suffice it to say, it's been a huge migration.

Indexing is a fine idea in the main. However, like anything else, it may have unintended consequences when done in the extreme. As funds flow into an index fund, the index fund managers buy a certain group of stocks in certain proportions. Fees are low because no analysis or thought is required. Thus, by definition, indexing is *non-thinking* investing. Index fund managers must be fully invested at all times to mirror the index. Thus, when a shareholder says "send me my money," the manager must sell those same stocks in those same proportions to raise the cash. As Hardin would ask, *And then what?* If (and when) everyone says "sell" at the same time, index managers will be selling the same stocks in those same proportions en masse, without regard for price.

We prefer *thinking* investing and especially like our cadre of *thinking* investors. Berkshire Hathaway has a phenomenal record of capital allocation and $110 billion in cash. Likewise, the relentlessly rational leaders at our other investees generally hold much larger than average cash balances. What's the common link? These entities are owned and operated by honest, intelligent investors with excellent long-term records. They think like owners *because they are owners*. As market downdrafts and economic down swings come along, these investors stand ready to take advantage.

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