Pecaut & Company

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

The bi-polar world of fear and greed in the markets continues. On the one hand, investors are driven by fear – fear of the unknown, political risks, trade and tariff wars, bombing in Saudi Arabia, massive debt accumulations at both sovereign and corporate levels, rapid technological change, and who has our data and what are they doing with it! Every presidential tweet moves the market up or down.

On the other hand there is greed – greed to keep up with this momentum, technology-driven market. The IPO market is the hottest in years. The stampede into indexation continues apace (see below).

We maintain a sense of caution. Pay off your debts. Have plenty of cash for emergencies. If you're setting up a retirement income stream, be sure to have ample liquidity for future withdrawals. With the balance, continue to own well capitalized, reasonably priced, owner/operators that are built dynamically, ready to evolve and deal with whatever comes.

Thinking vs. Non-Thinking Investment Update

The theater keeps getting more crowded, but the exit door is the same as it always was.

- *Michael Burry*

Michael Burry was the hero in Michael Lewis's book *The Big Short*. He made a bundle shorting tranches of subprime mortgages in 2008. Recently Burry warned that passive fund flows are inflating a new stock and bond bubble that is bound to blow as money linked to fund indexes exceeds amounts traded in individual stocks. He is highlighting an issue we've discussed numerous times in our newsletter.

Last year, we reached a new high in the indexation mania when there were more ETFs than stocks in the stock market. Now, as of August, for the first time in history, assets in U.S. index-based equity mutual funds and ETFs eclipsed those in actively managed stock funds. Morningstar Inc. reports that investors added $89 billion to passive U.S. stock funds while pulling $124 billion from active funds for the year through August. Riding this wave of momentum, passive mutual fund assets rose to $4.27 trillion, topping assets in active stock funds of $4.26 trillion.

The concept of indexation is fine. However, anything taken to an extreme can create its own set of problems. As we've asserted in previous newsletters, indexation is *non-thinking* investing. As dollars flow in, the index manager must buy the select group of stocks that make up the index in their proper proportions. No thought required. Hence lower fees. Upon redemption, the index manager must sell the same securities. If investors panic en masse, to whom will the index

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manager sell? This is what Burry is referring to. The theater of indexable stocks has become increasingly crowded. Meanwhile, the exit doors are no larger. This creates the potential for a very messy accident.

Accidents happen and that's when thinking investing ("active management") can help; especially when there's high quality thinking about what could go wrong. This is when a thoughtful, risk averse philosophy of investing may prove most helpful.

Accidents Happen

Did you ever observe to whom the accidents happen? Chance favors only the prepared mind.

– Louis Pasteur

With our value-oriented investment approach, one of the most important questions we ask ourselves again and again is "*What could go wrong?*" As we all know, accidents do happen.

In that vein, in our July letter under our header "*Invasion of the Killer BBB's*," we noted that today's U.S. bond market was most likely the junkiest in history; driven by yield-starved investors seeking higher coupons on the one hand and by capital hungry businesses with only limited access to bank lending on the other. Meeting in the bond market, these two forces conspired to generate some $3 trillion of BBB rated bond issuance. That's 50% of the U.S. bond market. BBB is barely investment grade, just above "junk". If and when such bonds get downgraded, there will be forced selling by those institutions that are required to hold only investment grade bonds. This is an accident waiting to happen.

For an accident that is happening as we speak, we refer you to our October 2017 newsletter, under "*Reaching for Yield*," where we noted that Argentina sold $2.75 billion of century bonds with a yield of 8%. While 8% sounded good, we reported that Argentina had defaulted on its debt 8 times in its 200-year history, most recently in 2014. It was a virtual certainty that these bonds would default before the end of this century. Now it looks as though they may not even make it to the end of the decade!

Argentina's economy is a mess, featuring runaway inflation amid a sharp economic contraction. The Argentine stock market, the MERVAL index, fell 48% in a single day after the recent elections, the second biggest one day decline in the history of global stock markets. The century bonds now trade for a fraction of their issue price. It's amazing how quickly these bonds proved to be a really bad idea for investors. Reaching for yield – one of the most common of investment mistakes.

Another Accident Waiting to Happen

Corey has built a little index of "cloud companies;" software-as-a-service companies: Atlassian, Guidewire, Service Now, Temonos AG, and Veeva Systems. On average, they sell at 17 times revenues. That's right. Revenues. There are no earnings to speak of. This so reminds us of the Internet bubble. No doubt these are interesting, innovative companies. But the valuations are extreme. When the mania breaks, the prices of these stocks could easily fall just as fast as those of an Argentine century bond.

Evening the Playing Field

As we get older, Corey and I admit we are becoming grumpier. In particular, we have long complained about the horrible waste of government giveaways to "create" business. Tax abatements, revenue bonds, all sorts of chicanery in the name of creating jobs for the loyal taxpayers of our communities. A vast majority of this is completely wasted, leaving ***the loyal taxpayers to pick up the tab*** for the local goods and services the government generously provides to the non-taxpaying new businesses.

Amazon has played this game routinely in locating its distribution centers across the country. Most (in)famously, Amazon pitted America's largest cities against each other to see who would give it the most

generous location package for a second headquarters. Absolutely maddening.

Amazon has been a significant beneficiary of another sort of mis-government. Little appreciated is that 2018 was the first year that Amazon paid sales taxes in all 50 states. Not paying sales tax in a thin margin business like retail has been a massive advantage and a massive tax giveaway by state governments. Winning with this hand is not brilliance. This is like getting dealt 7 cards in a 5-card poker game. Hand after hand. With an advantage like that, you should win and win big.

According to Scott Galloway, author of The Four: The Hidden DNA of Amazon, Apple, Facebook, and Google, since 2008 Walmart has paid $64 billion in taxes while Amazon has paid $1.4 billion. Paying 2% as much in taxes, Amazon ($240 billion in revenues) should be able to take a little market share from Walmart ($510 billion in revenues). And take a far larger share from thousands of taxpaying mid to small-sized retailers.

Who pays the taxes as those smaller players fold? The remaining businesses. This little discussed tax element has acted as an accelerant in the "retail apocalypse" underway with some 8000 store closings so far this year.

Amazon delivers an amazing service and Jeff Bezos is an amazing manager. The vision and execution have been incredible. People want what Amazon does or it wouldn't have been so stupendously successful. It's just a bit duplicitous for the government to suddenly "discover" that big tech might be due for investigation only after the competition has long since been crushed; a process driven, in part, by its tax policy.

In a similar vein, the state of California just passed legislation mandating app-based companies like Lyft, Uber, and DoorDash treat contracted workers as employees, not freelancers. Adhering to minimum wage laws and providing basic benefits like unemployment insurance are estimated to cost the companies 20-30% more for labor. Cities will have the ability to sue companies that do not follow the new laws.

Here again, up to now, the government has allowed these start-ups to play by different rules. Using contracted employees gave these delivery service companies a major cost advantage. Only after the conventional taxi business has been destroyed is a thorough review and response to these exceptions underway. Despite this unfair advantage, Uber managed to lose $1.3 billion on operations last quarter. Uber's money losing margins will worsen with laws like these. Uber and Lyft have quietly been raising prices.

The Empire Strikes Back

The truth is that today, every company is a technology company. The question is whether the company has the vision, resources, and scale to get on the innovation wave.

While the government begins to review big tech, older established companies are rolling out their answers to the future. One of our old favorites, Nestle, brought in Mark Schneider as its CEO in 2017, the first outsider to run Nestle since 1922. He brought three priorities to his new job: Speed, speed, and speed. His sense of urgency is paying off with more innovative products, the sale of slower growing subsidiaries, and an uptick in the company's growth rate.

Disney is planning to offer a $7/month streaming service this fall. Netflix has shown the direct-to-consumer model is a winner. Disney has enormous content and brand power, so it seems likely their service could be a big success. Unlike Netflix, Disney has many ways to monetize their streaming customers' loyalty with the theme parks, merchandise, and other services.

Walmart is gaining momentum with its online grocery business, which is outgrowing Amazon's. With same day delivery and pickup and Omni-channel shopping, Walmart is set to be a dominant player in the grocery business for the decade to come.

Selling at elevated valuations, these companies are not cheap but they have quality, scale, and momentum in their operations; stocks to consider on the next big sell-off.

Banking's big four, JP Morgan, Citibank, BankAmerica and Wells Fargo, have spent massively on technology. Each is on the list of the world's ten biggest technology spenders! As a result, they've created a business moat that mid to smaller banks cannot hope to compete with. Steady growth in deposits and growth *in the rate of deposit growth* proves they are taking share from the rest of the industry. In addition, with more conservative banking rules, these banks are sound financially (overcapitalized in fact), able to pay large and growing dividends, and able to buy-back shares. Wells Fargo bought in 10% of its shares in the past year and plans to buy in another 20% over the next 2 years. These stocks are cheap, selling at low double digit PE's.

Unlike cloud computing stocks, each of these companies has been through multiple business cycles. And they have earnings. Just sayin'.

Business is Dynamic

All of this is to say that business is ***dynamic.*** Things change. So businesses change, responding and innovating in the midst of challenge. We just shared the names of a few companies that are responding well to the shift toward a technological economy. This is part of what we love about business.

One of the great Houdini business acts of all time was Warren Buffett's transformation of Berkshire Hathaway from a sleepy New England textile company destined for obsolescence into a wealth compounding machine. We detail this transformation in our book, *University of Berkshire Hathaway.* In particular, we draw your attention to *Appendix I: In the Beginning…There Was Capital Allocation*, where we detail Buffett's early days with Berkshire.

Briefly put, Buffett took over the troubled textile company in 1965 with a book value of $19.65 and earnings of $0.15 per share. At year-end 1969, just four years later, Berkshire's per share book value was $43.18, up 120%, with per share earnings of $8.07. A spectacular turnaround. Was this because the economy was good? No. It was because Buffett put on a clinic in brilliant capital allocation. He sold unneeded inventory to raise cash. He bought back shares at ultra-cheap prices. He invested excess cash in undervalued stocks. He sold the stocks for big profits a few years later. He sheltered profits with a very large tax-loss carryforward. He bought an insurance company, National Indemnity. He bought The Illinois National Bank and Trust Co. of Rockford, Illinois. By 1969, Berkshire still had ownership interests in the fading textile industry, but those were dwarfed by the earning power of his insurance and banking operations and the substantial capital on Berkshire's balance sheet. That's dynamic!

Buffett's success with Berkshire Hathaway was not assured. In fact, if he hadn't acted boldly and, instead, stayed solely in the textile business, he would have gone out of business! Get this: *the threat of obsolescence is what drove Buffett to perhaps his finest work*. This is the essence of why we focus on intelligent owner/operator businesses. With their net worth on the line, such owners will not turn away from hardship. For the prepared mind, as Louis Pasteur suggests, this is the very thing that puts chance in our favor. Over the long run, the very things that scare the casual investor are the very things that create grist for the mill of the wealth building process.

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