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Don't Bring a Knife To a Gun Fight

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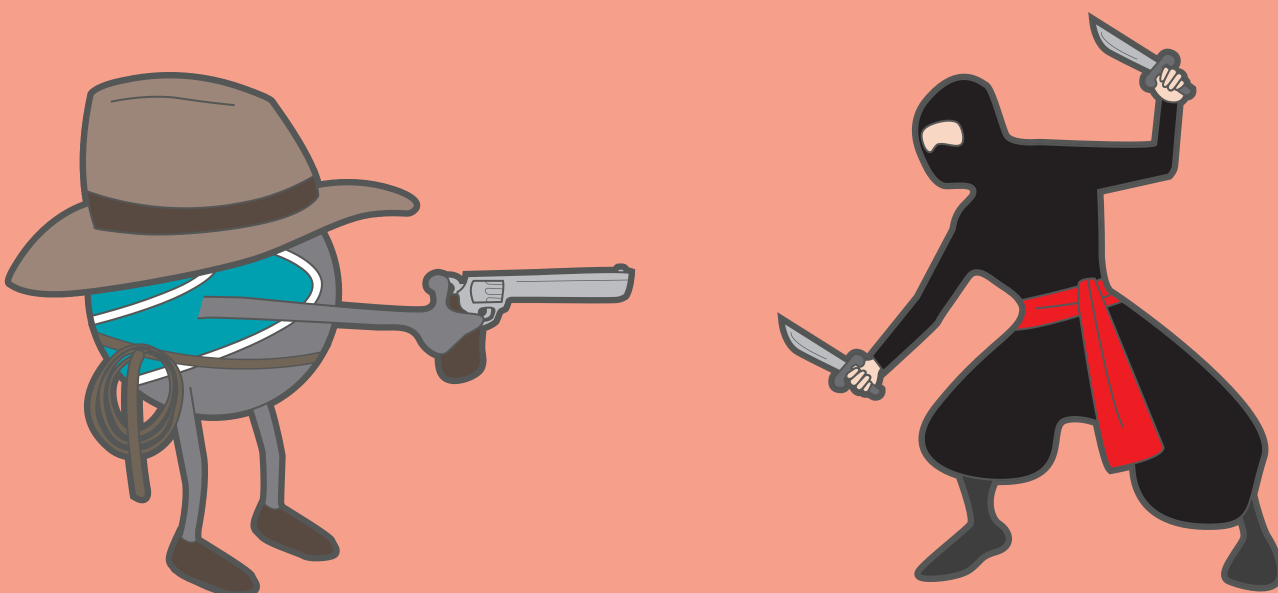

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Don't Bring a Knife to a Gun Fight

MAY 2015 — While several somewhat big things have changed in the last six months—the price of oil and the value of the dollar—what has really not changed is our continued disbelief in the construct of the current financial market environment. Some portion of current equity and credit values is being supported and driven by zero (or lower) interest rates. It is difficult to say whether that is 10% or 30%. Current monetary policy is nothing more than a grand experiment—undertaken on a global stage—with near zero precedent and that simply bugs us. Attempts to suppress market rates are actually a worse intellectual exercise than is trying to value an energy stock without any high probability of accurately predicting oil prices.

Sovereign entities around the world have been incredibly successful in using quantitative easing and verbal jawboning to induce way more than the marginal dollar into "risk bearing" assets and, after watching for a number of years, we are hauling out the caution flag. Part of this stems from our own success this year as we have done well and are quantitatively seeing our fishing pool dry up. When a recent investment meeting involved a 45 minute discussion on Avon, Layne Christensen, and newspaper stocks, you don't have to be a particularly perspicacious investor to see that risk/reward equations might not be skewing in an investor's favor. As both noted value investor Sam Zell and real estate investor Steven Roth of Vornado stated on recent investor calls, "Our sense is that this is the time in the cycle when the smart guys build cash." (As a side note, we are now investors in what is known as Zell's Equity Commonwealth and yes, you must read the transcript from the February 19th earnings call.)

Our sense is that all of this should really bug you. While I am trying to make the final changes to this letter, I am busy working with our trader to sell a small cap holding that is going up 10 percent an hour on volume equivalent to 50% of its shares outstanding, because it has been linked on Twitter to a 40-bagging penny stock that also happens to be owned by Carl Icahn. No matter that this is a liquidating cigar butt of a value stock if we have ever seen one. As recently noted in the *Wall Street Journal*, your shoe-shine guy has now apparently migrated to Twitter and is selling Tesla tips via subscription. These are signs that the revulsion toward equity ownership that has mostly existed since late 2008 has pretty much run its course and anyone claiming that the current valuation environment in public and private tech, venture and bio-tech is not directionally close to what was going in 1999 is…use your own colorful adverb before the word dumb.

The funny thing about being smart in the investment business is of course that it is not always highly correlated with being right. As Howard Marks, of Oaktree Capital Management, has written, "Unconventional behavior is the only road to superior investment results, but it isn't for everyone." (If it were, then it wouldn't be unconventional.) Added Marks: "In addition to superior skill, successful investing requires the ability to look wrong for a while and survive some mistakes."

Which brings us to the miles of words recently being trotted out about the continuing death of active equity management. (For an audio version of Jim Grant whupping on Vanguard's John Bogle on the topic, click through to Grantspub.com/TheGreatDebate.)

It is absolutely correct to say that the "industry" is designed to collect assets and charge fees. It is also correct to say there are numerous disincentives and structural impediments put in place by clients, consultants and investment management firms themselves that contribute to the overall poor showing by active equity management. By no means a complete list would include: high fees, too much trading and asset movement, short-termism, restrictive guidelines, narrow and inflexible asset classes, inability to hold cash for longer than 24 hours, over-diversification, closet indexing…and etc. Much of this falls under the very simple headline of: "We are afraid for our jobs, families, and lifestyle and therefore taking the necessary business and career risk to pursue the intellectual purity of great long-term performance is not worth the hassle." Oh, and managing money on a competitive basis against many of the world's highest IQs is simply not easy.

But to paraphrase Indiana Jones, why is one committed to bringing a knife to a gun fight? And why can't an investor pick the right fight? "How many mutual funds routinely beat the market" is not the right fight, despite being often taken up by the *New York Times*. The proper fight takes place "over time" and is a battle that can only be won if one is willing to cede the short-term and the silly to the CNBC world. Do you really want to be known as the guy who wins the quarterly Russian roulette tournament? The fun part is the joint determination of what is an appropriate time horizon. I can tell you that 3 years is absolutely NOT the time horizon despite its overwhelming use in institutional money management. In fact, in nearly every study I have read and on the basis of HIGHLY personal experience, 3 years is likely to be a time horizon that is nearly perfectly inversely correlated with investment success.

While this should not be a bold statement given how much money is tied up in private equity and venture capital funds with much higher fees, with much less transparency and not a lot of visible signs of obvious success, seven years seems to resonate as a time horizon. Why? I will throw out two somewhat related thoughts. The first improbably comes from bond guru Martin Leibowitz. (CFAPubs.org—*Long-Term Bond Returns Under Duration Targeting*) What I "heard" in this piece is that all else being equal, somewhere between the 6th and 7th year your annualized total return on a duration targeted bond portfolio will equal your starting yield, no matter what happens in the interim. Our internal takeaway: if the manager has a reasonably supported strategy (value investing), has a reasonably stable firm and talent base, and is charging a reasonable fee, then your results are highly likely to be reasonable no matter what happens during the first year you decide to give him or her money.

The second example comes from the omnipresent GMO "seven year mean reversion forecasts," a system that has apparently been in use since 2002 when GMO dropped it from ten years. Free lunch to someone out there who can find the mathematical or modeling support for seven years other than strongly suspecting that GMO found that a ten year time horizon was so much outrageously longer than any client had the stomach for, they heuristically cut it back to seven. But it mentally correlates to what is simply crucial in longer-term investing: the inevitability that there will be mean reversion in valuation among individual securities and assets classes and it really helps results to directionally be on the right side of that. Trying to be on the right side of that every moment does not constitute being on the right side. (As an example, we present the new leader of year-to-date worst quotes from the sell-side: "We still see AIG as the best stock to own during the 1Q reporting season.") In conclusion, while we always would like to be right quickly, "we" must recognize that life and investment success don't proceed on a linear 3 year calendar. I am willing to cede ten years is not likely to be a winning offer in most new client meetings, but I think a mental 7 is the right math.

The other part of this digression is the gun versus the knife. After twenty-seven years of watching a lot of what an investor, a client, and an investment firm can do to tilt a very competitive playing field in its favor, we think it's fiendishly simple: a value focus; small cap orientation; concentration; thinking long-term; not trying to be like an index or being afraid of a reasonable dose of illiquidity; a small, stable, "talent dense" team; a hard limit on assets; and being associated with money/partners that also get it. It is not easy to say no, particularly when a firm finds itself with lots of mouths and egos to feed after "3 years" of growth and growing ambitions. It is also not easy to put yourself in a position of looking stupid or getting fired. What we can tell you is that we have a mental and financial structure at our firm to endure these difficult periods, which incidentally does not include the terrific year we are having in 2015.

On a very related note, while this was a question related to what to do about bonds in a balanced account, "smart guy" investor David Abrams hit the nail on the head at a recent Grant's investment conference. (Reprinted with full authority from the eponymous boss.)

> "What would you say," came a question from the audience, "to a traditional, long-only, balanced manager after 33 years of declining interest rates? The long-only manager is mandated to have a balanced portfolio. What should he be doing with his bond holdings?" Answer: "I would suck it up and go really short, really safe, if you have a mandate to be in bonds," Abrams answered him. "Tell your clients it is not my fault and I am protecting you. I have an expression I use around our firm: Leaders have to lead. If people have given you money to invest, they've hired you for a lot of things. In part, they've hired you for your judgment. My opinion is that you're doing them a terrible disservice if you cop out and say, 'My client made me do it.' No, your clients didn't make you do it. You did it. Whatever you do, you have to own that. Leaders have to lead."

Our next note is in regard to the latest homily from Uncle Warren in Omaha who put in print that essentially, upon his passing, everyone should give their money to Vanguard to be indexed. Of course, before that fateful day comes, people who are too busy to do the work themselves should entrust their wealth to him and Charlie—who will be happy to run a concentrated portfolio with a small number of equity holdings. Really? This seems to join other pieces of recent populism: every other successful person should pay 40% in taxes while we engage in intelligent tax planning (i.e. the Graham Holdings swap); and excessive leverage and financial engineering is terrible, unless of course you get to invest with your special Brazilian friends at 3G. Personally, I think "the sidekick" got it more right at his recent *Daily Journal* annual meeting: "The teaching of efficient markets produces a disadvantage for students and a big advantage for those who read and try to find value. It personally gives me an edge when other people are not paying attention to reading and thinking, and are instead on their phones. It means that I gain knowledge from reading a few 10-K's while others are tweeting what they had for breakfast."

What always remains interesting is practical application. It is easy to bemoan the global state of affairs and the lack of buyable ideas on a Tuesday, but in a universe of thousands of ideas, what really happens is that 5 people spending 60 plus hours a week reading, studying, and meeting people actually start to find interesting "stuff." We noted the aforementioned Equity Commonwealth and we will throw in our $160 purchase of IBM in All Cap. We have a variety of others in progress, but what we have come to realize is that we are now at a size where we can be at cross purposes to mention interesting ideas that we may or actually do want to buy more of at lower levels. That's the beauty of being one of our clients!

One ending thought. We have spent a fair amount of time on GE over the years. It was part of the very misguided plan to "go into late 2008 with a small bucket of high quality financials who will be there to pick up the pieces in the wreckage." We purchased more in the mess, and then took a proverbial double (there is always a double from some price) and moved on for reasons to be noted below. What the recent announcement to effectively end GE Capital as we know it means is two-fold. First, it is an awful indictment of the horrendously misguided state of affairs in the global regulation of financial companies and second, it is a dangerous confirmation of the precarious state of "wholesale" finance. As far as I can tell, people have been making wholesale markets in stuff since the infamous short donkey, long papyrus trade of 2565 BC. It is the behind the scenes grease that allows the more public systems of credit to flow. What is self-evident today is that public systems involve voters and wholesale systems involve financial piñatas that are seemingly available to be sued and fleeced ostensibly for the benefit of said voters. There presently exists a perverse system where the only asset that seems to curry favor with regulators is a government bond and the only form of financing must be equity-oriented and long-term. This simply ignores the fact that many assets are very short duration or are designed to "move" intra system, because a giant bag of shells is really hard to carry across town. So if a monolith like GE can be choked into submission and cannot operate in commercial markets, there will either be less credit available or credit will move toward non-regulated entities, an outcome that sort of defeats the purpose of the present swathe of clownish attempts at effective regulation. The real lesson that has never been learned regarding financial regulation and risk management is not that the approach taken by regulators and the banks themselves is too simple; it is simply that all attempts to be too precise about risk are innately ineffective. No one can truly account for everything. As the great French risk managers Voltaire and Christian Louboutin respectively noted, "Doubt is not a pleasant condition, but certainty is absurd," and "le petit quelque chose qui fout tout par terre."

Now, while now might be a great time to execute the dismemberment of most of GE Capital given low interest rates, low cap rates in real estate and the appetite of other large organizations starved for growth, GE's problem in the era of Jeff Immelt has been a problem of asset allocation. This is a big organization that has assembled every rational thought that can be Power-Pointed over a decade and made huge "thematic" acquisitions at the top of nearly every great cycle. Healthcare, media, and energy assets were all bought at top dollar and right in the teeth of a massive decline in public valuation multiples. Despite terrific scale and awesome industrial capabilities, it is going to be hard for GE to be a high performing investment with that hurdle. If I had to put down a wager on the wisdom and real cash cost of this move, history would suggest putting money on the buyer, not on the seller of these assets.

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