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Hooey and the Sausage Making

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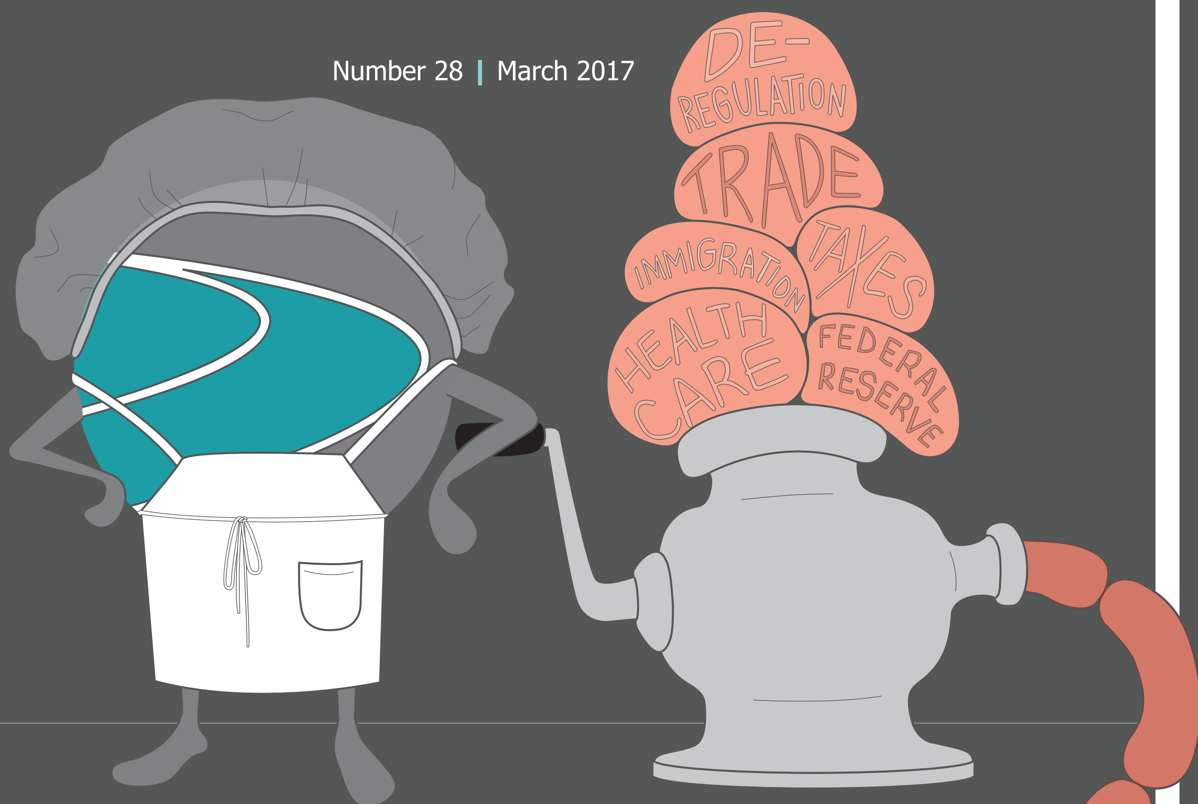

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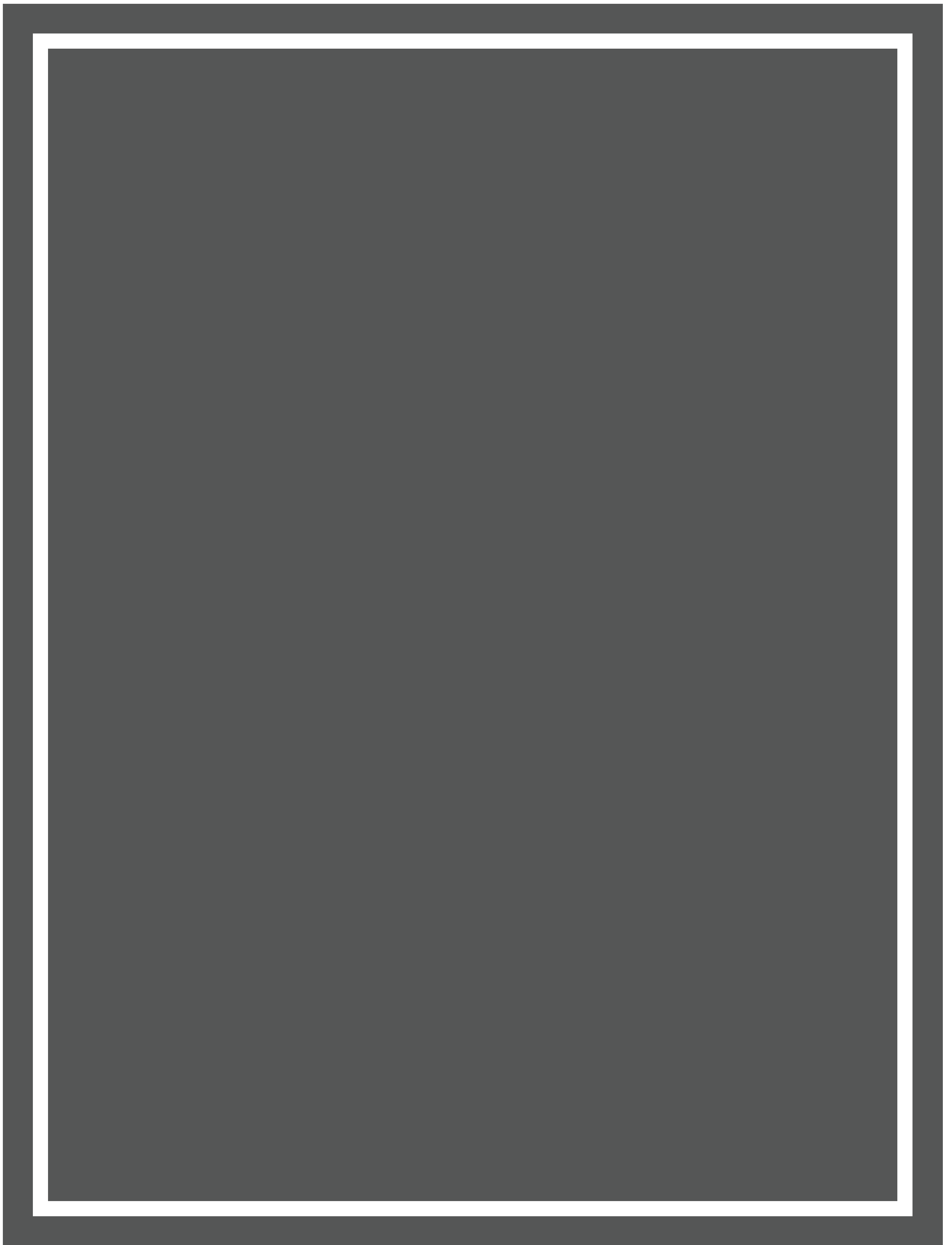

Hooey and the Sausage Making

MARCH 2017 — So here we are in the blessed sunshine of post-election America and the remarkable events of daily life remain remarkable. We have often talked about being in completely uncharted waters as far as Federal Reserve policy and the true unknowability of how financial markets will react to an ever more likely new era of irregularly higher interest rates and a diminution of the impact of monetary policy in the face of massive changes in fiscal policy. But clearly the election has dumped a new ocean full of water in the "ain't seen nothing like this" tub.

We are betwixt and between. Every monstrous bull market starts with something that looks like the last 4 months: a stampede from an inflection point that looks obvious six months from now, but in its infancy is picked to death by articulate purveyors of the obvious. And the world is full of the highly educated, the highly articulate, and the data driven, and now they have internet and access to our inbox with little claim to better forecasting. As noted in Berkshire's recent shareholder letter and in these ramblings for over 20 years, the beauty of bearishness is that it is full of precision-laden facts based upon TRAILING data that can always suggest we are the verge of imminent disaster. (Go ahead and Google news pieces around the great inflection points of 1982, 1988, 2001, 2009, etc.) In comparison, the bullish case for the future almost always sounds dopey: this is America, we are a democracy and a free market that is still the envy of the world, and somewhere and somehow, we manage to grow the economy, and as of yet unidentified people will create companies and hire people, and...so on.

And yet there is a pretty damn good historical case for it; and irrespective of tweets there remains a very strong animal spirits-based case for upside surprises when businesses are encouraged to invest with lower tax rates and with fewer regulations. Every "survey" of business expectations from small business to large corporations is off the charts high, as is arguably the "great survey," the stock market. And isn't it nice to see people with business experience overseeing business regulation and finance experience overseeing financial regulation? No dear reader, a PhD, a law degree, and/or a tenured position at an Ivy League school is not a qualification for thoughtful economic foresight.

Yet, there is obviously plenty of other stuff falling under the heading of "sausage making" because that is how our system works and the joke remains the same: watching the intimate details of perfectly respectable ideas get ground into something that passes into the law of the land is an awful process, particularly in the "gotcha" world of social media. And for the record, it also works the other way as absolutely asinine ideas like a border tax get ground up on the other side into something hopefully palatable. And among all the things about which we can complain, the border tax concept

is worth another few sentences because it is wrong on so many levels: fiendish complexity when the goal of tax reform is simplicity; dependence on a PhD-driven, model-generated guess that markets will cooperate and price the dollar 25% higher, an outcome which will have the magic effect negating its pain; a high likelihood of being met with sovereign competitive measures which will counter the modeled effects; and lastly (and most awfully) implicit support of a key premise of what was wrong with the past 8 years—the idea that an elected group in the United States of America should deliberately attempt to pick the future winners and losers in the global economy as opposed to the historical baseline of establishing a consistent and transparent marketplace that enables all comers to take their shots. Someone tweet it for me: it's stupid. And throw in another tweet about the idiocy on either side of the aisle that is against free trade.

As he explained to a radio audience in 1985, the Smoot-Hawley tariff act "helped plunge this nation and the world into a decade of depression and despair." Ronald Reagan vowed, "From now on, if the ghost of Smoot-Hawley rears its ugly head in Congress, if Congress crafts a depression-making bill, I'll fight it."

Where is this resistance?

Our real area of concern is simply the valuation of many common stocks and what assumptions have to be made to justify their valuation. The future remains full of probability weighted possibilities and x% is clearly tied to 3%-plus GDP growth rate with awesome earnings power well in excess of what we are "used to." Yet, as anyone who has walked into an institutional client meeting 2.5 years into a relationship knows, 8 years is a veritable eternity in the minds of the economic and financial community, so a backend weighted set of economic goodness is now well-priced in today's equity market. There is simply a lot that has to go right—and go right right away—or prices will adjust accordingly. Understanding expectations implied by valuation is critically important to the process of not losing money, and it is correct that in investing and marriage, if you start with low expectations, you are less likely to be disappointed. There are some headshaking examples of value to implied expectations trading in front of our faces, such as Intel paying $15.3 billion or 40 times sales for Mobileye being particularly noteworthy…or just silly. As a Bernstein analyst put it, "It's going to be 10 to 15 years before we know if this is actually going to pay dividends for Intel or not." Now THAT is a great CEO day job!

But this is not 1981 with stocks trading at book values that were wildly understated given the ravages of double digit inflation, interest rates about to go from 18% to effectively zero, and one William E. Simon about to teach the finance world about the fun inherent in massive leverage and buyout funds. We are much closer to full employment today, versus double digit levels in 1981, and take a serious look at the demographic trends which conspire against the pure math of economic growth. There are some narrative parallels and we all know we behaviorally love a good narrative; but I sense they are much slimmer than perceived in some camps.

One thing we think you can take to the bank about the interim future is the recognition that stocks can and should be much more volatile than they have been in a zero interest rate world and frankly we look forward to those days. We had a pretty decent year last year, ex-banks, and we have picked up both relative and absolute ground this year. But frankly we hate markets that go up every day. We like a certain degree of mess and uncertainty and I am quite certain we are going to get our fair share in 2017.

So we have adjusted accordingly and have leaned into some wonderful winners bought in the economic dog days of late 2015, partially or in their entirety. Their replacements and our short list of candidates are eclectic: mattresses, aerospace, consulting, post-bankruptcy companies, nursing homes, media, and, gulp, some retail. We acknowledge that might be a little too eclectic—an outcome of the paucity of choices available—but we have nice optionality in our portfolios that is not necessarily beta-driven. Throw in a concentrated portfolio, and in theory we can be defensive and create upside if enough internally generated ideas work on their own accord without much help from the outside world. That's the plan.

But things sometime do change, as one Charles B. Munger recently noted while addressing the Daily Journal annual meeting. There is an absolute global industry devoted to parsing the history, deeds, means, and motives of Berkshire Hathaway, and while I admit to be a tattered card member, it is nonetheless tiresome to consider how much intellectual effort is spent talking about investing and what "kind" of investing and what "kind" of value and what is X investor up to...rather than actually doing it. To wit, here is a train of thought that says volumes about the state of the world in investment management.

> "In the old days, what we did was shoot fish in a barrel. It was so easy, we didn't want to shoot fish while they were moving, so we waited until they slowed down and then we shot them with a shotgun. It was just that easy. It's gotten harder and harder and harder…Think of the hooey we built up over the years: we don't understand it, it's outside our circle of competency, the worst business in the world is airlines — and what appears in the holdings? Apple and a bunch of airlines. Have we gone crazy? I think the answer is, we're adapting reasonably to a business that's gotten much more difficult…Things have gotten so difficult in the investment world that we have to be satisfied with the type of advantage we can get…Indexes have created absolute agony among investment professionals because 95% of people have no chance of beating it over time… most people handle that with denial…I think the people who are worried and fretful are absolutely right. I would hate to manage $1 trillion in the major indexes." — Charles B. Munger

Right sir. Merit badges for style analysis don't seem to win the day in my experience. We have a "lens," but it is incredibly important to look at the opportunities offered to you as an investor rather than coming in every day with an intellectual or political cudgel. Investing is not easy and it can be maddeningly frustrating in the short-run. And the larger your asset base, the more rigid your guidelines, the more cacophonic the environment in which you live and the weaker the hands of your clients, the harder it gets.

So to reiterate, we think it is crucial both as an investor and as a firm operating within a rapidly changing ecosystem to think a little different than the average bear. We continue to think the advantages of fishing in smaller pools enhance our odds of finding something overlooked or underappreciated. We think limiting asset growth assists in our ability to deliver performance for clients. We think working for a fee well south of the GDP of many African countries offers clients good value for their decision to partner with us. And we think having a smaller group of passionate and focused professionals is an advantage. We don't need more ideas; we need to be more thoughtful about what is in front of our faces every day.

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