GVA Newsletter

April 2016

TINA

"Of course the 64 million dollar question is what should one assume going forward? The bulls will presumably argue that this Fed impact is now part of the accepted wisdom, and that P/Es should remain higher than history in order to reflect the Greenspan/Bernanke/Yellen Put. The bears will suggest that if ever there were a time for the scales to fall from investors eyes over the Wizard-of-Oz-like nature of the Fed, then this is it. We are inclined to the latter view. Betting on the Fed's ability to generate continued market levitation seems like a dangerous game to us, but as Newton long opined 'I can calculate the motion of heavenly bodies, but not the madness of people.'"

- James Montier, GMO – March, 2016

A prevailing view in the investment environment today is captured in the acronym TINA – "There Is No Alternative". Essentially what that means is there is a recognition by informed investors that stocks and bonds are not a great buy right now, but what else are you going to do? Elliottwave International analyst Steve Hochberg describes this philosophy in the following way:

"There Is No Alternative in not an investment strategy, it is a state of mind. States of mind change…"

We would also point out that TINA is a position taken by people who are in the business of investing money for people largely in publicly traded stocks and bonds. The folks at Harvard and Yale endowments, for example, don't follow this line of reasoning. They invest a relatively small amount in publicly traded stocks and bonds. The quote above from James Montier represents thinking inside a firm that manages over $100 billion of assets for wealthy clients and institutions.

From our own perspective we see better opportunities for our clients in certain types of real estate, in private investments, absolute return strategies, in investing in their own business or in themselves or in cash. Just think, for example, of how much more oil or copper you could buy today with one dollar than you could buy a year ago. That is deflation.

In our November 2015 newsletter "Anything Goes" we shared that one should expect Central Banks to continue their policies to the extreme. In March European Central Bank Chair Mario Draghi delivered. In our January newsletter "The Switch", we suggested that if markets rally to expect *CNBC* and other market cheerleaders to paint a rosy picture as if all the problems were solved. And, in our opinion, that is what we are experiencing today.

If we merely step back and look at the S&P 500 for the last year, we can see that there have been bouts of speculation engendering feelings of optimism and periods of selling generating some fear, but there has been no progress. In fact, markets are essentially where they were one year ago. Below the surface, quarterly earnings for the S&P 500 for the first quarter are expected to decline by as much as 9%. This would be the worst performance since 2009.

Our view is that things have changed, and they have changed for the worse in the past year. The evidence is everywhere and the Fed, the IMF and respectable economists have been continually reducing their expectation for growth.

Furthermore, given the separation between economic reality and asset prices we think that risk is higher in most asset classes than it has been since…well pick a time. That is not to say that there are not opportunities, they just might be more selective. Nor is it a time to bury one's head in the sand. Now is a time where it is even more critical to have a clear strategy for investing, protecting and growing one's wealth.

Thank you for reading and happy spring!

Matt and Tom

TINA

Executive Summary

Investment Risks and Solutions
Part 1: The smart money is selling. Both recently and over the last ten years, the smart money has been moving steadily away from the public equity and bond markets. Let's take a look.

Part 2: A recent paper crossed our desk that illustrated the potential risk in one of the most popular investment strategies – indexing. We'll share why they come to this conclusion and provide some thoughts about what strategies to consider as either alternatives or compliments to passive indexing.

Stock Market Earnings and Market Charts – A lot of emotion has been spent going nowhere while profit margins look to have peaked and earnings are deteriorating. Two major investment firms just say their revenues decline by more than 40%.

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Credit Market Charts – 2008-2009 was a credit event. Credit conditions are contracting again and we have significantly more debt than in 2007. Some think the next credit event may be larger than the last.

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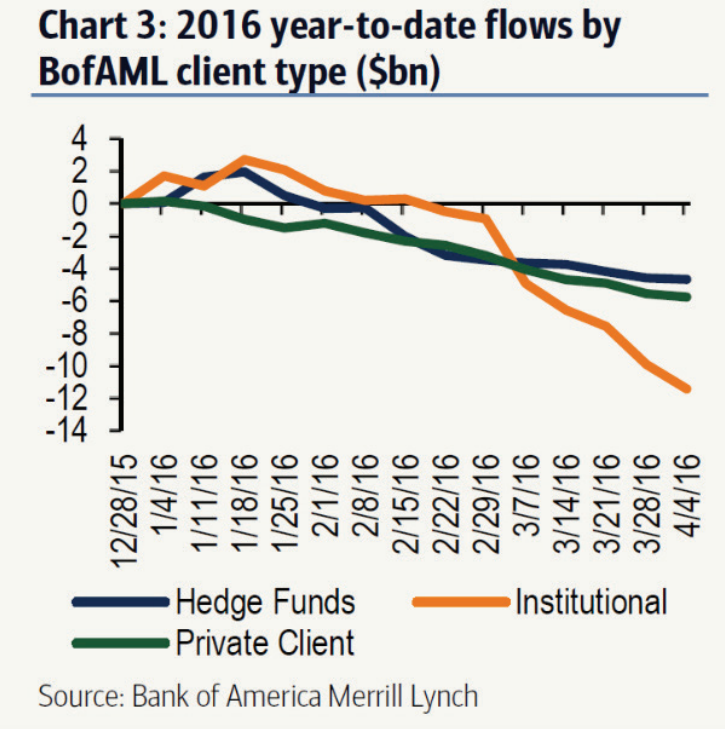
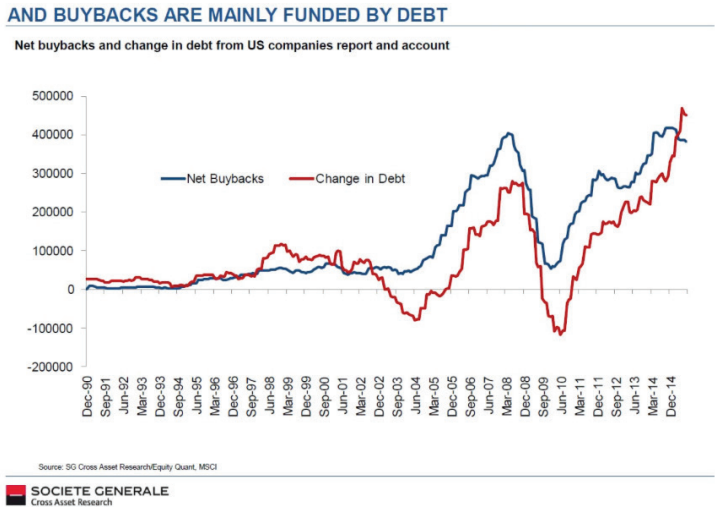
TINA

Investment Risks and Solutions
Part 1 – Smart Money Moves
Bank of America tracks the trading activity of their biggest clients. For the past 12 weeks Hedge Funds, Institutions and Private clients have been net sellers of stocks. See below:



Why is the "smart money" is selling? What is it they are concerned about? And if they are selling who is buying? According to Goldman Sachs the only real buyers of stocks has been corporations buying back their own stock. We have discussed in past newsletters how companies are borrowing money to buy back their own shares rather than invest in future revenue generating projects. Below is a chart from Societe General illustrating the growth in corporate debt funding the growth in share buybacks.

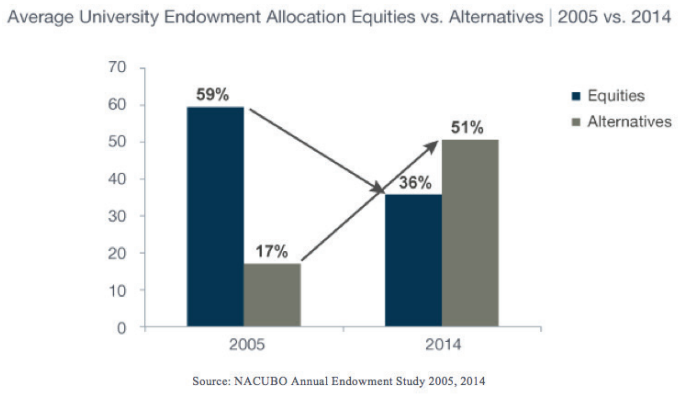


We have suggested for many years now that the economic issue of our time is excessive debt. Central banks are trying to solve a problem of too much debt by encouraging individuals and corporations to take on more debt. Corporations are doing just what the central banks want – they are borrowing money and buying their own stock. Mario Draghi understands this. This is why in his latest expansion of quantitative easing in Europe he increased the amount of purchases the bank was making each month and focused that expansion to include corporate bonds. He also recently clarified that the corporations whose bonds he is buying can include companies whose parent companies are outside the European Union. Companies can use that increased ability to raise money through debt they sell to central banks to buy more of their own stock.

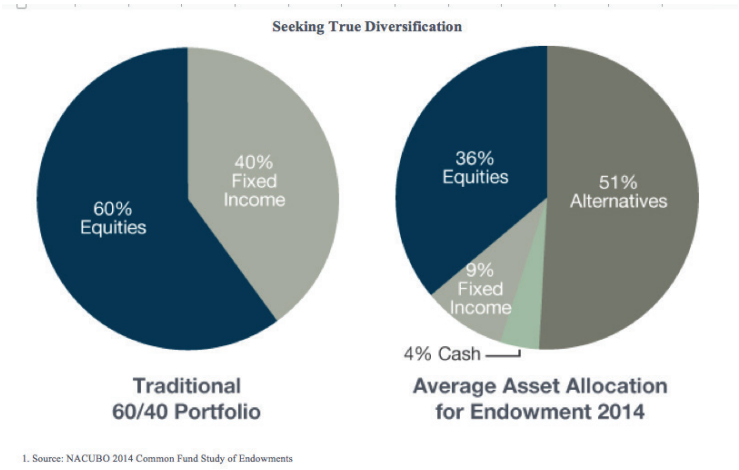
In the short-term this makes these companies look more profitable. But long-term, corporations are undermining their balance sheets and neglecting investments in future revenue generating projects. Look at this chart above again. Companies tend to be very bad timers, buying more of their own stock at highs. The last peak in corporate share buybacks was 2007. Central Banks are just making this peak bigger.

Another way to look at how the "smart money" is investing is to look at the investment strategies of large endowments and foundations. We have shared this concept with our clients for many years. The following research piece comes from investment firm Steben & Co.:

Endowments Have Sharply Increased The Use of Alternatives Over the last 10 Years



Further analyzing how these endowments allocate their portfolios, we see a significant difference versus a more traditional "moderate" portfolio of 60% stocks and 40% bonds. Endowments have as much as 53% of their portfolio committed to alternative investing strategies.



The reason the Harvard and Yales of the world invest more outside of traditional investments than inside traditional investments is to increase return over time and reduce volatility. Why the focus on reduced volatility? Because studies show that over time reducing portfolio volatility increases performance and is less dependent on timing the market correctly.

As we try to give our clients the highest probability of achieving their stated investment and planning objectives we want them to understand and employ the thinking used by the best.

Investment Risks and Solutions
Part II Hidden Dangers in Indexing:

It has been a rough time for active equity managers since 2009 on a relative basis. It has been even worse for hedge fund managers, alternative strategies and long/short managers. There has been almost nothing better than just owning the whole stock market or sectors of the stock market through index funds or ETFs for the past six years. What adds to the appeal of indexing are low costs and they appear to remove a level of human error.

We would suggest that indexing has been successful during the recent period precisely because there is little judgement or discernment about the quality of the investments held within the index or ETF. The Fed wants the market to go up – buy the market. But if Fed policy fails to keep the market up, you should expect to lose at least as much as the market.

Investment management like financial planning is about making choices based on the information you have at your disposal with the goal of reaching a stated objective. Active managers (in theory) are making decisions about the quality of the investments they choose to hold in their portfolios.

Salient Partners' Ben Hunt writes a newsletter called Epsilon Theory. In its recent release, "My Passion is Puppetry" Hunt suggests that the performance of the market since 2009 has been largely a function of marketing:

> *"This will strike some as a silly argument, but I don't think it is a coincidence that the modern focus on entertainment marketing for financial risk products began in the Great Recession and its aftermath. When the financial ground isn't steady underneath your feet, fundamentals don't matter nearly as much as a fresh narrative. Why? Because fundamentals are scary. Because you don't buy when*

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you're scared. So you need a new perspective from the puppet masters to get you to buy, a new "conversation", to use Don Draper's words of advertising wisdom from Mad Men."

We'd recommend you read the whole letter and you can find it here: www.salientpartners.com But there are two charts we want to share from the article. What Hunt is comparing in the charts is an index called the Deutsche Bank Quality Index which is long (meaning that it owns) high quality stocks and short (betting on these stocks to decline) low quality stocks – based on a variety of measures because in his words:

"Quality is the embedded bias of almost every stock picker in the world. As stock pickers we are trained to look for quality management teams, quality earnings, quality cash flows, quality balance sheets, etc."

The first chart is from February 2000 to March 2009:

Source: Bloomberg Finance L.P., as of 03/06/2009. For illustrative purposes only.

In this period, from 2000 to 2008, quality was very well rewarded rising 78% while the S&P fell 51 %. The next chart compares these same indexes from 2009 to 2016. The Quality Index is up only 10% total return and the S&P has tripled.

Source: Bloomberg Finance L.P., as of 03/28/2016. For illustrative purposes only.

Hunt's theory is that the Fed does not care about quality – they just want stocks to go up regardless of quality. Well run companies do not need the Fed's help to prosper as they have quality management teams making quality decisions. Importantly his conclusion, looking at the charts, is not to buy index strategies, but rather to understand what is happening today and the role of actively managed strategies:

"There is a role for actively managed stock-picking strategies in a puppeted market, but it is not to "beat" the market. It is to "survive this puppeted market by getting as close to a real fractional ownership of real assets and real cash flows as possible. It's recognizing that owning indices and ETF's is owning a casino chip, a totally different thing from a fractional ownership of a real world thing. Sure I want my portfolio to have some casino chips, but I ALSO want to own quality real assets and quality real cash flows, regardless of the game that is going on all around me in the casino."

In 2000 investors largely abandoned sound investment for a seat at the tech casino. Our concern today is that people are drifting further and further into ETF's and unmanaged indexes and they do not understand the level of risk they are taking.

OK Matt and Tom - What is your point after all that? Given this is the section on solutions we have several:

1. Don't chase what's hot and popular based just on recent past performance
2. Focus on quality investments with good cash flows based on real things – be it real estate, high quality bonds or high quality stocks.
3. Own some managers that have a methodology for protecting against downside market risk i.e. long/short strategy or hedge funds.
4. Understand the trends like demographics, people are getting older –10,000 baby boomers are turning 65 every day for the next 10-plus years. What will be in demand?
5. Have some strategies that can capitalize on trends regardless of if they are up or down.
6. Keep cash when the opportunities are not clear and compelling – don't just invest because There Is No Alternative. Cash would buy you a lot more oil today than it did one year ago.

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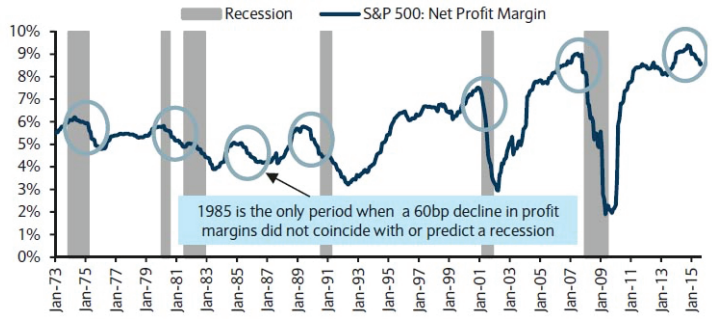
Stock Market Earnings and Market Charts

According to Bloomberg, earnings for the first quarter of this year are expected to decline by 9.5%. Given the game they play they will likely fall 5 or 6% and call it a victory. And while financial engineering continues to hide some of the deterioration, it has finally stopped making profit margins rise. Profit margins in the S&P 500, according to Societe General, peaked at the end of last year. The last cycle peak in profit margins occurred in 2007. Below is the chart from Societe General.

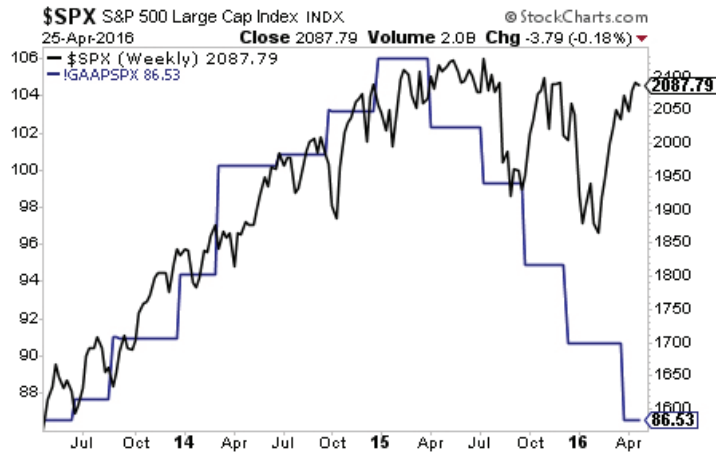
FIGURE 2
A large decline in profit margins usually leads to or coincides with a recession



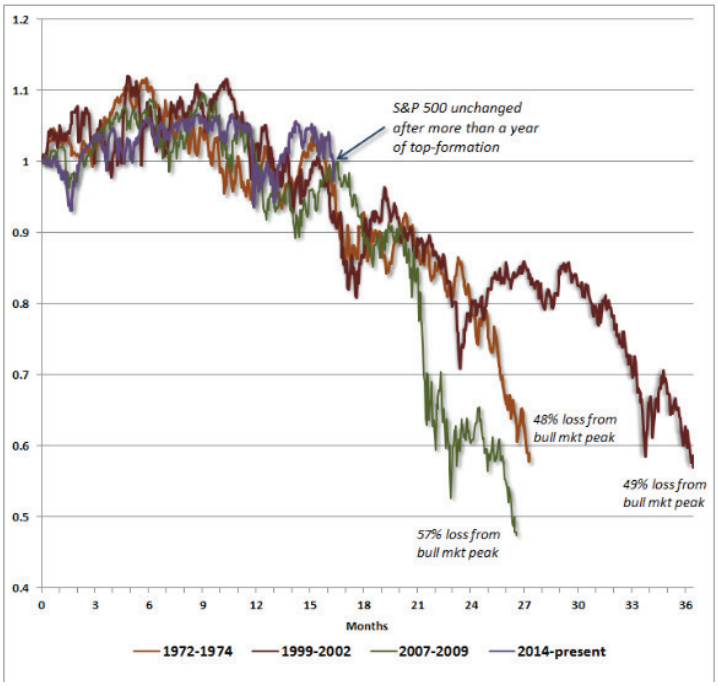
Source: Thomson Reuters, Barclays Research

Their point in the communication that included this chart is that declines in profits led to recession the last 5 out of 6 times with 1985 being the exception. It has also led to acceleration in corporate defaults.

Below is a chart of the S&P 500 going back roughly three years with earnings for the S&P 500 over the same time frame. Earnings are listed on the left axis and the S&P on the right axis. You can see that earnings have been declining since the end of 2014. We shared the charts of the last two market tops in our newsletter "Anything Goes" that showed the similarity of those market periods and this one:



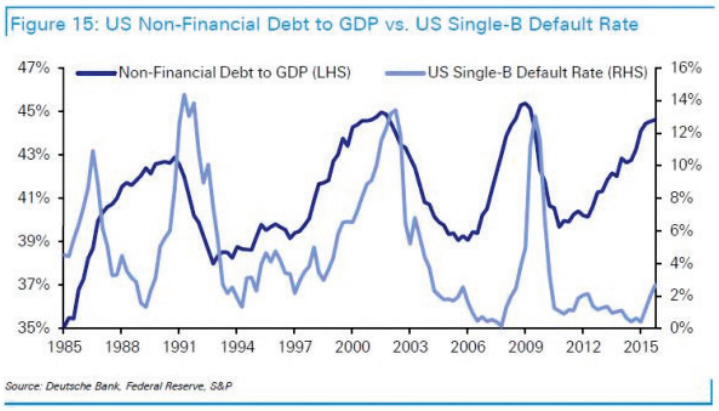
We also said in our newsletter "The Switch" that if markets rise from their slow start to the year many would be cheering as if all problems were solved. We think those conditions have been met. We would not be surprised to see the market reach a new high in the Dow over 18,300 or S&P 500 at 2134 driven by a narrow group of stocks. The same happened in 2000 and 2007 - several 10% corrections followed by new highs. We still think this is likely a topping process that the market is going through, but that is a function of market sentiment. Could there be more speculative thrusts left? Absolutely. Market tops can take a long time and God knows the Fed wants to keep things going. But just as a reference, let's look at how the last three major market peaks in 1974, 2000 and 2007 ended with a chart from John Hussman:



Credit Market Charts

As we mentioned before, the 2007-2009 financial crisis was a credit event. German banking giant Deutche Bank Global Head of the Fundamental Credit Strategy Group Jim Reid is widely respected as one of the best in the business. He recently released a report that included the following chart of non-financial debt-to-GDP and US single B (the best of the high yield or junk bond market) default rates with the preface:

> *"In the modern era of leveraged finance the debt cycle waves have been well correlated to defaults."*



In other words, what the report is saying is that when this ratio of debt to GDP gets to a certain point, default rates rise. When we say that 2007-2009 was a credit event what we mean is that there were lots and lots of defaults. People/companies/governments did not pay because they could not pay their debts. He concludes the report saying:

> *"We can therefore conclude that the pre-requisites for the next default cycle are now in place"*

And from Zero Hedge this week:

> *"Bank of America's Michael Contopoluos warned last week, it may be the worst default cycle in history with "'cumulative losses over the length of the entire cycle could be worse that we've ever seen before.'"*

On April 18th – this year Matt Krantz wrote an article in the USA Today titled: "Defaults hit highest level since 2009." The following is an excerpt:

> *"So far this year, 46 companies have defaulted on their debt, the highest level since 2009, according to S&P Ratings Services. Five companies defaulted this week, based on the latest data available from S&P Ratings Services. That includes New Jersey-based specialty chemical company Vertellus Specialties and Ohio-based iron ore producer Cliffs Natural. Of the world's defaults this year, 37 are of companies based in the U.S."*

Bank of America has a composite called "Global Liquidity Tracker" which seeks to measure in real time various relationships in spreads, asset prices, monetary and credit data of emerging and developed economies. They are trying to measure credit conditions – how easy it is to borrow money essentially. As we have mentioned before many times, 2008 was a credit event. Liquidity dried up, nobody would lend and asset prices fell. Let's take a look at what Bank of America's GLT is showing right now:

While, as James Montier put it, the Fed has been able to continue the levitation act, below the surface conditions are worsening. If you have not seen the movie "The Big Short" we would encourage you to do so. It illustrates that financial crises are predictable. People don't want to see it and after the crisis they will say that no one saw it coming, but it just does not hold up. We have greater imbalances today than in 2007. The imbalances are in different places, the outcomes may be a little different than last time, but the conditions that create problems in financial markets exist right now. Invest accordingly.

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The Big Bang Theory seeks to explain the origin of the Universe by suggesting that around 13.7 billion years ago there was a "singularity" that began the unfolding of our Universe. Physicists study the movements of planets and galaxies and have theorized that the Universe is constantly expanding and getting larger.

Philosophers have related our connection to the expanding universe by suggesting that as part of an expanding universe we have an innate desire to expand. Deepak Chopra for instance talks about how we are creators intended to create and expand.

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But sometimes we can get false signals from the world around us. When the stock market goes up and our house values go up and our incomes go up we get a sense that we are making progress. Our material world has expanded. However, our constant immersion in the material world can make us lose sight of our larger potential for expansion. It can also mask our need to change direction or make new choices. One example is how the savings rate in the US has declined with rising markets in the last 30 years. We all have come to believe that rising markets and housing values will replace the need for discipline in how we spend and save.

But there is a much larger expansion and opportunity for progress that is available to us. We can expand spiritually or expand our consciousness or expand our intellectual capacity for example. We can also expand our ability to make a difference or to handle difficult challenges we can improve our physical and mental health and expand our capacity to enjoy life and deal with stress.

In 2009 most people lost money, their houses went down in value, their incomes went down many lost their jobs. That led to a sense of loss and of moving backward. But many saw the opportunity in the crisis to learn, to adjust, to make progress and expand in a multitude of ways.

What is the progress that you are looking for? Having more money is usually not the goal but the tool to achieve a goal like educating kids, being financially independent, buying a home, starting a business, or having great experiences. What are the ways that you want to expand and experience life differently? Where can you make progress regardless of what is happening in the world around you?

Thanks for reading.

Matt and Tom

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