GVA Newsletter

November 2017

Hurricane Season

"Everything should be made as simple as possible, but not simpler." Albert Einstein

"Today's market looks like it did at the peaks before the last 13 bear markets." Robert Shiller

"We seem to be living in the riskiest market of our lives, and yet the stock market seems to be napping" Richard Thaler – Nobel Laureate

Let's keep this simple. The fact that we have something called hurricane season indicates that we have a pretty good idea when we can expect a higher probability of hurricanes to occur. In the Atlantic this is June 1 through November 30 every single year. In addition, advanced meteorological tools can tell us what the likelihood of a stronger than average hurricane season is. Certain conditions are responsible for hurricanes, warmer water, air pressure, air temperature etc. This year conditions were predicted to be conducive for a stronger, more active hurricane season than average. So far that prediction has proved accurate. Weather forecasters do not get it right every time, they are working in probabilities. But we have learned to pay attention to their forecasts and they have learned to become better in forecasting.

Today we have most of the conditions present for a financial hurricane: high debt relative to income, overvalued asset prices, very low corporate bond spreads and high level of investor optimism. These conditions are similar to mid 2007 right before our last financial hurricane as well as 1929 before the other largest financial hurricane in the past century. None of these measures can speak to the question of when things will change.

In our last newsletter we discussed the likelihood of a "Melt Up" or "Blow-off-Top", which it seems we are experiencing. The market rise over the past 8 years has been driven primarily by Central Banks holding interest rates low and buying assets to encourage borrowing and risk taking. Central Banks have created asset price inflation well beyond income growth setting the stage for the next wave of deflation or rapid inflation, or both. We perceive risk as very elevated in the most widely held assets, stocks and bonds, and believe most investors should be focused on broader diversification and wealth preservation.

The question to ask is: what to do to prepare for a hurricane? If you have the flexibility, you might not want to be in the Caribbean or on the Gulf coast for instance. But being in the Rockies is not so bad. In financial markets high growth stocks or highly leveraged investments are like beach front properties, fun to own in the nice weather, but with more downside. Boring but stable investments tend to weather storms better. Even more interesting are opportunities that have clear trends that have yet to play out and deliver cash flow. This is the idea behind value investing which is often overlooked or out of favor just before the hurricane hits.

We hope you find this information useful and informative. Thank you for reading.

Matt and Tom

Executive Summary

Big Picture:
Everything Bubble and Central Bank Balance Sheets – A cursory look at the balance sheets of major central banks around the world shows the incredible effort to inflate asset prices.

Market Valuation, Expected Return and Investor Exuberance- This has been referred to as the "Most Hated Bull Market Ever" but a step back reveals that it is anything but. Institutions realize this and are selling equities while retail investors are jumping in.

Solutions:
Endowment Model – Institutional investors appear to be allocating a larger portion of their assets to alternative investments. In particular industry leader Yale is notably overweight alternatives and underweight publicly traded stocks and bonds.

Demographics and the Trend of Healthcare Real Estate – Demographics is a powerful driver of trends and Americans are getting older by the day. One area that stands to benefit is healthcare.

Howard Marks on Investing Today – Value investing legend Howard Marks wrote this summer about the state of the market and how investors might approach the current environment.

Create Your Own Economy Corner – Failing Forward
Sometimes it pays to follow the herd, but at important times in history leaders must lead and not be satisfied with the comfort of agreement. Ultimately, we will all be known for what we stand for but that begins with standing for something.

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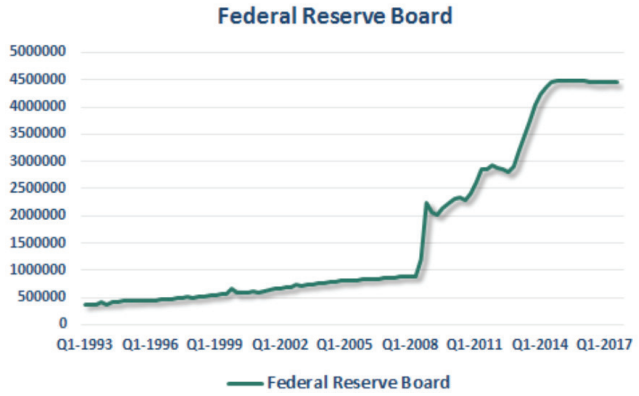
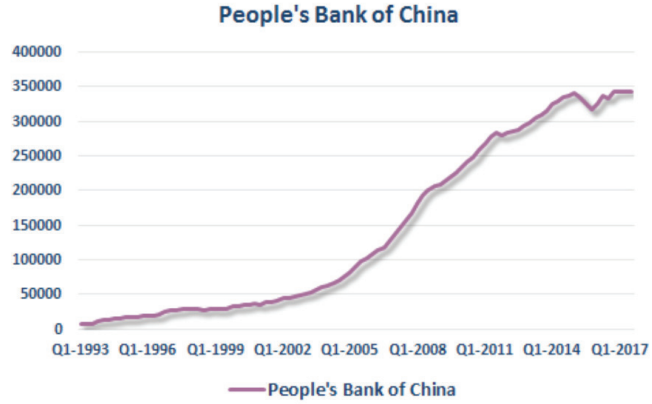
Everything Bubble

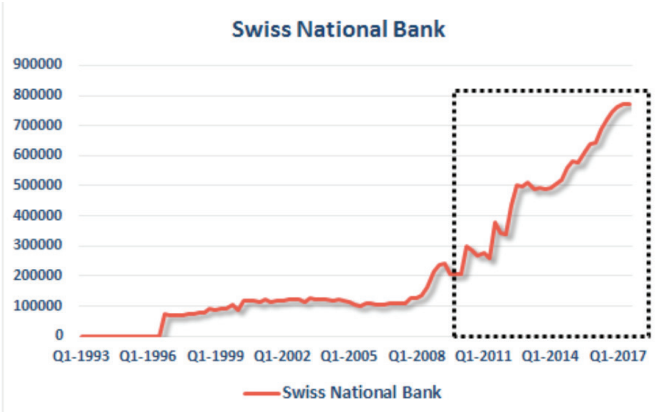
In our last newsletter we made the case that valuations were stretched and what this indicated is that long-term market returns would likely be meager while risks were high. We also made the case for a "blow off top" or "melt-up" in stocks. At this point it feels like we may be experiencing that process. None of this comes as much of a surprise. And yet we know the folly of trying to predict when this process will end.

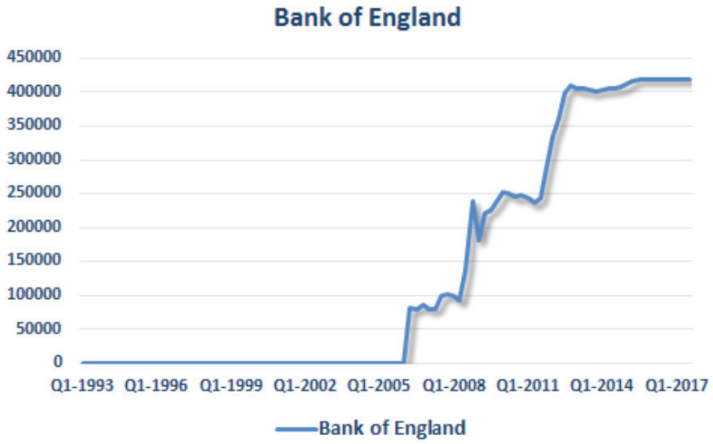
We hear daily warnings from respected market watchers of the extent of the current excesses throughout our financial system. At the same time, we see the average investor returning to the marketplace after markets have risen for an extended period of time. It feels like a bad movie and it can be a challenge to maintain a sense of balance within it all.

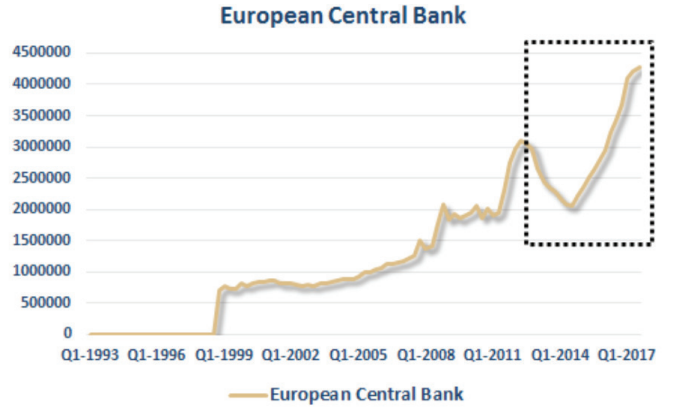
The single biggest market driver of the market's rise over the past 8 years has been the willingness of Central Banks to finance speculation and drive investors toward risk in an attempt to create an economic recovery – which for most has not materialized. Below are charts of the debt on the balance sheets of the major Central Banks going back to 1993, showing just how much they have changed since the financial crisis in 2008.











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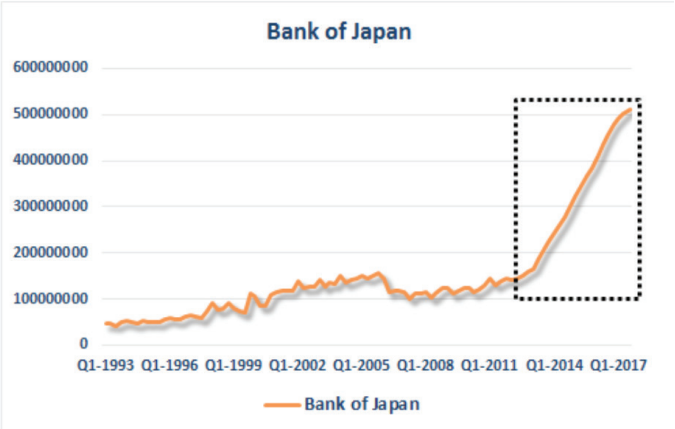
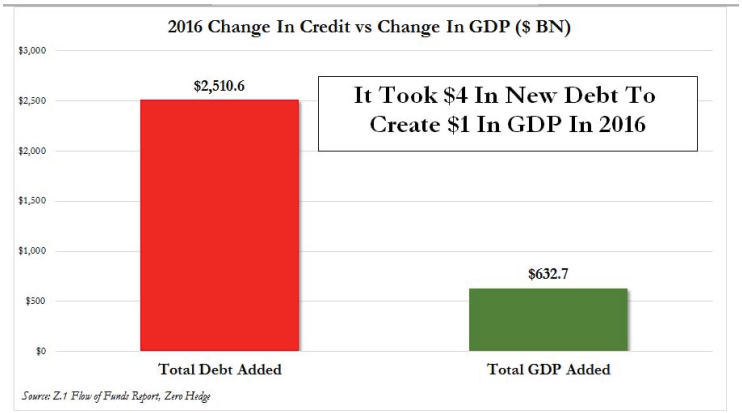
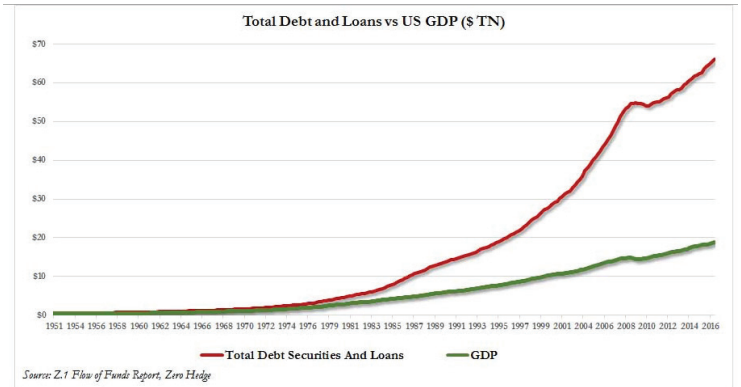


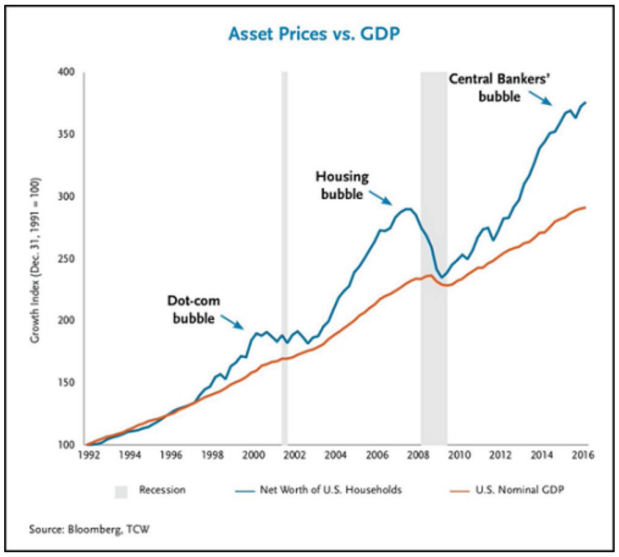
Since February 2016 when markets began the year by correcting, balance sheets have expanded by $5.6 trillion. This coordinated or at least simultaneous effort on the part of Central Banks around the world has encouraged an extreme level of speculation across all asset classes but particularly in stocks and bonds. What it has not created is a recovery in the growth rate of GDP. Below is a chart indicating that in the U.S. we added $4 of debt in 2016 for $1 of GDP:



The longer trend shows that we have been on this trajectory for some time with a brief pause in 2008:



This has led to what many refer to as "The Everything Bubble". Below is a chart illustrating the relationship of Net Worth of Households vs GDP. The shaded areas indicate recessions which tend to occur – shortly following the peak in this ratio. It should be noted that a recession does not tend to precipitate market declines, rather markets tend to peak before recessions are clear.



When this odyssey began, sceptics wondered how it might end. This final chapter has yet to be written, however, the Federal Reserve has begun its attempt to normalize interest rates and its balance sheet. Short-term interest rates are rising and inflation signals are picking up. Economic history would suggest that the process of returning to a sense of normalcy will be a very bumpy ride.

Market Valuation, Expected Returns and Investor Exuberance – What the "Top" Might Look Like

In our last newsletter we outlined the case for record valuations and low forward returns. GMO expects returns of -4.1% for the next 7 years, Hussman expects -1.5% for the next 10 years. Valuations by many measures are at or exceeding record levels. But these mea-

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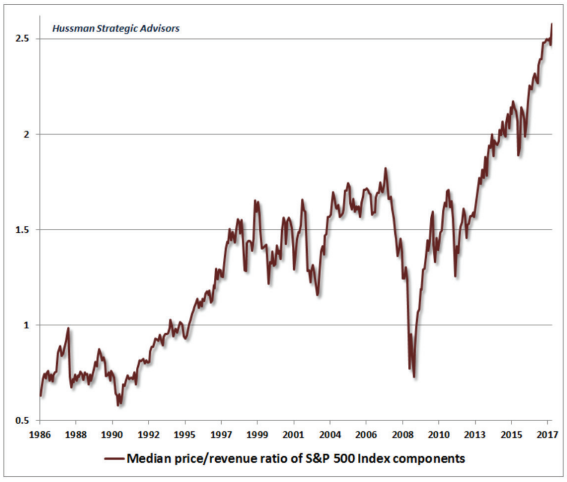
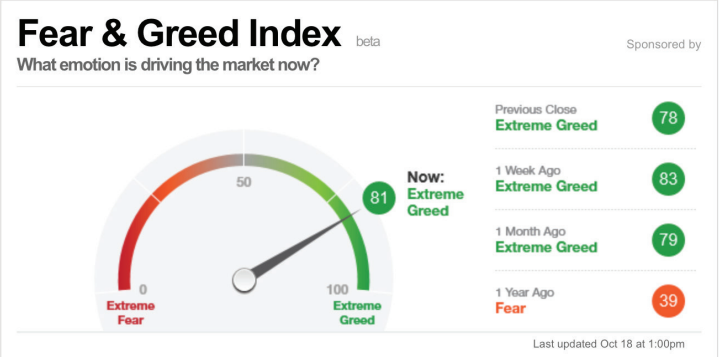
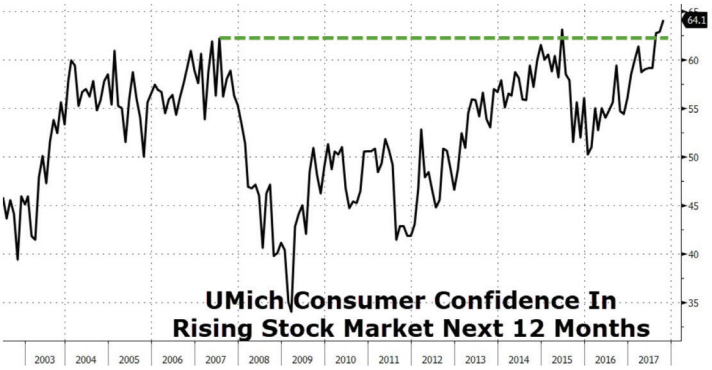
surements are not timing tools. They are, however, good tools for judging what you might expect in return for the risk you are taking. Below is a chart showing the S&P median price/revenue ratio. This is indicating that the median stock in the S&P 500 is much more expensive than in 2000 or 2007.



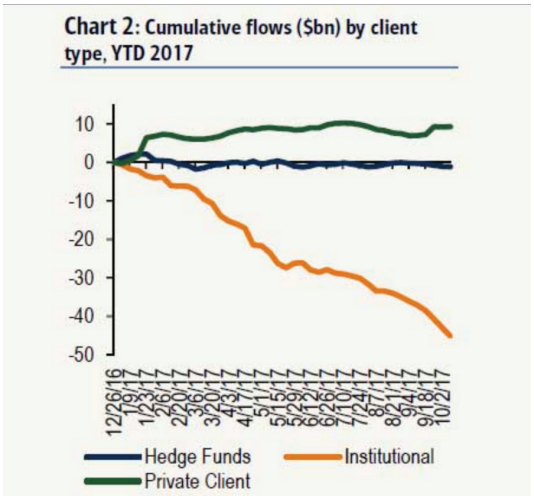
What would be expected near market tops is high levels of investor optimism which can be measured in many ways. CNN Money has a diagram that illustrates a composite of factors measuring investor fear and greed. Below is where it stands currently:



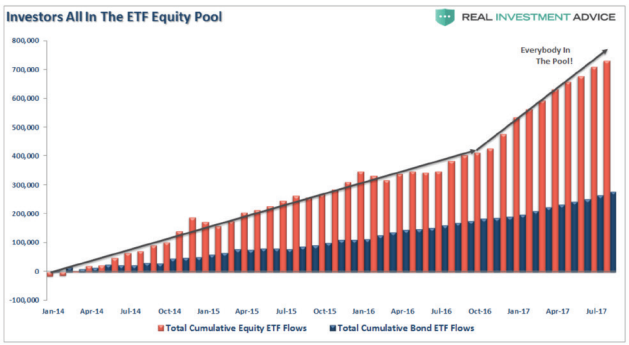
We are seeing extremes in the low allocation to cash among professional and retail investors, the lowest level of volatility ever, extremes in the amount of debt and quality of debt held by consumers, businesses and governments and extreme lows in bearish sentiment. These are all signs of extreme optimism about the future. The last domino to fall in this game is usually the retail investor. Below is a chart of the University of Michigan Sentiment Survey showing the percentage of respondents expecting stocks to rise over the next year. It is the highest reading ever.



The next chart comes from Bank of America showing fund flows over the last year. This is indicating that institutions have been selling stocks to retail investors. In other words, the "Smart Money": pensions and endowments, are selling their expensive stocks to retail investors who have been waiting until now to get fully invested in the market:



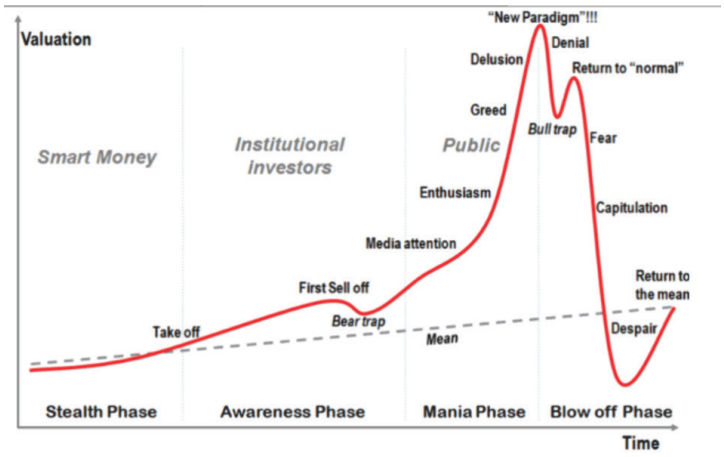
What we think in hindsight will be the biggest threat to markets is the herding into passive investments by investors. Below is a chart of the fund flows into passive stock and bond strategies. Many of these strategies have more invested than the value of their underlying holdings.



The previous record inflow to passively managed funds and ETF's was $160 billion in 2014. In the first half of 2017 these strategies saw over $500 billion of inflows which would translate to $1 trillion for the year equaling six times the previous record. Jim Rogers, who worked with George Soros on the Quantum Fund, recently said in an interview with Steve Diggle of Real Vision the following:

> *"Steve: So there are excesses developing in the ETF business?...Jim: There's no question about that. But don't worry Steve, we're going to have a bear market. And when we have the bear market, a lot of people are going to find that, oh my God, I own an ETF and they collapsed. It went down more than anything else. And the reason it went down more than anything else is because that is what everybody owns."*

The chart below shows the psychological pattern of market cycles that have played out time and time again. We included this in our last newsletter. Take a look again and notice at what stage institutional investors are buying and at what stage the public gets more involved.



There are so many extremes occurring today that we could fill a book with charts and data. But none of this provides a crystal ball so instead we take a look at where the institutions are moving their money to.

Solutions:

The Endowment Model

As we seek out ways to help our clients achieve their goals, we lean on the investment wisdom of the group that, in our opinion, has the most interest in meeting long-term return objectives rather than beating benchmarks over short periods to attract new capital. Our experience over the last 24 years has been that endowments, as a group, fit this mold. Below is a chart of where endowments have been allocating the capital they are charged with managing:

Where Are Endowments Investing?

Asset Class	2009	2010	2011	2012	2013	2014	2015	2016
Short-Term Securities/Cash/Other	4%	5%	5%	4%	3%	4%	4%	4%
Fixed Income	13%	12%	10%	10%	10%	9%	9%	8%
Domestic Equity	18%	15%	16%	14%	16%	17%	16%	16%
International Equities	14%	16%	17%	15%	18%	19%	19%	19%
Alternative Strategies	**51%**	**52%**	**53%**	**54%**	**53%**	**51%**	**52%**	**53%**

Source: National Association of College and University Business Officers , 2016 NACUBO-Commonfund Study of Endowments. Diversification does not assure a profit or protect against losses in a declining market.

Note that the investment objectives of endowments may be significantly different from that of individual investors. Investors should carefully consider whether the use of alternative investments is appropriate in their own portfolios.

What you will notice is that as a group the largest allocation is to Alternative Investments. This category includes: Absolute Return, Hedge Funds, Real Estate, Commodities and Managed Futures, Energy, Private Equity, Private Loans and Venture Capital. While not all of these strategies are appropriate for the average investor, changes in the investment landscape over the last 20 years have made many of these investments much more accessible to the average investor than they once were.

What you might also notice is the relatively low allocation to publicly traded stocks and bonds. To take this a step further, the endowments that have been considered the most successful in recent history have been Harvard and Yale's. A quick search on Google will show you what Yale's target allocation is for 2018. Here it is below:

Yale's One Year Investment Return is 11.3%

Yale continues to maintain a well-diversified, equity-oriented portfolio, with the following asset allocation targets for fiscal 2018:

- Absolute Return — 25.0%
- Venture Capital — 17.0%
- Foreign Equity — 15.5%
- Leveraged Buyouts — 14.0%
- Real Estate — 10.0%
- Bonds and Cash — 7.5%
- Natural Resources — 7.0%
- Domestic Equity — 4%

Source: Yale Investment Office. Investments.yale.edu *October 1, 2017*

Incredibly, Yale's endowment is targeting only a 4% allocation to publicly traded U.S. equity in 2018 and a slightly larger allocation to international equity. There are a few reasons for this. One has to do with their understanding of valuation and cycles. Another has to do with their need to match assets with liabilities – this is particularly the case for pensions. Yet another reason for the kind of diversification seen in endowments in general is the desire for "low correla-

tion" with traditional assets. In other words, they are seeking assets that can deliver returns that do not behave the same way as stocks or bonds. This helps to reduce volatility seeking to produce more consistent returns that are less dependent on timing.

This over-all framework is just a place to start. While we are concerned with the levels of valuation across most asset classes, we look at specific markets and tend to identify where our clients might have a higher probability for cash flow and growth. One of the macroeconomic indicators we follow is demographics.

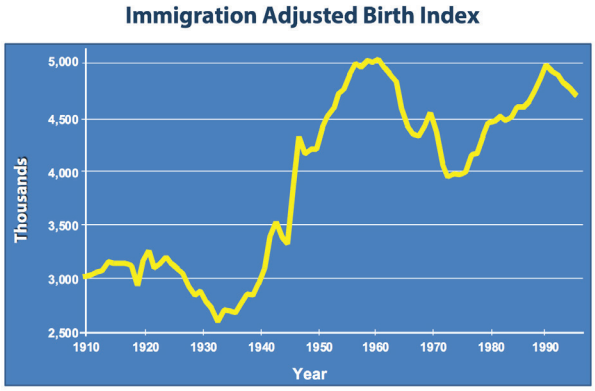
Demographics and the Trend of Healthcare Real Estate

David Rosenberg of Gluskin and Sheff, formerly Chief Economist at Merrill Lynch, puts demographics above all else as a tool for understanding the future of financial markets. The three "D's" he often sights are Debt, Deflation and Demographics. For a brief period in 2014 and 2015 Rosenberg became optimistic about the prospects for wage inflation, but he no longer sees that as a likely outcome and now expects low growth and low yields for a long time. This quote is from one of his July 2017 newsletters:

> *"So what to expect going forward has been what is already happening this cycle which is that aggregate growth in incomes and spending will be decelerating, and will be posing additional deflationary pressures in the economy, and this in and of itself will ensure that bond yields remain extremely low."*

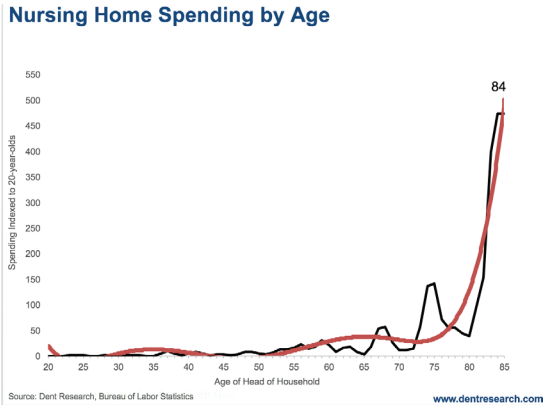
We will see how that plays out, however economists Gary Shilling, Lacy Hunt, Albert Edwards, Harry Dent, and Steve Keene all agree with this basic outcome. But demographic trends also point to where demand is growing in our economy. One of those trends is in healthcare and, in particular, healthcare real estate.

To get a picture of what demographics might teach us, below is a chart on the immigration adjusted birth index. What this is illustrating is the large cohort of our population between 1946 and 1964: the Baby Boomers. Marketers have long followed this crowd to see where the spending will be:

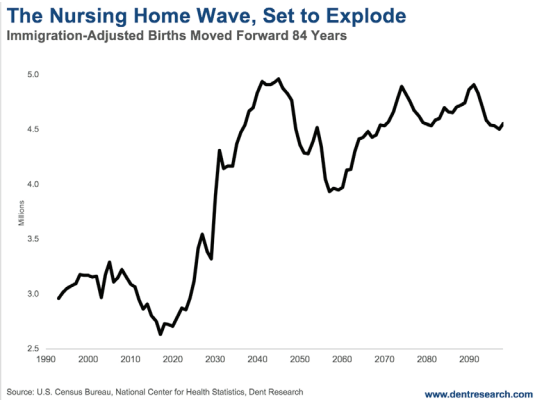


Source: H.S. Dent

The next chart is the demand for skilled nursing care by age. Notice that demand for skilled nursing care skyrockets at age 84.



Now if we take the Immigration Adjusted Birth Index and push it out to reflect the pattern of when our population turns 84 you will see that we are at a very low point of 84 year olds in our economy. But you can also see that this is about to change quite dramatically and grow for the next 20 years roughly.



Healthcare real estate has one of the highest average yields of any asset class. And demand for this asset class is likely to climb. Furthermore, healthcare tends to be relatively recession resistant, and

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it is already the largest segment of our economy. There are many ways to invest in this sector which is a topic of discussion with our clients. Our belief is that while many areas of investment are built on very flimsy fundamentals with the hope of promised growth that fails to materialize, this is a trend that has more reasonable support in the present and the future.

Howard Marks on Investing Today

Howard Marks is an investing legend. He describes the current market environment not as a bubble but rather "high and therefore risky." His July 2017 newsletter titled "There They Go Again…Again" received a lot of attention for its focus on caution as a prescription for today's investing environment. From the newsletter:

> *"If you refuse to fall in line in carefree markets like today's, it's likely that, for a while, you'll (a) lag in terms of return and (b) look like an old fogey. But neither of those is much price to pay if it means keeping your head (and capital) when others eventually lose theirs. In my experience, times of laxness have always been followed eventually by corrections in which penalties are imposed."*

Marks goes further to outline a set of limited options investors have in today's low return world.

1. Invest as you always have and expect your historic returns
2. Invest as you always have and settle for today's low returns
3. Reduce risk to prepare for the correction and accept still lower returns.
4. Go to cash at near zero return and wait for a better environment.
5. Increase risk in pursuit of higher returns
6. Put more into special niches and special investment managers.

To give you the Cliff Notes version, he believes that a combination of 2, 3 and 6 make the most sense.

Investing is about balancing risk and return. What gets lost at tops and bottoms of markets is that things will always change. In 2000 people thought tech would go up forever, in 2002 some thought it would never come back. In 2007 people thought real estate would never fall, in 2009 people made choices to never own real estate again. It is at peaks and valleys of markets when investors become the least disciplined. This is a hard lesson we have learned first-hand over our 24 year careers. For us this is not a theoretical exercise.

We take the advice of Howard Marks to heart as well as the disciplined practice of endowment models. Our goal is to give our clients the best chance of achieving their goals, keeping the full market cycle in mind. We continue to seek out special niches in the markets like healthcare real estate and energy infrastructure, and special managers in the tactical and absolute return space. If history is any guide, there will be many opportunities ahead to invest in wide areas of the market at better valuations with healthier prospects for return at lower risk levels.

Create Your Own Economy Corner - Falling Forward

What moves you? What do you really want? What is your life about? If you read the stories about the most successful people in the world there is a common thread or theme. They all had a burning desire to achieve something and the persistence to see it through even in the face of periodic failure.

These are uncommon characteristics, which is why most people do not achieve the level of success that they desire for themselves. Perhaps the most well-known book about the psychology of success is Napolean Hill's "Think and Grow Rich". This book has inspired countless authors and speakers in the world of personal growth. Napolean Hill credits influences such as Ralph Waldo Emerson and Andrew Carnegie in developing his philosophy of success.

What is not as well-known is just how much failure Napolean Hill faced in his life and how much that contributed to his ability to write about success. The same can be said of Abraham Lincoln who faced countless failures in his life before becoming one of our country's most beloved leaders.

Today, one of the most respected figures in the world of finance is Ray Dalio, founder of Bridgewater Associates, the largest hedge fund in the world. Ray Dalio recently released a two-part book called "Principles". In it he details principles that he has accumulated over his lifetime that have led to his success in business and in life.

Once again, what stands out in Dalio's life story is not a record of success after success, but rather a process of trial and error. In some cases, incredible error. For example in 1982 Dalio was building his investment consulting business and had gained enough of a following to be the featured guest on the most watched financial show of the time – Louis Rukeyser's "Wall St Week in Review". On that show Dalio made the case that the US economy was entering a depression "There will be no soft landing, I can say that with absolute certainty because I know how markets work." What ended up happening instead was one of the most robust economic recoveries and bull markets of all time. In spite of that epic and very public failure, today

Dalio presides over the largest hedge fund in the world managing over $150 billion in assets.

In the introduction to his book, Dalio describes the value of failure:

> *"I learned my principles over a lifetime of making a lot of mistakes and spending a lot of time reflecting on them."*
>
> *"I believe the key to success lies in knowing how to both strive for a lot and fail well. By failing well, I mean being able to experience painful failure that provide big learnings without failing badly enough to get knocked out of the game."*

Dalio then diagrams the pattern:

Audacious goals –> failure –> learning principles -> improving-> more audacious goals.

Dalio's point, echoing many who have gone before him, is that failure is just a step along the way to your goals. Only you can keep yourself in the game or take yourself out. In this way you are ultimately in control of your destiny.

Matt and Tom

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