The Long & Short of It

Quarterly Newsletter
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Chrysalis

We have seen this moment before. Like a butterfly about to emerge from its cocoon, our approach awaits its moment. Midway through the sixth year of this bull market, our value-oriented, somewhat contrarian equity strategy has been generating solid returns but recently has been lagging the market. Here we review the first quarter of 2000 and second quarter of 2007 to put the second quarter of 2015 in perspective. Then as now, a hot stock market that had been fueled by monetary policy and massive debt expansion was exhibiting narrowing leadership, leaving prudent investors feeling left behind.

Confidence is most difficult to sustain just before the strategy shines. It is a moment for us to say "Thank you" to our clients. We are grateful for your patience and for sharing in a common understanding of the approach. Much like the caterpillar that stores up energy to demonstrate its purpose, this is exactly the moment in which we more fully embrace our disciplines.

Looking Back

From our first quarter of 2000 *Long & Short of It,* when the S&P 500 index rested above 1,500, we wrote:

> *Extreme valuation levels are a sufficient reason to expect a correction, but predicting when it will occur is a much more challenging task. Tightening liquidity gives us a catalyst that might cause one to expect the correction sooner… A large supply of stock hanging over the market introduces the possibility of a larger, more sustained correction…unprecedented levels of margin debt in the midst of these other factors introduce a greater likelihood that some investors will panic causing a severe correction.*

By September 2002, the S&P 500 had declined almost 50% to 800. In the letter discussing the second quarter of 2007, with the S&P 500 again over 1,500, we wrote:

> *When the average investor finally tunes in to the opportunity of the latest boom, the boom usually begins to unravel.*

By September 2009, the S&P 500 was below 700, a more than 55% drop.

Today

The S&P 500 recently peaked above 2,100. With the end of Quantitative Easing in October of 2014, the Federal Reserve began to tighten monetary policy. Much like the earlier periods of 2000 and 2007, we are beginning to see manifestations of that tightening. Conversations about the lack of liquidity in the bond market are a constant among its institutional participants. Central banks own (and have removed from the markets) huge quantities of debt and regulators do not want investment banks trading debt on a proprietary basis anymore.

Greece and Puerto Rico are facing debt crises right in the midst of a global economic upswing. This will tighten liquidity further. The European Stability Mechanism (ESM) has no loan-loss contingency reserves. The only way it can deal with a default is to issue more paper or have the member countries sell bonds in their own countries to support the debt. As we mentioned, issuing more sovereign debt is becoming a less viable solution with each bailout. Germany would need to raise approximately 35 billion euros by selling Bunds (German government debt) just to cover Germany's share of ESM losses on Greek bonds. Greece looks like the Lehman Brothers of Europe in this cycle and Puerto Rico may be our Greece.

Moreover, the presumably independent Fed still faces growing, significant political pressure to raise interest rates, specifically to end the zero interest rate policy it began in December 2008. Yet economic growth is not robust and deflation remains a concern. Meanwhile, valuations on equities are full-tostretched. Any further increase in interest rates would be damaging. The supply of stock is also growing very rapidly. June had more IPOs than any month since August 2000. Finally, margin debt (covered in last quarter's letter) remains at extremely high levels. The stock market faces the prospects of a significant policy error by the Fed, or at least a short-term shock if there is any contagion from Greece and Puerto Rico—or if the Fed raises rates earlier than Mr. Market expects.

Most governments across the globe dramatically increased their sovereign debt during the credit crisis of 2009 to stem declines. China was the lone exception in not issuing massive amounts of debt. For a while, it gave us some comfort that China still had dry powder for the next global credit squeeze. But its stock market has fallen about 25% since mid-June. Although it is still up more than 100% over the last year, China's government has closed its IPO market, formed a "market stabilization" fund and will inject capital into China Securities Finance Corporation (owned by the securities regulator) to expand brokerages' business of financing investors' stock purchases. Much of China's market rise paralleled a dramatic surge in its debt load (government, corporate, and household) to an unsustainable 282% of GDP, according to a recent McKinsey Global Institute report.

When the momentum of private sector credit creation finally turns down, this time will be different because governments will not find it as easy to issue massive sovereign debt and bail out every failure. Does a debt crisis without the sovereign debt backstop become a currency crisis?

Tomorrow

So now, ever more deeply, we embrace the disciplines that have helped us to weather these storms successfully over the past 30 years. Solid industry-leading businesses with defensible balance sheets and proven track records of sustained profitability, coupled with tactical and cyclical adjustments to portfolio exposures, mitigate the risk inherent to any equity portfolio while still delivering premium equity returns over the long-run.

In summary, our defensive approach lags in the last innings of the bull market. It is always an emotionally challenging moment to stick with it. Invariably, this occurs right at the moment one should embrace the strategy most deeply. The discipline applies not only to the identification of affordably priced stocks, but also to the emotional self-control that must be exercised when results lag as markets run. At these times, it becomes so tempting to break with our research and discipline. It is a defining moment. This sentiment was communicated in April of 2000, very near the market peak, when we said:

> *We welcome a return to a more rational pricing environment by nearly any means. We own companies with solid businesses and proven track records of sustained profitability; and we own them at historically low multiples. In the long run, profits will come…As usual, we continue to search for low risk opportunities to grow wealth in equity markets and will not compromise our disciplines, which have stood the test of time.*

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