Holland Macro Views

Three Cycles and Margins of Safety

We see pockets of value in today markets, but they are getting smaller; as a result we think a little caution is warranted. This is not due to, say, any major economic crisis we might foresee, but rather just to the lower margin of safety that higher share prices result in. We also suggest a few too many investors and commentators are either anchored to past beliefs or have let ideology stand in the way of a rational assessment of markets in the last few years. We continue to like the prospects for the US economy, and its banking sector in particular, but it is getting a little crowded here in the "Be Bullish on America" fan club! Otherwise we continue to search for value in Special Situations and reflect longingly on those 2010-2012 'Tri-Factor' opportunities, i.e. when we were able to buy Great companies run by Great managers at Great prices.

The Dangers of Anchoring…

If an investor was bearish for the right reasons before the crisis it was much easier to turn bullish when they felt the cycle had run is course. Conversely, if one saw little wrong with the investing world in 2007, it likely took a few years to realise the scale of the economic challenge the world soon faced. As some stage fear took over and maybe some turned bearish a year or two later – just as the market troughed. This was arguably the case for the average global investor and as a result many of their subsequent assessments are likely affected by the psychological misjudgements such as Anchoring or Confirmation Bias. Many believe they are being objective but often they are just framing each new piece of information to fit with their previously-held view. I know this feeling pretty well having been a UK housing market bear for so long it is laughable – in this asset class my objectivity has often been poor as I sought to reconfirm my existing view (likely, I still do!).

…. and ideology

Equally, ideology is another trap it is easy to fall into. Most of us see occasional examples of individuals in our everyday lives that are too tied to an extreme dogma (often political or even religious) to see things objectively. There are plenty of these individuals in the stock market too, examples being the Perennial Bear, or the Conspiracy Theorist. The latter would have you believe that each twist and upward turn of the stock market is a fiddle, orchestrated by central banks and politicians. For such people (a few of which were Credit bears before the down cycle began and therefore have real credibility – but not many) every step up in the stock markets c.200% rise in the last 5 years has been a fake. I take a more sanguine view.

A more objective look at money printing

I have always observed money printing in a rather different light to the Conspiracy Theorists. Like most others, I never thought I would witness it in my investing lifetime, let alone three times in five years. But I was also a Credit bear and very fearful of the deflation that could follow. As such I remain open-minded as to whether any negative long term implications of money printing (as yet unknown) would justify having not intervened at all. Very relevant to such a debate, but rarely considered, is the starting price for the assets QE likely affected.

As an example let's consider two alternative assets:

- Asset X – whose price has fallen 50% and is valued at a 30% discount to its intrinsic value
- Asset Y – whose price has fallen 15% but is valued at a 30% premium to its intrinsic value

If money printing were to drive the price of these two assets higher arguably all it would be doing to Asset X is helping it get to its intrinsic value, whereas in Asset Y it could be creating a bubble and thus distorting the market and creating future problems. Simply put, at the point of initial QE in 2009/2010 the price of US equities (and many other US economically-sensitive assets) looked like Asset X. By contrast I assessed (wrongly so far) that UK house prices, were closer to the definition of Asset Y. Maybe long bonds were/are Asset Y too? When the Conspiracy Theorists call 'foul' at every twist and turn this consideration of starting value vs. intrinsic value on the assets affected by QE is rarely, if ever, considered. But I think this is highly relevant when we are considering the resulting rise in assets prices that followed. As ever, value matters.

Of course, there is greater complexity

I can almost see the bears bristling as I write this. Of course I realise there are many interlinked complexities, not least the fact that the economic activity on which the equity markets intrinsic value is based was helped hugely by the same money printing. However, maybe the case for economic intervention is the same as in the example of asset prices X and Y: i.e. it can be justified in highly extreme circumstances when an economy is looking like it will soon be operating at way below its normal output, but clearly not at any other point in time. As we are all living in a real life experiment we will only know the answer to this question some years from now.

I share the sentiments expressed by the likes of Ray Dalio and Jamie Dimon in the past year or two, expressed in these articles/letters

Ray Dalio's article: http://tinyurl.com/87y78h2
Jamie Dimon's letter: http://tinyurl.com/l6ujsq4

They I surmise, like me, would have never voted for money printing 10 years ago but the circumstances demanded it and thus it was the correct action. What has also always made the link between QE and raising equity prices a little too simplistic in my mind, was that much of the liquidity created actually stayed inside the banks. Huge amounts of new money was indeed been created **but**, normal multipliers of money supply were not occurring at that time or for a long while afterwards, hence why QE was needed in the first place. As annual spirits have recovered so have money multipliers. Our reliance on money printing thus has been gradually reduced – Dalio and Dimon get this point. Dalio even went as far as to describe this recovery cycle as 'A Beautiful Deleveraging'.

Three Cycles – Not One

I have long believed that there are three different cycles at work as an investment backdrop: The Economic Cycle (commentated on by all), the Political Cycle and the often ignored Stock Market Cycle. Ironically, the time spent thinking about each by investors is often inversely proportional to the actual impact it is likely to have on investment performance. Politics and the Economy receive much airtime but the Stock Market has cycles of its own, but because they are often unexplainable and thus tend to be largely ignored.

The ability to explain 'Mr Market' has always evaded us

> *On Monday May 29th May 1962 the stock market fell 35 points in a single day. This was a huge fall at the time of c.7% of the markets value and the greatest single fall since the 1929 crash. It also happened on an extremely high volume of trades, causing widespread panic. The next day, with many looking at worrying parallels of 1929, the market fell very hard again in the morning session with many stocks off significantly. The President of the US Chamber of Commerce, Mr HL Pumley, chose to make a speech that day to address the issue. In it he launched a scathing attack on the policies of then US president Kennedy and how they alone had brought the economy to the brink of this Abyss. The tone was said to be one of "I told you so".*
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> *In those days, at such times of market panic the ticker displays of share prices and news could be much delayed. The result was that just as his speech was being relayed to investors at midday on the second day of the crash with all prices again down sharply, prices did what no one expected - they started to recover…. and boy did they recover. By the end of that Tuesday rising 27 points - the day of his speech. On the third day they rose a further 9 points thus recovering all of their initial losses.*

Many try to explain movements of markets as Mr Plumley did, but most are not as unlucky as him in their timing. Bear markets, booms and panics are all stages of Stock Market Cycles; sometimes they reflect economic or other concerns but just as often they markets just fluctuate. It is our job to accept such fluctuations, not pretend we can forecast markets too accurately and focus our attention on acting when we find individual companies whose shares we see as significantly mispriced. Three years ago there were was much mispricing, today there is less.

Many great investors (the ones we follow anyway) are superb business analysts and identifiers of mispriced value but more than a few others have made great fortunes by being callers of these market cycles. Whilst this is not something we claim to possess any skill in what-so-ever pretending these cycles do not exist is foolish. Long ago, Ben Graham referred to such market phycology as 'Mr Market'. Many of us cannot read his moods, but we should accept he exists and use only the presence of value offered to decide on our level of investment conviction not guesswork on his likely future level.

Does this help assess equities now..?

We suggest that 'anchoring to past views' and ideologies surrounding money printing explain many investors cynical views of the markets today. Rather than considering what unknown economic scenario might upset equity markets we are inclined to observe that what we have been experiencing is just another stock market cycle. It has been a bullish one for some years now borne out of low starting-valuations and extreme fear. Maybe this phase will continue for a while yet, or maybe it is time for a correction. If a correction does come we must be careful not to jump to explain it too quickly, or listen to others that do so either.

Very, very, few investors ever made their fortunes calling the level of the overall market. An easier call today for someone that looks for value and mispriced franchises is to state openly that such pickings are a little slim. This view is not borne out of a worry that a QE manipulated market is doomed to fall or the belief we can predict the economy better than others, merely from an honest assessment of what value we are able (or not) to find using a wide variety of value based approaches. We can find enough to make a small portfolio, but only just. That said we must still

accept that vs. many other asset classes equities offer relative value. That tells us a lot on the value (or lack of it) in bonds!

> *"The less the prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own"*- Warren Buffett

Some in the US equity market are happy paying a lofty multiple for newly floated 'growth' stocks in the hope other more optimistic investors will soon take them off their hands. Equally the speed with which activists can take stakes, agitate and achieve corporate change sometimes leaves little time for a slow, quiet consideration of the deeper value offered in more troubled Special Situations. Such traits are evidence of the recovery of the very animal spirits that policy makers wanted to revive. Whilst such behaviour itself does suggest an imminent market problem, in fact in some ways it suggests business sentiment has recovered more fully, they do suggest we should conduct ourselves as the quote above urges … prudently.

The key point is the current absence of Value and Quality combined in a single investment. We still see it in pockets but in no more than maybe 10-15 companies globally (of which 1/2 would be US banks!). We can find quality companies, but we do not assess them as quality investments due to the price we must pay for them. Equally we can identify what looks like 'Value' but often it comes with a catch such as an uncertain cyclical outlook, declining fundamentals or a need for radical surgery. Such Special Situation ideas always exist but we are finding fewer today at the absolute valuations that we think should accompany them.

Not a time for buckets

In his 2010 letter Buffett famously reflected that such down cycles do not come along very often. As such he observed *"when it is raining gold reach for a bucket, not a thimble"* With many investors having money in their pockets today but unsure what to do with it we can now reflect on the wisdom of such insights at that time.

As stated earlier we like the outlook for the US economy and the Dollar, but it seems all now feel the same way. Equally we thought it interesting that in the recent European banks stress test the regulators chose not to have a 'Deflation' scenario. We found this interesting and instructive at the same time – only 2 months later the Eurozone reported it first EU wide Deflation figure since 2009! It has been clear to us for some while that the EU and US economies are likely for some time to be operating at very different speeds, but again most are now of this view.

We have used the analogy before of suggesting that investing is like driving a car. Looking at the macro- economic drivers is like looking at your mirrors; it is a wise thing to do to get a little perspective, but you would be crazy not spending the bulk of your time not looking through the front windscreen (i.e. searching for quality companies and value in areas where others are not). We will keep checking our mirrors but also suggest that now is not a time for 'buckets'

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