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Confusing Brains with a Bull Market

Dear fellow investors,

It is hard to think about 1981, my first full year in the investment business. Three-month Treasury bills were paying 18%, longer-term Treasury bonds yielded 15% to maturity and cheap stocks got 20% cheaper. In the summer of 1981, we saw a stock market decline from an already depressed market trading at eight-times after-tax profits down closer to six times. Participation in the stock market was down to 13.2% of U.S. household financial assets at the market bottom in 1982.

Inflation was high, gold was popular and energy stocks peaked at 28% of the S&P 500 Index. Investors were sensibly choosing to earn interest or make a speculative bet on high inflation. Companies sold shares to raise capital because the banks had to charge a 20% rate for its "prime" customers. Equity was dear, but it was the source of capital in the absence of borrowing sources. Horrid stock markets for 15 years and a 30-year bond bear market made investors feel brainless.

Fast forward to today. We are in a nearly polar opposite circumstance. Interest rates range from 0.5% to 3% on Treasury debt instruments. The major stock indexes trade for 20 to 28 times after-tax profits. Companies rarely sell shares on initial or secondary public offerings, because money can be borrowed cheaply and/or alternative investment funds are drunk with excess cash from institutions. These institutions are chasing private equity and venture capital bonanzas in the privately-held and highly-illiquid markets. The number of public companies in the Wilshire 5000 has busted the use of the name because there are only 3,600 of them left. Participation in the stock market was up to 38% of household financial assets, before the rally in 2017. It appears we are confusing brains with a bull market.[1]

Two of the finest investors of all time, Warren Buffett and Jeremy Grantham, are pointing out that today's low interest rates justify the prices of the average S&P 500 stock. Grantham insinuated recently that corporate profits as a percentage of GDP might have hit a permanently higher plateau, even though his long-term market forecast has been too bearish on stocks for three years. Furthermore, Buffett is ignoring the bearish advice he gave in his talk in the summer of 1999 at the Allen and Co. M&A boondoggle. In his talk, he examined stock prices in relationship to interest rates and corporate profits. The rates are lower now and the corporate profits as a percentage of GDP are much higher today than in 1999. It appears we are confusing brains with a bull market.

Growth and momentum investors have clobbered value managers. Price-to-earnings ratios don't seem to matter much and it is hard to tell what companies are actually earning because of all the equity comp not included in what is called "operating income." The low-cost S&P 500 Index funds, so successfully promoted by

[1]Source: Federal Reserve Board. Quarterly Data 1951-12-31 to 2016-12-31.

their wholesaler-in-chief, John Bogle, cause anyone to automatically appear genius. The S&P 500 hasn't had a down total-return year since 2008 and is loaded with the large growth and momentum stocks which have been on fire.

Glamour revenue growth stories have been so hot the last two years that Mr. Buffett apologizes for not owning them, even though they are out of his circle of competency. Wall Street analysts love these stocks as much as they hated blue chips in 1981, even though they really don't know much about what goes on inside the tech darlings. It appears we are confusing brains with a bull market.

In 1981, a Republican was inaugurated to be President on a tax-cutting platform. Our economic confidence was as low as our stock market. Today, we are about to enjoy lower income taxes from a Republican President, but the confidence in stocks and the economy is at extremely high levels.

When I started in the investment business, New York City was a filthy, unsafe dump and today it is a popular and chic place for Millennials to live and work. For the last ten years, young, college-educated singles congregated in the largest coastal cities and rode the most recent tech wave. My economics classes taught me that when differentials in value get big enough, people will move. Usually that differential becomes interesting at the screaming voice of a baby or two. It appears we're confusing brains with a bull market.

Here is our prediction for 2018. A strengthening economy will drive interest rates up and begin to move people around the country. Capital will be demanded by Main Street interests. Coastal cities and the bull market in tech companies, which has driven the growth, will have "unforeseen" problems. We believe that sometime during 2018, this "Cinderella" market for growth stocks will have its clock strike midnight and it could all turn to "pumpkins and mice."

As a firm, we are going to tack toward value as much as we can with our low-turnover discipline. We will pledge to our investors to only make new purchases into companies fitting our eight criteria that we would have been interested in without a bull market in stocks. In this way, we will do our level best to not confuse brains with a bull market.

Warm regards,

William Smead