October 20, 2016

On the Matter of Correlations

The third quarter was a strong one, with the S&P rising 3.26% and the Russell 2000 tacking on 8.03%. After several consecutive years of summertime volatility, the summer of 2016 saw an historic volatility compression. This certainly was not a summer to "Sell in May and Go Away" (while we are here invoking that line, it's important to caveat that even were it a successful strategy—and it's not—it runs entirely contra to our philosophy of finding and investing in high quality businesses).

All sectors were not equally strong, however, with notable weakness in the yield-sensitive areas. In our May Commentary we told investors to have their "staple remover ready" and the point applies similarly to Utilities and REITs.[1] These three sectors (just last month the REITs officially became a sector of their own) share one very important trait in common: they have each become proxies or replacements for investors in the quest for yield amidst seven years of Zero Interest Rate Policy (ZIRP).

From our vantage point, some of these trends towards dividend investing involve conflation of several themes that have become popular in recent years:

1) Quality investing—what has become synonymous with the search for companies with consistently high ROICs and mid-single digits growth
2) Dividend—the increasing popularity for anything and everything with yield[2]
3) Low beta/volatility—people have gotten frustrated with the whipsaw moves in markets and have been isolating companies that are more immune than others.

When someone not steeped in the financial lexicon is overwhelmed with certain themes, it becomes all too easy for confusion to take over. It also becomes too easy to take what are good ideas with a solid foundation to an extreme far beyond reason.

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[1] http://www.rgaia.com/may2016/

[2] Dividend investing got so extreme that in the MLPs in particular, investors were looking purely at screened "dividend yield" and ignoring dividend coverage. Dividend coverage is the extent to which net income (actual earnings) affords the company an opportunity to pay a dividend. Throughout this entire sector, coverage ratios were negative; meaning, dividends either had to be paid with balance sheet cash, increased indebtedness, or raising new equity (or some combination of the 3). It took worsening fundamentals for investors to painfully realize that what seemed like a dividend, was not actually a yield, but rather their very own invested capital returned at the expense of increased risk on the corporate level.

The strength in these sectors over the past few years has been driven by allocators targeting certain levels of yield for portfolios and not by investors analyzing businesses and determining a fair worth. This is an important distinction. Additional drivers have been a preference on the part of investors for lower volatility and a movement towards passive (from active) types of management. In the modern incarnation of passive management, portfolio managers seek to capture factor exposures in desired proportions generally via ETFs.

During the last quarter, there was an important change in the yield sensitive names that we think has gone largely unnoticed but will be meaningful going forward. Since equities are long duration assets, and the short-term rates are set directly by the Federal Reserve Bank, we decided to use TLT as a proxy for long-term rates. We first looked at the average daily returns and standard deviations of the S&P, TLT and the yield sensitive sectors over the past three, six and twelve months:

	SPY	TLT	XLU	XLP	IYR	XLF
Average daily return - 12 mo	0.037%	0.039%	0.033%	0.032%	0.023%	0.023%
Average daily return - 6 mo	0.037%	0.025%	-0.034%	-0.016%	-0.009%	0.057%
Average daily return - 3 mo	0.043%	-0.063%	-0.156%	-0.069%	-0.106%	0.093%
12 mo Standard Deviation	0.901%	0.787%	0.968%	0.802%	1.013%	1.193%
6 mo Standard Deviation	0.745%	0.782%	0.951%	0.730%	0.888%	1.045%
3 mo Standard Deviation	0.609%	0.751%	1.028%	0.663%	0.955%	0.777%

There are two important takeaways from this chart:

1) All but one sector—XLU (Utilities)—has a lower volatility (standard deviation) over the past three months than over the past year. This is a distinct change in character for the Utilities, a sector that generally is not very volatile.
2) The average daily return over the last three months in every yield sensitive area (Treasuries itself, and Utilities, Staples and REITs) has turned negative, while the S&P remains positive, on average, every day.

This was the first step in calculating the betas of yield sensitive areas compared to each the S&P and Treasuries. Here are those betas[3]:

Beta vs SPY	12 mo	6 mo	3 mo
TLT	0.436	0.695	0.019
XLU	0.583	0.477	-0.276
XLP	0.619	0.572	0.225
IYR	1.003	0.915	0.553
XLF	1.069	1.148	0.995

Beta vs TLT	12 mo	6 mo	3 mo
SPY	0.572	0.630	0.012
XLU	1.133	0.944	0.882
XLP	0.898	0.746	0.668
IYR	0.947	0.996	0.878
XLF	-0.098	0.281	-0.393

Note that the betas of XLU (Utilities), XLP (Staples) and IYR (REITs) are greater with respect to TLT than they are with respect to the S&P. Further, in our timeframe comparison, these betas have actually lessened as time has gone on—the betas of these sectors verse the S&P are less over the past three months than over the past twelve months. In fact, the Utilities sector is slightly negative against the S&P over the past three months meaning that for each unit the S&P went up, the Utilities actually went down.

There is an extremely important takeaway here worth emphasizing:

If you are buying these sectors today, you are making an explicit wager on the direction of long-term interest rates.

While some may think they are engaging in some kind of investment, diversification or capture of yield, in reality they are wagering on the direction of interest rates. Yes, to an extent there will be some yield capture along the way, but one problem with low rates is how the sensitive the principal (your invested dollars) is to the change in yields. If it is yield you seek, we are afraid to tell you that this market does not offer much of it. If instead you are looking to make an explicit wager on interest rates, there are far

[3] In case you were wondering, there was one more step along the way: calculating the correlations between the various securities. We have not included that look here as the same general points are captured by the betas.

better ways to do it than through these vehicles. Needless to say, we feel many investors are in these places right now for all of the wrong reasons.

You may have noticed that all this while, we have spoken about the "yield sensitive areas" without touching on XLF (the financials)—the other sector in our grids above. We are saving this for our conversation below.

Portfolio Update:

After an active first half of the year for portfolio activity, the second half has had a slow start. We made one notable portfolio change—we purchased shares in The Charles Schwab Corporation (NYSE: SCHW). We love when a confluence of themes we believe in come together in one company, with a reasonable valuation.[4] Our business, our investment in Envestnet (NYSE: ENV), and now our investment in Schwab (NYSE: SCHW) all are at least partly premised on the big transition from a commission-based to fiduciary, fee-based wealth and asset management industry. Registered Investment Advisors continue to grow at the expense of the brokerage wirehouses, reporting double-digit annualized growth for over a decade.

At first glance, the online and discount brokers are typically associated with cheap commissions for retail clients. Yet at Schwab, this is a small and diminishing part of the story. As recently as 2011, trading revenues accounted for more than 20% of the company's total top line. Today, trading accounts for about 14% of revenues. Net interest revenues have been the primary beneficiary in terms of total revenue share—rising from 37% to 40% of net revenues. Notably, net interest revenues have grown in share despite the persistence of the Fed's zero interest rate policy and the corresponding waiver of money market fund management fees.

Despite the money market fee waiver headwind, Schwab has exhibited consistent operating leverage throughout the post-crisis period. Each year has seen an average of a 1% operating margin increase, with 2016 seeing an accelerating on the heels the December 2015 rate hike—the first since getting down to 0% in late 2008.

This growth is impressive and stems from the company's consistent ability to provide value-added services to retail and institutional clients, fostering consistent double-digit asset growth and mid-single digit account growth. A great example of this is the traction Schwab continues to make in its robo-advisor offering (what Schwab calls "Intelligent Portfolios). Assets now exceed $10b, with many of the

[4] Several of these themes were recently covered by Elliot in a presentation at the ValueConferences Wide Moat Investing Summit. http://www.rgaia.com/envestnet/

clients coming from outside of Schwab's existing clientele. Moreover, asset growth in this segment contributes to further growth in the company's ETF offerings—an area where the company has become an increasingly formidable force alongside the likes of BlackRock and Vanguard. Per Bloomberg, "Five years ago, Schwab wasn't even in the top 10 of ETF managers by assets. Now it's ranked fifth, with $54 billion in its 21 ETFs."[5] These are nice examples of a virtuous cycle at work, driving significant growth at the company. They are also evidence of steps Schwab has taken through the years to shift their business from trading, to areas that are growing in need and will continue to do so over time. In its illustrious history of driving value for small and retail clients, Schwab has exhibited an exceptional track record of anticipating and driving, rather than reacting to industry trends.

In the past year, the financial sector has traded inversely correlated to the direction of rates. This has been increasingly so in the past 3 months. Stated another way: as rates have gone up (down), financial stocks have gone up (down). Thus in some respects, a purchase of a financial stock seems like a bet that rates will go up. Further yet, over the past year, financials have appeared to be a levered bet (i.e. high beta) on the direction of the S&P. This relationship has been breaking down over the past three months and we think this change is both notable and enduring. With respect to the Great Financial Crisis, we have often evoked the idea that it is safer to fly after a crash than before, because everyone in a position of accountability is on their highest alert for potential problems. The disdain for financials as a sector (as evidenced by their market low valuations and high volatilities) is an example of the market fighting the past battle instead of looking forward. The system itself is far more resilient and robust today than before the Crisis, yet people seem more worried now. This is a problem of perception.

We paid 26 times trailing earnings, though if interest rates normalize this would be more like a 15 times multiple. What we like about Schwab in particular is the evidence that the company has driven great results irrespective of the rate direction. Upside in rates, will lead to meaningful upside in the stock; however, a rate move notwithstanding, the company continues to drive immense value with its diverse offerings. We are hardly the first to note this relationship between Schwab's future earnings and the trajectory of rates. These moves have in fact been driving the stock over the past year. Where we think our perception is unique is with respect to the underlying diversity in quality and growth that Schwab has exhibited and how those forces will drive the business.

[5] http://www.bloomberg.com/news/articles/2016-10-06/schwab-s-etfs-are-gobbling-up-a-2-4-trillion-market?utm_content=business&utm_campaign=socialflow-organic&utm_source=twitter&utm_medium=social&cmpid%3D=socialflow-twitter-business

The stock has spent most of the past 20 years trading with a mid-20s multiple. If that stays constant (and rates never normalize), we think we will earn a double digit percent long-term return on the heels of strong account growth, robust asset growth and consistent operating leverage. Should the stock's multiple regress to the market's multiple (~17x) then we would still be looking at mid-single digit returns over eight to ten years. If rates do return to levels above 1% on the Fed Funds over the next decade, upside and IRRs would be comfortably in the double digits, even with multiple compression. As a result, there is the potential for something special here without taking on very much downside risk.

Housekeeping:

You may have noticed that we did not issue a monthly commentary over the past few months. In our internal talks and talks with many of you, we realized that the frequency of commentaries was creating two problems—one specific to us, and one for you, our clients. For us, we have been writing these commentaries for so long now that we have run out of unique general philosophical bits to share without getting overly redundant. For you, the frequency and lengths of some of our narrative resulted in a lower than expected read-count. Quarterly commentaries provide a solution to both: we can go in-depth on a well thought out topic without overwhelming your inbox.

To that end, we plan on approaching these with a different format than in the past. Each will start with a general overview of something timely or relevant in markets, or a philosophical concept that we would like to delve into (often we anticipate an overlap between both). Next, we will do an update on the latest actions within your portfolios, and if there are none, we will focus on notable stock moves or news within the quarter.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-1945. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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