October 12, 2015

A Liquidation Move

In the third quarter, the S&P lost 6.9%. This was the worst quarterly decline since the third quarter of 2011 when the debt ceiling and Europe's potential breakup loomed over markets. The third quarter was no kinder to bond markets. Toward the end of Q3, 2015 was shaping up to be the first time since 1990 where both stocks and bonds lost money in the same year.[1] In other words, the best performing global asset class thus far this year has been cash. While 2011's route had clearly identifiable causes that warranted a repricing of risk, this year's selloff came with vague explanations like "fears of a Fed rate hike," "a hard landing in China," and "Glencore is Lehman."[2] [3] In our opinion, these are merely convenient excuses that portend well for markets down the line.

First, as we have pointed out several times in the past two years: markets had risen too far in recent years compared to the progress in the real economy. Second, this market action is what we would call a "liquidation move" where a large seller, for non-fundamental reasons, rapidly cut their market exposure. We covered this first part in August's commentary, so much of the space below will focus on what we mean by a "liquidation move" before circling back around to the valuation backdrop of the stock market.[4]

Commodity Losers Gotta Sell

Commodities are a sector wrought with leverage. This leverage exists on the company level—commodity extractors of all kinds tend to deploy considerable leverage in their capital structures—and on the trading level—futures contracts typically are levered over 10 times (ie for $1 of capital, someone can take $10 of positions). With commodity prices declining sharply, the stocks of these companies whose debt was predicated on higher levels were vulnerable to sharp declines. This is but one reason

[1] http://www.marketwatch.com/story/in-a-quarter-century-cash-had-never-beaten-stocks-bondsuntil-now-2015-09-25
[2] http://www.zerohedge.com/news/2015-10-07/shocking-100-billion-glencore-debt-emerges-next-lehman-has-arrived
[3] We apologize for linking to Zerohedge in the above footnote. Typically we would refrain from doing so; however, this meme has drawn enough mainstream attention as to justify our mention.
[4] http://www.rgaia.com/zones-of-reasonableness/

why high yield bonds had a rough quarter and energy stocks continued the decline which accelerated last Thanksgiving.[5]

In the prior decade, commodities and commodity companies were outstanding performers. This led many to believe the "hard stuff" deserved a permanent place in building a diversified portfolio. As so often happens, investors built these commodity positions after (not before or during) the outstanding decade. Since the commodity crash accelerated, we have been operating under the assumption that there would be a maximum point of pain these late commodity investors would be willing to take in their portfolios in the name of "diversification." Since last year, we had been asking ourselves who would be in line to trim down risk tolerance in their portfolio because of how wrongly exposed to commodities they ended up. We looked at all kinds of hedge fund and mutual fund filings in an attempt to ascertain where the selling could come from. Once the selling in the markets began, we looked for particularly pained hedge fund portfolios and still did not identify an obvious seller.

In past selloffs we had a pretty clear idea as to where the selling originated. Studying the history of similar selloffs led us to look at 1998 as an example. 1998's panic happened amidst a similarly strong fundamental US economic backdrop and a challenging Emerging Market landscape. Investors were at least somewhat aware that Long Term Capital Management's positions combined with leverage left the markets vulnerable. This time around, we were mostly scratching our heads at the lack of a clear culprit. That was so until the Financial Times published a piece titled "Saudi Arabia Withdraws Overseas Funds."[6] It turns out, we were asking the wrong question. We should not have been hunting for the hedge fund(s) exposed to commodities, but rather the much bigger global pools of funds with indirect, but meaningful exposure to commodity prices.

Per the FT, Saudi Arabia's sovereign wealth fund, SAMA, was said to have liquidated over $70 billion of money from global equities and bonds within the past 52-weeks. This is a massive headwind for market prices to contend against. SAMA began 2015 as the third largest sovereign wealth fund in the world, managing over $700 billion. As of June 30, 2015, the last reporting period, SAMA's assets were down to $671b. This was when markets were still up on the year. Between recent declines and the accelerated withdrawals that began in August, it's reasonable to suspect that SAMA is now a sub-$600b fund.

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[5] http://www.rgaia.com/the-oil-investors-who-dont-even-know-it/
[6] http://www.ft.com/intl/cms/s/0/8f2eb94c-62ac-11e5-a28b-50226830d644.html?ftcamp=published_links%2Frss%2Fglobal-economy%2Ffeed%2F%2Fproduct#axzz3mxcGbfiD

Saudi Arabia came into the year with a projected $38.6b 2015 deficit.[7] We suspect they have a good grasp of the revenue side given their capacity to sell oil on the futures market (oil accounts for over 90% of Saudi government revenue) and there is little reason to suspect their expense side would have grown. SAMA exists to fund such deficits when necessary. The problem for Saudi is that the revenue side for 2016 will be considerably worse than 2015 given the futures curve in oil. We think much of the global selling was triggered by Saudi Arabia and other oil rich countries using their sovereign wealth funds to cover these budgetary holes. This aggressive selling from SAMA is a clear sign that Saudi Arabia is planning on covering deep deficits into 2016, and that Saudi's plan to squeeze some newer sources of global oil supply (like American shale) out of the market is nearing its endgame.

There are different kinds of reserve-driven selling. Many investors have raised concerns about China's reserve drawdown and its consequences on global liquidity (including David Tepper, who we respect to the extreme).[8] In our estimation, the Chinese reserve drawdowns are far more benign (and possibly supportive of global asset prices) compared to what with the action out of Saudi Arabia. China is drawing down its reserves in order to counter cash outflows from citizens. Chinese citizens have been buying property and assets outside of the country as a response to their domestic economic woes, and China was using its accumulated global savings in order to maintain a desired exchange rate between the Yuan and the dollar. Saudi's global selling is going directly into domestic Saudi expenses, whereas China's drawdown is a net neutral on global liquidity. By nature, Saudi's drawdown on reserves is extractive of global liquidity.

Fundamental Valuations, Contd.

Last month we spoke about how the market's P/E ratio was now well within a "zone of reasonableness." That conclusion is in some respects predicated on the direction and magnitude of earnings growth. This year looks like one in which earnings will neither grow nor shrink; however, that's somewhat misleading. Energy sector earnings will drop around 36% year-over-year, while the S&P excluding energy will grow at about 3.25%. This is pretty decent growth. We did an exercise extrapolating forward S&P earnings on a sector-by-sector basis. For each sector we calculated the 10 year compound annual growth rate (CAGR) and the year-over-year change in earnings. We picked the lower of the two and extrapolated that forward 10 years, simply to paint a picture as to what the S&P earnings might look like moving forward. Bare in mind, this middle of this timeframe includes the Great Recession. As such, it's hard to claim

[7] https://www.mof.gov.sa/English/DownloadsCenter/Budget/Ministry's%20of%20Finance%20statment%20about%20the%20national%20budget%20for%202015.pdf

[8] http://www.cnbc.com/2015/09/10/david-tepper-good-time-to-take-money-off-the-table.html

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these past ten years were an outlier featuring strong growth. The only sector where we afforded ourselves an exception to picking the lowest growth rate was in energy where the -36% would have been far too onerous. Instead, we used the -7.66% 10-year CAGR the sector has experienced. This is what the picture looks like (forward multiple was based on the S&P's quarter-closing price of 1920, all data is from Bloomberg, using S&P 500 operating earnings):

YOY Change	6.43%	4.49%	-36.30%	2.11%	13.72%	11.03%	10.20%	4.72%	-6.28%	2.51%				
CAGR	10.93%	5.22%	-7.66%	12.51%	3.27%	9.84%	6.89%	1.42%	8.05%	0.70%				
Date	**Consumer Discr**	**Consumer Staples**	**Energy**	**Financials**	**Health Care**	**Industrials**	**Info Tech**	**Materials**	**Telecom**	**Utilities**	**Total**	**Growth**		**Forward Multiple**
12/31/2016	35249.85336	28650.36122	13877.90536	57344.80256	42516.95081	36554.1622	74715.61246	8278.547553	5565.030932	6542.16108	309295.3875	8.13%		**15.76316**
12/31/2017	37515.43939	29936.02996	12814.35531	58557.61218	43905.922	40151.34398	79864.05912	8396.394515	5215.420555	6587.908922	322944.4859	4.41%		**15.09694**
12/31/2018	39926.63966	31279.39236	11832.31171	59796.07202	45340.26901	44102.51327	85367.27103	8515.919055	4887.773653	6633.976668	337682.1384	4.56%		**14.43806**
12/31/2019	42492.81309	32683.03739	10925.5282	61060.72458	46821.47418	48442.50488	91249.69408	8637.145053	4580.71042	6680.366555	353573.9984	4.71%		**13.78912**
12/31/2020	45223.92017	34149.67019	10088.23715	62352.12381	48351.06833	53209.58161	97537.45868	8760.09673	4292.937734	6727.080836	370692.1752	4.84%		**13.15235**
12/31/2021	48130.56155	35682.11731	9315.112902	63670.8354	49930.63224	58445.77159	104258.4958	8884.798652	4023.243711	6774.121779	389115.6909	4.97%		**12.52962**
12/31/2022	51224.01919	37283.33212	8601.237968	65017.43697	51561.79837	64197.23878	111442.661	9011.275733	3770.4926	6821.491669	408930.9844	5.09%		**11.92248**
12/31/2023	54516.30019	38956.40055	7942.071702	66392.5184	53246.25248	70514.69004	119121.8672	9139.553243	3533.620002	6869.192806	430232.4666	5.21%		**11.33218**
12/31/2024	58020.18338	40704.54697	7333.42144	67796.682	54985.73543	77453.82209	127330.2263	9269.656812	3311.628384	6917.227506	453123.1304	5.32%		**10.75971**
12/31/2025	61749.26889	42531.14047	6771.415826	69230.54287	56782.04493	85075.81261	136104.2008	9401.612435	3103.582883	6965.598102	477715.2199	5.43%		**10.20582**
										9 yr CAGR	4.95%			

Please note: this is not a forecast, it is simply an exercise. We would be shocked were the S&P earnings to have any real correlation to these numbers. Instead, this is merely an attempt to visualize what kind of long-term earnings yield we are paying for in today's market as long-term investors. We think this is hardly exuberant.

Our Portfolio Activity is Correlated with Market Volatility

There is one fundamental reality of our long-term, low-turnover strategy: the more markets move, the more moves we will be inclined to make. That held true this past quarter, as we chopped several positions, concentrated the portfolio deeper into a few of our favorites, added two new positions and built a deep watchlist which already afforded us the opportunity to commence one more new position between quarter-end and the publication of this newsletter. In effect, this quarter justified more action than the past two years combined. We look forward to elaborating on these new positions in our commentary over the coming months.

What do we own?

The Leaders:

Google (NASDAQ: GOOG) +16.9%

Markel Corporation (NYSE: MKL) +1.5%

<u>Walgreens Boots Alliance (NASDAQ: WBA) -1.2%</u>

<u>The Laggards:</u>

Howard Hughes Corp (NYSE: HHC) -20.1%

Bed Bath & Beyond (NASDAQ: BBBY) -17.3%

IMAX Corporation (NYSE: IMAX) -16.1%

On a personal note: we want to give a warm thank you to Ryan King, our 2015 Summer Intern, who has now returned to the University of Michigan for his sophomore year at the Ross School of Business. Ryan's work this summer was crucial in preparing our watchlist for the market turmoil. He did a deep dive into the semiconductor sector which will have value for our firm for years to come and helped expand our knowledge-base on numerous companies within the vertical. We wish Ryan a fun and inspiring year back at Michigan.

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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