MEAD
CAPITAL MANAGEMENT

Volume: 5 Issue: 1 | **January 15, 2018**

"I am a better investor because I am businessman, and a better businessman because I am an investor." – Warren Buffett

Little to Buy; Lots to Do

With the current bull market continuing its seemingly-endless run higher and higher, returns have been, by most accounts, quite satisfactory (assuming you've been along for the ride). The key words, however, are "have been". With each new milestone the expected *future* returns from stocks keep going down – after all, the more you outlay for an asset the lower must be your relative return. You can't have your cake (stock price gains in excess of underlying fundamental business growth) today and expect it to be around tomorrow. While the evidence certainly points toward stocks being expensive, it is one particular fact that causes me to come to that conclusion: I can't find things to buy at a price that includes meaningful margin of safety.

"My conclusion…is that there is little to buy today that will carry with it reasonable prospects of above-average returns. And here's why…"

For me and my clients this has meant more cash in our portfolios – not as an intentional allocation but *as a result* of a lack of opportunities falling within my circle of competence.

That doesn't mean I'm sitting around, however. Quite the contrary, my investment process has continued unchanged – and it won't change no matter what the stock market does. That process is one of building a roster of excellent companies that I know and understand deeply, regardless of price, and waiting for them to go on sale. I know full well that I may never get to purchase all of them at prices that provide a high probability of satisfactory returns with a built-in margin of safety. But some eventually will meet all my criteria, and I'll be ready. There is little to buy today at current prices, but much to do to prepare, to expand the roster of great businesses, and deepen my knowledge of those already on the list.

"That doesn't mean I'm sitting around, however…my investment process has continued unchanged – and it won't change no matter what the stock market does."

In his excellent book "The Most Important Thing", Howard Marks explains his approach to assessing the markets for their degree of attractiveness. Rather than plug in numbers to a formula that provides him with a number, Marks looks for an undefined but not unimportant "feel". What are investors' attitudes generally, are they nervous, excited, neither? Are credit markets accommodative, tight, somewhere in between? Where are interest rates, are they high or low historically? What do valuations look like relative to long-term earnings? Where are we in the business cycle? Marks' approach is one of taking the market's temperature and looking to see if many metrics point to the same conclusion. My conclusion, as noted above, is that there is little to buy today that will carry with it reasonable prospects of above-average returns. Using Marks' general approach here are my reasons why:

1. ***What are investors' attitudes to the market, generally?***
   While it seems the ever-increasing market points to exuberance, the severity of the 'Great Recession' of '08 and '09 still lingers in the minds of investors. Still, going on a decade since the last major market upheaval would tend to dull investors' minds to the pain they then experienced, and include those who didn't live through it. The recent Bitcoin / cryptocurrency mania (and a mania is what it is, more on that later) would be strong check mark for some degree of speculative fever. And if one can speculate on cryptocurrencies it's a risky downward slide into speculation on other fronts.

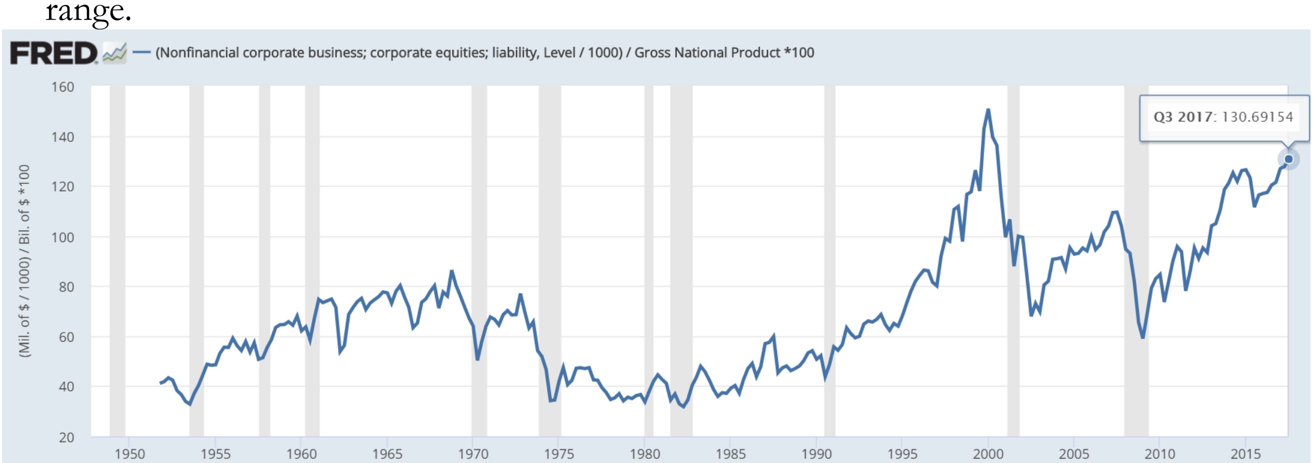
2. ***Are credit markets accommodative, tight, somewhere in-between?***
   The graph below charts the spread between high-yield (read: "junk" or "risky") debt and US Treasuries (essentially risk free). It is the premium investors demand to step away from a riskless option. While not close to the trough of around 2.50% seen in 2007, today's spread is fairly low at 3.35%. Coupled with the fact that covenants – generally, protections put in loan documents to protect the lender – have been easing or in some cases eliminated altogether, and my assessment must be one of "accommodation".

3. ***Where are interest rates, are they high or low historically?***
   Not much to say here. Interest rates are low historically-speaking. All things being equal lower interest rates mean higher valuations.

4. ***What do valuations look like relative to long-term earnings?***

While I don't condone the practice of 'charting', there are certain fundamental relationships within the economy that hold over longer periods of time. One of those is the stock market's valuation relative to the output of the economy. Since stocks are businesses and businesses produce the nation's output, measuring the relationship between production and the cost to "own" that production makes sense for a broad-based valuation perspective (similar to a price/earnings ratio).

As can be seen clearly below the only other time markets were this expensive was the 'dot-com' boom of the early 2000's. Of course, if interest rates are fundamentally "stuck" at a lower absolute level then the higher valuation of stocks relative to their earning power would be a more rational outcome and not necessarily indicate speculation. Still, looking at the graph below it's not unreasonable to conclude that valuations are "high". And if you adjust for the fact that the market continued to go up after Q3 of 2017 today's ratio of around 139% starts to feel closer to that speculative range.



Volume: 5 Issue: 1 | **January 15, 2018**

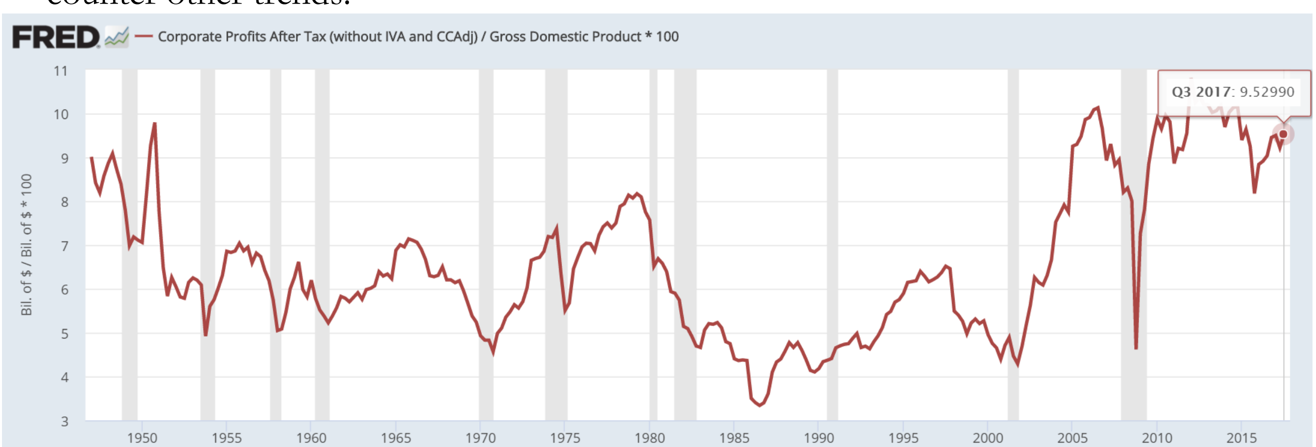
"I am a better investor because I am businessman, and a better businessman because I am an investor." – Warren Buffett

5. ***Where are we in the business cycle?***

While I'd never venture to call the top, it certainly 'feels' like were at or near a top. Low unemployment, high profit margins (see below), high valuations and a very positive outlook are all signs it being 'good times'.

6. ***What are corporate profit margins?***

At close to 10%, corporate profit margins are at or near the highest they've ever been, historically. With a tight labor market and the prospects of higher inflation in other areas generally, margins likely don't have much higher to go from here. There's a case for structurally higher margins given the asset-lite nature of many of today's tech businesses which seems to have merit. That said, I don't know if I could bet against such a long-term trend. One would think that if lower capital requirements begin to apply more broadly that temporary advantage could eventually disappear (not dissimilar to how internet companies found their 'advantage' applied to everyone). We'll find out in ten years. An important offsetting factor is the recent tax law change, which will allow businesses to retain more earnings via lower taxes. Still, it likely won't be enough to counter other trends.



7. ***A closer look at the S&P 500…***

The Standard and Poor's website provides some interesting raw data on the index, open for anyone to see. These include operating earnings, net earnings, dividends, buybacks, and data on book value. A closer look is very illuminating.

"Said another way, earnings per share grew by 4.18% per year over that period yet the *price* of those earnings grew at a rate of 12.5% - a differential of over 8% per year. This isn't sustainable - trees don't grow to the sky."

At the end of 2012 the index stood at $1,426 and investors were willing to pay about 16.5 times the $86.51 in earnings. Fast forward 4.5 years to mid-

2017 (data are final through this period for all categories) and investors were willing to pay $2,423 for $104.02 in annual earnings – representing a multiple of 23.3 times. Said another way, earnings per share grew by 4.18% per year over that period yet the *price* of those earnings grew at 12.5% - a differential of over 8% per year. This isn't sustainable - trees don't grow to the sky.

Switching to total dollars illuminates where that growth may have come from. The companies in the S&P 500 collectively reported earnings of $3.85 billion between 2013 and the first half of 2017. During that four-and-a-half-year period they spent, combined, $4.04 billion on dividends and buybacks. Taken as a whole the S&P 500 gave back to shareholders more than they earned – approximately 105% based on the preceding analysis. (If one uses operating earnings the ratio is 95%, however, for such longer-period analyses I prefer to include – that is not exclude – one-time charges, etc.)

Interestingly, the S&P 500 companies actually increased their book value per share by 20% or 4.1% per annum over that same 4.5-year period. How can this be? It can be attributed to the result of buybacks decreasing the number of shares outstanding. And where did these companies come up with the cash to buy shares? By increasing debt. Between year-end 2012 and June 30, 2017 the S&P 500 companies took on more debt, increasing their debt-to-equity ratios from 40.5% to over 54%. Yes, today's S&P companies have more cash on their balance sheets but on a net-debt basis they are weaker than just a few years ago.

	S&P 500 Per Share Analysis			
	12/31/2012	**6/30/2017**	**Change**	**Annualized % Change**
S&P 500 Index	$1,426	$2,423	$997	12.50%
EPS (last 12 months)	$86.51	$104.02	$17.51	4.18%
Multiple	16.5	23.3	6.8	7.99%
Book value per share	$666.97	$798.64	$131.67	4.08%
Debt per share	$270.08	$433.72	$163.64	11.10%
Cash per share	$143.74	$216.86	$73.12	9.57%
Net debt per share	$126.34	$216.86	$90.52	12.76%
Debt-to-equity	40%	54%	14%	n/a
Debt-to-total cap	29%	35%	6%	n/a

Volume: 5 Issue: 1 | **January 15, 2018**

8. ***Bitcoin.***

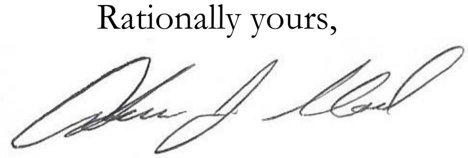
It's everywhere! I swore I wouldn't get into a discussion about cryptocurrencies but it's illustrative. In my mind cryptocurrencies are an order of magnitude worse than gold (to be clear I mean as an *investment*, not the underlying *technology,* which may be useful). And I very much dislike gold. I dislike gold be because it has no cash flows; and an asset without cash flow, in my mind, cannot be valued. Gold, however, at the very least, has scarcity going for it. Sure, we can mine gold but it's hard (and expensive) to do. Thousands of years of alchemy has failed.

Enter cryptocurrencies. Their proponents point to the fact that the algorithm behind each currency creates scarcity, which will prevent additional 'printing of dollars' like the US Treasury does. There's one glaring problem with this argument and that's the fact that scarcity cannot be "created". If one can create scarcity isn't that proof enough that it can be modified to make it less scarce? Charlie Munger, someone with piercing insights in many areas summed it up nicely (paraphrasing): given enough incentive, such as the high price of these cryptocurrencies, someone will find a way to cheat. Charlie also has a great final word on the subject: one should "avoid it like the plague…even if it works that harms you because you'll be tempted to try it again".

Suffice it to say that my clients and I will be taking a 500-mile berth of anything "crypto". It's sad that actual businesses, such as the Long Island Ice Tea Company, are totally revamping their business strategy to enter such folly. This is not going to end well.

To sum up, at present there is little to buy but much to do. Regardless of what the market does, or if speculative fever grips some area or another, there is plenty of work to be done to uncover great businesses, assess their long-term prospects, and estimate reasonable valuations for them. The work of a capital allocator is never done. There are many indicators pointing to an unfavorable investment climate at present, but as the sage said, "this too shall pass", and I'll be ready.

Rationally yours,



P.S. Check out my other articles at www.meadcm.com/memos.