The Equus Report

—BY BARNABY LEVIN

ESSENTIAL CONTEXT

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The purpose of my writing these Articles is not only to share my thoughts and Outlook, but also to provide clients the framework within which we are managing their money as that outlook will clearly influence our decisions. I find that it gives us an opportunity to make sure, in this fast-changing world, that we remain philosophically aligned and, if not, open a dialogue so we can come up with ways to make sure we *are* going forward.

To begin with, we serve our clients in many ways, from referring great CPAs and Estate Planning Attorneys, to annual Tax Planning and Charitable Giving. Over time, our conversations frequently turn to career discussions and we sometimes have an opportunity to help clients, not only recognize their own talent in ways they may not be doing, but also to become aware of trends that might affect their direction or choice of career. We help them determine the best ways to fund their children's High School and College educations; discuss parents; and look at Real Estate on an ongoing basis. As their Advisor, we have a chance to provide solutions and, we hope, a valuable perspective to help our clients make important decisions that, ultimately, involve and positively impact their finances.

As *Portfolio Managers*, we feel our concentrated approach and thematic insights are unique and often help us take advantage of longer-term trends, from Globalization to Emerging Markets. Yet, if you read the many articles I have written – while comforting to see that most of what I have said has either come true or is in the process of doing so (or that people from Stan Druckenmiller to Jeff Gundlach are now in our camp) – we, like Ray Dalio of Bridgewater Associates, remain concerned about everything we *don't* know! It seems the more we learn in this QE[1] / negative-interest-rate world of ours, the more we realize it will always be a constant battle.

That said, I have predicted for some time that Quantitative Easing, Zero Interest Rates and taking on massive amounts of Debt would, as it has in Japan, *fail* and leave not only Japan but, now, the EU and US in untenable positions and have, therefore, resisted the "TINA"[2] mentality that allowed many to turn a blind eye simply because the Fed had their back. Today, the growing isolationism and discontent from a widening inequality gap and a sometimes inexplicable sense of entitlement so popular with followers of both Trump and Sanders is being played out all over the world, while the EU is beginning to steer ominously close to collapse. Perhaps this last is a little extreme – but I *have* predicted the EU would ultimately dissolve or be dramatically restructured because, in the end, I don't think any sovereign nation wants someone else telling them what to do. Nor do I think that England's pending "Brexit" vote on June 23rd will be helped by the heavy-handed way in which Jean-Claude Juncker, the President of the European Commission, recently threatened Great Britain should

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[1] Quantitative Easing (**QE**): an unconventional monetary policy in which a central bank purchases (mostly) government securities from the market in an attempt to lower interest rates, increase money supply and, thereby, encourage financial institutions to increase lending and liquidity (Investopedia)

[2] "TINA": **T**here **I**s **N**o **A**lternative

they leave (He said they will be treated as "deserters" and that the UK would face the "consequences") so the vote may be a little closer than markets might like as a result.

But the U.S. isn't, in my opinion, doing any better when it comes to alienating allies and enemies alike. By releasing $100 Billion in frozen assets to Iran, for example, and allowing them to freely trade with everyone but us, we may inadvertently be helping to fund terrorism and are certainly upsetting Saudi Arabia. Or the way our Senate recently passed legislation allowing individuals to sue the Saudi government for any part they *or their citizens* might have played in 9/11? Ignoring the fact that our politicians can't agree on anything, why this? Why are they *unanimous* on an issue that would certainly result in retaliation, effectively *daring* Saudi Arabia to turn against us at a time when the country already has its back against a wall with growing deficits and internal unrest? In my opinion, our Senate is either ignorant or ignorant of the consequences that a devaluation of the Riyal by the world's largest oil producer could have if Saudi Arabia is forced into a corner, but I predict it would be as big or bigger than what happened last August when China devalued by a mere 2%.

All of these issues can have an impact and result in unintended consequences and, because they have the potential to affect our markets, they are critical to people's understanding of how and why we have been positioning portfolios the way we are.

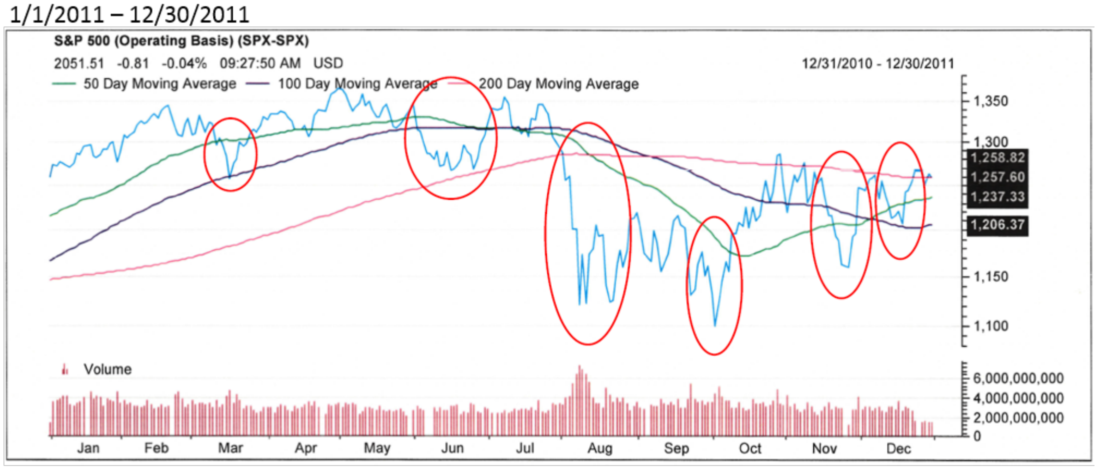
Once more, I believe we are near enough to a breaking point that it could be triggered by the slightest straw and, given current valuations, result in a collapse as big as 2008 and I have been undeterred in developing a strategy that would allow us to better weather another Crash.

Part of the problem has been that – other than riding it out and hoping the trouble would soon pass – there *were* no good alternatives and "hope," simply, has never struck me as a very good "strategy." So we have kept large amounts of Cash; added Precious Metals; and, in 2011 and 2012, Inverse Shares. Then, after eliminating all hedges and dramatically reducing Gold and Silver by early 2013 when Draghi said he'd "do whatever it takes," we began to adopt a sort of technical, "trading" mentality in an attempt to stay *ahead* of trouble which, for some time, worked well on the stock side of things. But as the charts on the next page show, the periodic drops that continued to take place were often too sudden; too harsh; and too frequent to always maneuver in time and, virtually overnight, would sometimes undo months of hard work, like last August when China devalued.

Over the past few years, the market has been like a big bathtub, where water is constantly washing back and forth from one side to another and, if one simply bought the S&P500 Index and went on a long vacation, they might have returned to find they were doing better than most active Managers who tried their best to make adjustments along the way. So, many people now think it's easy. But they'd be wrong, because the markets have been lulled by an accommodative Fed and Central Banks globally that have all been using the same monetary tools that are coming to an end with nothing to show for their efforts but debt. GDP remains flat and, as measured by CPI, inflation low while unemployment, if improved, has only been amongst lower-skilled, lower paying jobs that draws attention to the widening income-inequality gap between the Haves and Have-Nots. We may not remember the Great Depression, but we've certainly read about it or heard about it from our parents and we *have* experienced the Stagflation of the 70s; the Asian Financial Crisis and demise of Long Term Capital in 1998; the Dot-Com Crash; and the "Great *Recession*" of 2008, which fueled much of the recent, broad scale rotation into Hedge Funds. That industry has more than doubled in the past five years and, fortunately or unfortunately, they're now being discredited *as a group* and discarded at almost as fast a clip at a time when they may, once again, be of most value. Even Warren Buffet, who I admire, bet five hedge funds eight years ago that a passive investment in the S&P500 would outperform over a ten-year period and, for the moment, he's looking pretty darn smart. But with two years left, we'll have to wait to see if he "wins" or not in the end.

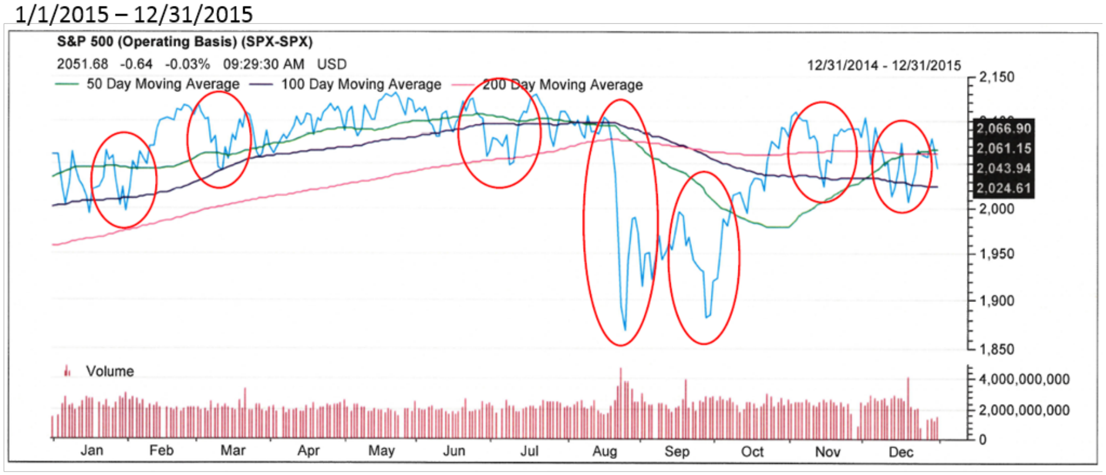
In the meantime, let's consider how the markets have been behaving. Let's look at the charts below and compare 2011 (which ended the year flat) with that of 2015 (which did the same)

1/1/2011 – 12/30/2011



Source: FactSet

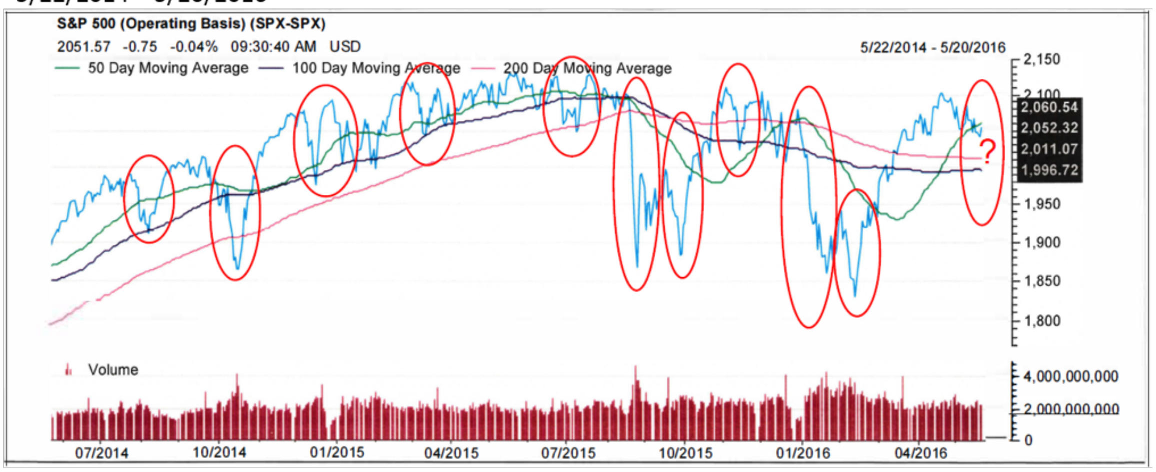
1/1/2015 – 12/31/2015



Source: FactSet

with that of the past two years.

5/22/2014 – 5/20/2016



Source: FactSet

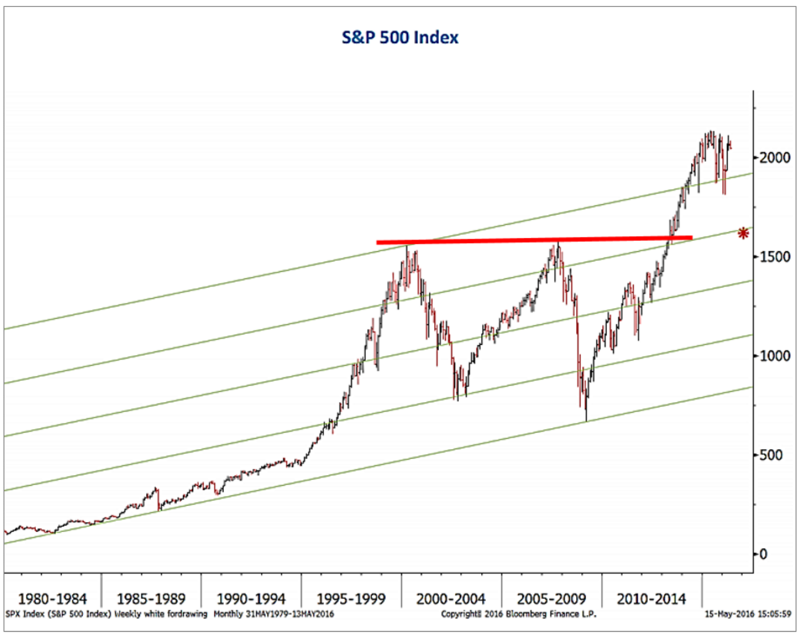
What you see are markets that finish their respective one- and two-year periods essentially unchanged while exhibiting a tremendous amount of volatility along the way. But do you see – not just the precipitous drops – but all the "V" recoveries that have, historically, been rare? When things (now known as "Black Swans"[3]) take people by surprise, they cause sharp and sudden drops and, understandably, it takes time for the fear to subside and markets to stabilize – but not so in recent years. Now days, these quick recoveries have become, not only common, but expected. So what has changed? Why have PE's expanded to historic highs (both on the basis of Trailing, 12-month or Shiller's CAPE Ratios) when revenues and (had it not been for record amounts of corporate stock buybacks) earnings are flat to down? Why have markets been willing to accept record (credit card, student loan, housing and automotive) debt at the individual, corporate and sovereign level when growth is stagnant? And why, each time there was a sell-off, have markets been so quick to recover? I believe it is because:

1. Central Banks (again) have been creating a "back-stop" or "Put" through a series of QEs to hold interest rates down, combined with Zero-Interest-Rate policies to force investors out of bonds into more aggressive, often inappropriate assets in the hope this would stimulate growth and, as long as that "Put" was there, Hedge Funds felt emboldened to pile back in the moment they got an "all clear."

[3] According to Wikipedia, "The **black swan theory** is a metaphor that describes an event that comes as a surprise, has a major effect, and is often inappropriately rationalized after the fact with the benefit of hindsight. The term is based on an ancient saying which presumed black swans did not exist. The theory was developed by Nassim Nicholas Taleb to explain 1) The disproportionate role of high-profile, hard-to-predict, and rare events that are beyond the realm of normal expectations in history, science, finance, and technology; 2) The non-computability of the probability of the consequential rare events using scientific methods (owing to the very nature of small probabilities); and 3) The psychological biases that blind people, both individually and collectively, to uncertainty and to a rare event's massive role in historical affairs."

2. Hedge Funds – using leverage, momentum and, now, a broad array of index shares – are quick to move in and out of entire sectors, almost entirely on a technical basis.

Yet according to Cornerstone Macro's Technical Analyst, Carter Worth (who I have found to be incredibly astute), the market has dramatically narrowed over the past two years and – not only are most stocks flat, down, or in the process of breaking down – the recoveries are becoming weaker, making them increasingly vulnerable to a more significant sell-off that, according to him, could easily erase all gains since April 2013 when the market first broke out. A drop in the S&P from Friday's 2099 Close to his initial, 1600 support would be a 24% loss:



Source: Worth, Carter, Cornerstone Macro: Technical Analysis, "Money In Motion", May 15, 2016.

http://cornerstonemacro.com/email_tmpl.php?contactid=121727&postid=29667

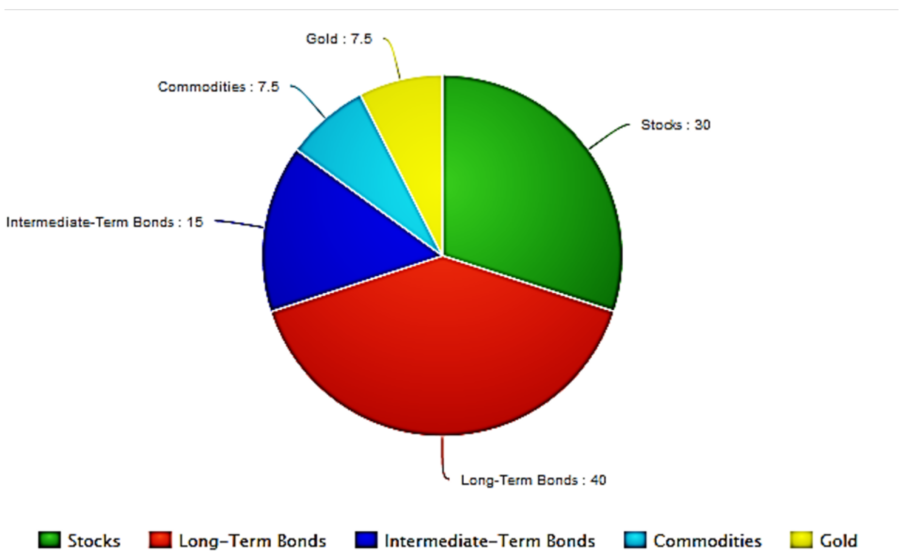
In fact, the only thing that may be preventing this sell-off for now (according to Macro Intelligence 2) may be the *negative sentiment itself* from the growing number of high-profile bears like Druckenmiller. You see, those Bears have already sold or sold short and the market is holding up in spite of them so, in a contrarian way, this becomes a "Bullish" indicator. And add to this the high levels of cash (earning 0%) from all the people who sold and the ongoing "Fear of Missing Out" by all the hedge funds whose existence is now in question. The latter are running scared and if the market starts to move against them by going higher, they could be forced into quickly covering their shorts, driving prices even higher in the process. In other words, if the market started to *really* rally, it could cause a *stampede* before – and this is important –*fundamentals* still and ultimately impose their discipline and take the market down to Carter's 1600 level.

Meanwhile, I believe *the volatility is here to stay* and the question is: what do we do if that's true?

For one thing, it seems prudent to reduce if not eliminate our exposure to smaller companies because of their greater risk and how quickly their stock prices change directions. With smaller companies, a new product delay or launch can have greater consequences than with a larger company because they don't yet have the breadth of offerings and, regardless of how long they may have been in business – if theirs is a young, publicly-traded *stock* – they can't think "long-term" like an Uber or Tesla may be able to do, as if they were private. While they might be *the* best-in-class, Market Leader, with a dominant market share; have a history of Innovation; a strong Balance Sheet; and are addressing markets with enormous potential – despite the fact that we have had some great home-runs and, through 2010, these often helped our returns – we will no longer include Small Caps in our Model because we can no longer invest in them with the kind of confidence we need from a portfolio of core holdings we hope to hang onto for years like we did in the 90s. Nor is this to say that, at *some* point, it might not be wise to stand aside and liquidate *all* our equity exposure. That's not the intention at this point (and we can talk about those scenarios if you like), but we *do* believe we need to reduce our equity exposure and for our concentrated Models to play a smaller role versus several, broad-based indexes that can capture the constant rotation and, within those Models, to stick to where we have repeatedly added value, which is Large-Cap, Blue Chips. With every holding, should it fall, we must have the confidence and ability to add without hesitation – *knowing*, as much as anything can be "known," that the stock will eventually recover and, as we have done with Apple and others, we can take advantage of that, compounding our long-term return in the process.

But still the question remains: how do we avoid those sell-offs *in the first place* without sitting 100% in Cash and facing the headwind of a 0% return? In Tony Robbins' book MONEY: Master the Game, Ray Dalio recommends the following "All Weather" Asset Allocation:

Ray Dalio's All Weather Asset Allocation



Source: Robbins, Anthony, *MONEY: Master the Game*, New York, Simon & Schuster, 2014

While for the moment, with interest rates so low, it's difficult to be quite so bullish on bonds, I do think we must bite the bullet and continue to maintain a significant Cash position to serve as an Opportunity Reserve and for Peace of Mind. It may be a drag on performance in a Zero Interest Rate world, but it gives us "optionality." I also think we still need an allocation (perhaps as much as 10%) in Gold and Silver, which are up 15% year-to-date. And, yes – if we don't already have a meaningful allocation to Fixed Income, we do need to increase our exposure, at least in shorter-duration instruments, some of which allow the Manager a flexible mandate so they can not only invest globally but can also adjust the average maturity as interest rates change. In lieu of Dalio's full, 40% allocation to long-term bonds, we can reduce our overall equity exposure to between 40-50% in the near term and increase other, "non-correlated" assets, including Best-in-Breed Managers who can go long and short across a variety of strategies and asset classes, as well as Real Estate that, in inflationary environments, can provide a steady stream of rising income. None of these will hedge whatever exposure we have in stock, but they will act as a counter-balance and, by hedging themselves, can help provide us protection for that part of our portfolio at least.

With regard to Real Estate, for accredited investors willing and able to tie up some of their money for up to ten years, I think a private equity fund like Virtus has an advantage over most REITs because it is small and nimble enough to fly under the radar – to shift focus and cherry-pick individual opportunities across the country in demographically-favored categories like senior-assisted and student-housing, with operating teams skilled in these verticals to identify and add value.

But with regard to Hedge Funds, when people (including myself) speak ill of them, I think there are all kinds of reasons to steer clear in general, which is why it has taken me so long to find ones I like and feel comfortable with on a long-term basis. The bottom line is that, in order to consistently add value (or "alpha"), it requires exceptional talent, hard work, resources, access and a stringent, *institutionally*-embedded, risk-control discipline – and the only conclusion one *can* reach is that, by definition, *"alpha" doesn't exist* in the aggregate. Of course, even the very best can and do stumble: even the great Berkshire Hathaway, using 3-year measurement periods, has underperformed the market 13 times over the past 49 years[4]. But it does seem that, like Pension Funds, we need to be *much* more diversified these days and to have access to many more asset classes and strategies (including things like "Long/Short," "Quantitative" and "Arbitrage") and to people like Buffet, Soros and Bill Miller, who make bigger, more concentrated bets. The latter, like myself, have the chance to excel over time because they have the freedom, not only to hold, but add to their positions when markets prove short-sighted, in a dollar-cost averaging approach. Otherwise, they just end up under-performing[5], being little more than Indexes with higher fees and people *should* just buy an index and,

[4] Berkshire Hathaway's 2015 Letter to Investors

[5] Tony Robbins, Money: Master the Game, page 482

as Jack Bogle at Vanguard says – no matter what – “just stand there and do nothing!”[6] Over a 20- or 30-year period, you’ll be “just fine…”

Of course, not everyone has these kinds of time frames in mind and, luckily, there *are* managers who have proven their value again and again in up-and-down markets and, through HighTower’s ability to tap multiple “platforms,” I think we are extremely fortunate to have access to some of these top funds at much lower minimums with lower fees than would otherwise be possible. We now have meaningful exposure to a number of “alternative” funds whose purpose – in different and, I believe, complementary ways – is to protect and prosper in volatile markets. And many of you, as accredited investors, have invested in Infinity, which is a great start on the more conservative, fund-of-fund side of things. While more concentrated than many in their category, it is still diversified across a broad array of strategies with some of the best Money Managers in the business, including Millennium, Citadel, Elliot and DE Shaw which, when appropriate, we may want to invest in directly as well.

I think the experience of the past five years has helped to provide us with essential context and the opportunity to finally find first-class solutions in a world that has dramatically changed when, until recently, some of those solutions either didn’t exist or were not available to us at an acceptable level. I look forward to speaking with you about any or all of this soon.

Barnaby Levin
Partner | Managing Director
HighTower Advisors LLC

[6] “An incredible 96% of actively managed mutual funds fail to beat the market over any sustained period of time,” Money: Master the Game, Tony Robbins, 2014