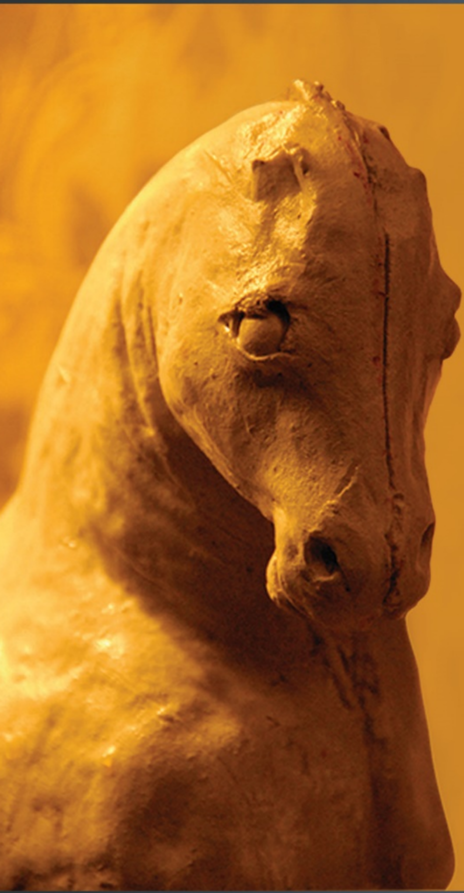

The Equus Report

—BY BARNABY LEVIN

WILE E.

December 31, 2013

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So much – and yet so little – has changed over the past two years that I haven't been sure what to say for a while. Nevertheless, this hasn't stopped us from making bold and sometimes difficult decisions with regard to Asset Allocation. Actions, we knew, would speak louder than words and it's clear today that these choices were the only and best thing for us to do on behalf of our clients.

For a moment, let's take a step back to look at the events of 2011. For many it was "Much Ado about Nothing"[1] – but from *our* perspective, markets (understandably) went through the most volatile and extreme swings that we have ever seen as Portugal, Italy, Greece and Spain imploded; the EU met time and again in vain; and the S&P 500 rose or fell 7% or more 24 times. Yet the greatest irony of it all is that, in the final weeks of the year, markets finished flat as though nothing had happened and, because the 17 EU nations *still* haven't passed anything into law, the truth is that "nothing" did!

That August in "Mea Culpa,"[2] I explained why the world's Central Banks – who, with their charters and standard toolbox, are clearly able and supposed to control short-term rates – would be unable to artificially keep *long*-term rates from rising above historically-low yields that were below the rate of inflation for long. Given the degree to which yields had fallen for more than thirty years, it only seemed logical that the bond market and foreign holders of our debt would rebel and, left to Central Banks' stimulative devices, the resulting devaluation of most of the world's major currencies (including the dollar) would lead to a negative reaction and the value of gold would continue to rise as it typically would in a market driven by the laws of Supply & Demand. But that was before QE 2 became 3 and, then, 4.[3]

I sit on the Board of Directors at Stanford's Institute of Economic Policy Research and, all this time, I expected to hear a number of their and other economists — based on actual increases in the prices of healthcare, education, food and fuel where we know most of *our* clients dollars go – say that inflation was (far?) higher than the official index and for *any* of them to decry the BEA[4] for daring to reclassify R&D spending (like the cost of making movies) as "business investment" and "intellectual property" instead of an expense and brazenly double-count by adding this newfound "revenue" to boost GDP. But not a word – not from some of our country's best and brightest minds – who might have cared to question the methodology for calculating "CPI" and "GDP" altogether.

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[1] Shakespeare

[2] "Mea Culpa," Barnaby Levin, HighTower Advisors LLC

[3] By the way: now that the "Taper" *has* finally begun, has anyone calculated what percent of our Nation's lower, deficit spending $75 Billion actually comprises?

[4] U.S. Bureau of Economic Analysis

I don't get it, so, maybe it's me who's crazy because, seriously, I have felt like a "Stranger in a Strange Land"[5] as all that analysis – all that planning that was years in the making – turned out (for now) to be nothing more than the "stuff" of which Pyrrhic Victories are made and it was clearly time to let go.

> *According to Wikipedia, the phrase "Pyrrhic Victory" is named after the Greek King Pyrrhus of Epirus, whose army suffered irreplaceable casualties in defeating the Romans at Heraclea in 280 BC and Asculum in 279 BC during the Pyrrhic War. In both of these victories, the Romans suffered far greater casualties than he did – but they had so much larger a supply of men from which to draw that their casualties actually did less damage to their effort than Pyrrhus's casualties to his. "Another such victory," he said, "and I come back to Epirus alone" and, since that time, the term has been used as an analogy in the fields of business, politics and sports to describe struggles that end up ruining the victor.*[6]

The truth is that I have watched the world embrace what I believe to be a profound and willing suspension of disbelief in which, regardless of longer-term repercussions, markets have chosen to focus on one thing only: the Fed and the decision not to fight it. While many have railed and called Fed actions such things as "kicking the can down the road" for so long and so often the phrase has grown tiresome – as long as investors knew that Central Banks "had their back," U.S. and European equity markets (at least) have been free to march higher. In fact, the greater the stimulus, the greater the gain, as we've seen in Japan.

Words like "fundamentals" have also been bandied about by people with such diametrically opposed views to justify their personal perspective that, as far as I can see, that word has lost meaning as well. "Based on fundamentals…" "Americans want…" As with most statistics, it's really quite easy to make an argument that supports whatever point of view one desires and, as I stated in my article, "Where You Sit Depends on Where You Stand,"[7] most things in life are subjective anyway. So, maybe that's all there is to it.

But I do (truly) stand in awe of Mario Draghi, the President of the European Central Bank, who I think should have been named "Man of the Year," if not the Decade. Where the balance sheet of our Central Bank has ballooned from under $800 Billion prior to TARP in 2008 to more than $4 Trillion today, Mario Draghi hasn't had to spend a euro. Given the fact that nothing yet has been passed into law, I'm not sure if he even *could* have – but that isn't the point. The fact is he hasn't. The OMT (Outright Monetary Transaction) Program was Europe's version of our QE

[5] "Stranger in a Strange Land," by Robert Heinlein
[6] Wikipedia
[7] "Where You Sit Depends on Where You Stand," Barnaby Levin, HighTower Advisors, January 26, 2011

and was aimed at holding interest rates artificially low so the "PIGS"[8] could raise money and roll over (not repay) debts that were threatening to crush them. It was yet another example of "robbing Peter to pay Paul"[9] but, on September 6, 2012, Draghi simply said "the ECB is ready to do whatever it takes to preserve the euro" and "believe me, it will be enough" – and, by god, it worked!

We, too, have kept rates low. But, in helping Corporate America and those individuals not underwater on their mortgages to refinance, we have done so at the expense of older folks who are in or near retirement and who, at this point in their lives, should be investing more conservatively. But "they" say that, in a Zero-Interest Rate world, "There Is No Alternative" and, given the "risk-free" rate of a zero-return offered by Treasuries, this "TINA" rally of ours has been almost entirely based on expanded multiples. "Assuming negative and other, 'extraordinary' earnings are excluded"[10] – and where, for companies with PEs greater than 60, they just cap it there – the S&P500 is "only" trading at a ratio of 22.63x trailing earnings when earnings, over the next 3-5 years, are expected to grow at an average of 8.8%[11]. We'll see (given that analyst projections tend to be overly optimistic at the start of each year and certainly haven't met expectations over the past several). But doesn't two and a half times growth seem a hefty premium when nearly half the index is composed of slow, single-digit growth sectors like financials, utilities, energy and materials? *Historically* it is, of course – but *not* (evidently) in a ZIRP world[12].

My career has been predicated on an ability to stand back and advise clients based on the "Bigger Picture" – or to change course when facts changed – but, this time around, so many things haven't made sense that it took me a little longer than usual and the conclusion I ultimately reached was that, like everyone else, I simply needed to let go – to stop fighting what everyone else was clearly so willing to accept – and our portfolios have been happier for it. Each day has felt like "The Emperor Has No Clothes"[13] – and I still believe we are living on borrowed time: that, like our friend Wile E. Coyote, our markets and economy are already out over that proverbial cliff, spinning their wheels as fast as they can to stay in place long enough until things *actually* improve. But our Strategic Equity portfolio, which focuses primarily on U.S. large cap stocks, is certainly doing well on an absolute and relative basis and, as Scott Minerd of Guggenheim Partners says – in a market like this – we can't *afford* to "shoot till we see the

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[8] The PIGS: Portugal, Italy, Greece, Spain
[9] Where financially distressed nations, like the "PIGS" – in dire need of help themselves – agree to support the others. The question is with what money? How can Spain help Portugal if Portugal needs help from Spain?
[10] iShares Core S&P 500 ETF
[11] Bloomberg, Nick Taborek and Whitney Kisling, "CEO Profit Skepticism Supports Weak Estimates for Stocks", January 21, 2014.
[12] Zero Interest Rate Policy
[13] "The Emperor's New Clothes," by Hans Christian Andersen

whites of their eyes."[14] We're "dancing with the one that brung ya"[15] and, as long as momentum continues in our favor, we'll be doing everything we can to take advantage of it. We'll buy great, fast growing companies trading at a reasonable valuation – with *trailing* PE ratios in line with *future* growth rates, as always – but every day, we will start with a blank slate; an open mind; and a laser focus to see which direction the markets want to go.

Conversely, when it comes to Emerging Markets, it no longer matters that, longer term, this may *be* where our demographics-based outlook argues we should continue to invest, or any of the many other statistics cited by a number of highly-regarded, portfolio managers: that EM economies are contributing more than 50% to global GDP; have 80% of the world's population; hold two thirds (or US$10.8 trillion) of the world's international currency reserves; and have an average debt ratio of only 39% of GDP versus 76% for developed economies; yet their combined market capitalization stands at less than 17% of the global total.[16] No matter what so many sage people advise; whether these markets are, as the "Quants" say, "undervalued;" or the fact that, for more than a decade, these markets have provided us with fine returns: if, in the midst of a "risk-on" market that has gone up nearly non-stop for two years, emerging markets are broadly *down*, it is highly doubtful that – if *our* market cracks – *they* would become the new safe haven and that money would flow from our market to theirs. Now, if and when that changes, we will change. But, throughout this year – and, in particular, since May 22 when Fed Chairman Ben Bernanke first mentioned "the Taper" – there's been no support or reliable demand for Emerging Markets and we have been steadily reducing our exposure since the second quarter, moving that money on an ongoing basis to domestic markets in which we continue to do well because we have the pleasure of working with innovative, globally-dominant, well-managed Market Leaders who are on "a mission" to build long and lasting legacies. But this too is only important as long as these companies' revenues, earnings and balance sheets continue to grow like they have been and, coincidentally, *so do their stocks*. Again: we are simply taking one day at a time and, in the end, they're only "inventory."

From a tactical perspective, these are the thoughts that have been driving us in recent months and which we have been applying like there's no tomorrow:

First and foremost, from Paul Tudor Jones: Never play macho with the market – that is, to be long the market when the market's going down and, *more importantly*, short when the market is going up.

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[14] "The Fed and the Economy, Macro View Market Commentary and Economic Update," by Scott Minerd, Guggenheim Partners, November 21, 2013

[15] A favorite expression of the University of Texas football coach, Darrell Royal, meaning to go with the players and plays that result in wins.

[16] Glovista Global Emerging Market Perspectives, Issue 48, December 2013

From Yra Harris at Praxis Trading: With its combined knowledge of all participants, the market is smarter than you'll ever be so pay attention to the signs. Be quick to admit when you're "wrong" and always be willing to change your mind when new information emerges. Sometimes you may have just made that decision – or believed in something to the very core of your being – *that* is how fast the world is changing and you need to change with it because these trends tend to have "legs."

From Jeff Weiss: Technicals precede fundamentals. Who would have thought the S&P500 would go from just over 1000 in late 2009 to more than 1800 today, given what has been going on in Europe and the Middle East? Don't be afraid to ride trends for all they're worth and go with momentum.

From Alexandra Lebenthal: Your first loss is your best loss. What kills most portfolios isn't *having* losers – it's *keeping* them.

From Kevin Landis: Forget what you paid. What it is worth now is all that matters – and what you think it will be worth going forward. *If it's not your best investment, switch*.

From Mark Twain: It's not (converse to what Don Rumsfeld once said[17]) what you don't know that will get you into trouble. It's what you know, for certain, *that just ain't true*!

And, finally, with regard to "Unmet Expectations": Either change the reality around you (like selling a losing security instead of agonizing over it) or change your expectations. Oftentimes (flash alert!), reality is difficult to change and fighting it isn't worth the effort.

Just like our current Congress, we have never seen such stark and widely-divergent opinions with regard to our markets – with smart people on either side who, each in their own way, all make great sense. For the past two years, it happens that "voices of reason" from Kyle Bass to Jeff Gundlach; Nouriel Roubini to John Mauldin and Byron Wien; and Marc Faber to Jim Rogers have been left in the dust while those like Leon Cooperman, David Tepper and (kudos to him after a dismal showing for so long) Bill Miller at Legg Mason have enjoyed record results and think there's more to come. Only time will tell whether the latter are all "talking their book," but their results year to date don't lie. The point is: we have learned that, in today's world, it can be treacherous to take any stance with too strong a conviction and so, for the time being, we won't. Fixed income, precious metals and emerging markets are still to be avoided or, at least, underweighted and developed markets like the U.S. and Western Europe emphasized. For now. But we do wish to make this note: when "bulls" speak lightly of 5-10% corrections, we think they're wrong. First of all, a hundred thousand dollars on a million dollar portfolio isn't

[17] "There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. These are things we don't know we don't know."

"chump change." Second, so much of this market's momentum has been driven on lighter than average volumes for so long from hedge funds – using greater leverage than they did in 2007[18] and which are trying to make up for lagging results – that, if and when the market cracks, we believe the rush to the exits will prove far more damaging than the bulls think and, as Alexandra Lebenthal says, that first "loss" will still be our best and we will want to quickly step aside and go to cash.

In the meantime – because I like to end my articles on a positive note and I'm in a "quoting" kind of mood – I would like to share my final thought from "The Bucket List." Humor me, if you will, by closing your eyes and imagining this said in that wonderful, timbrous voice of actor Morgan Freeman: "Our lives are streams, flowing into the same river, towards whatever heaven lies in the mist beyond the falls. Find the joy in your life; close your eyes; and let the waters take you home. Go to sleep with your eyes closed and your heart wide open." It was an awesome movie and, if you haven't already done so, I highly recommend you see it. In ancient Egypt it was said that, before being admitted to Heaven, the gods asked just two questions: "Have you found joy in your life?" and "Have you brought joy to others?" Our wish is that **your lives be filled with joy**.

We have your back.

Barnaby Levin
Partner | Managing Director
HighTower Advisors LLC

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[18] "Hedge Fund Leverage at 2007 Levels," Stephen Suttmeier, Bank of America Merrill Lynch, FIN Alternatives, May 7, 2013