BARRACK YARD ADVISORS

Current Anchors

First Quarter 2018

First Quarter 2018

The Big Picture:

After a year of abnormal calm, the stock market is jittery. No one knows why volatility is back, but there are theories. I note there is probably a connection between the recent rise in interest rates, profit taking in the parts of the market with stretched valuations, and questioning assumptions about the true strength of the global economy. Then there are threats of trade wars emanating from the White House.

Some interest rate investments are increasingly attractive, giving stocks competition. Not long ago, $100,000 invested in an 18-month bond might generate $500 a year in income. That number is now closer to $3,000. Most bonds remain unattractive, however, even after the 6% year-to-date decline in long-term Treasury prices.

Analysts expect corporate earnings to rise nearly 20% this year, according to Thomson Reuters. This is not far-fetched, given the whopping tax cuts recently bestowed on corporate America. Simple math: a company that paid the maximum rate last year will see earnings rise by over 20% this year, assuming no growth in underlying earnings and assuming they continue to pay the maximum tax rate.

Good investors are inured to the ups and downs of the stock market. So, the only relevant question should be: is a secular bear market imminent?

Assuming America's saber-rattling on trade issues does not result in a domino effect of protectionism, the upward trend in stocks remains intact. There will be volatility and scares, but odds are good that Armageddon is not nigh.

If there are parallels to today in financial history, my readings suggest we look to the 1920s. At least for now, think Coolidge, not Hoover.

The Stock Market's Most Out-of-Favor Sector

The objective of every value investor is to buy low and to eventually sell high. Simple enough aspiration, but when presented with opportunities to put that statement into practice, it is often difficult to follow through. When asset prices are low, there are always factors validating the bearish thesis: sure, it is cheap, but it is cheap for good reason!

I have been executing on what I believe to be a buy-low stratagem in the form of publicly-traded energy infrastructure businesses, as they arguably represent the most out-of-favor sector in the stock market. Not only are they at a significant discount in relative terms vis-à-vis the S&P 500, they are as cheap as they were in the Fall of 2009 on most metrics.

Energy Infrastructure businesses, also known as midstream assets, move oil and natural gas via pipelines. They also store oil and gas and engage in ancillary activities. Typically, these are low risk businesses because they are essentially regulated utilities, toll-takers with fee-based, long-term contracts from credit worthy customers. As is the case with all low-risk businesses, it is possible for management to transform them into a risky business. Some have taken on too much debt and engaged in other wealth destroying activities.

Continue page 2

1025 Connecticut Avenue, NW, Suite 1000, Washington, DC 20036 / Telephone: 202-870-9566

...continued from page 1 | The Stock Market's Most Out-of-Favor Sector

The industry is out-of-favor for several reasons and some context is required.

Several years ago, as the shale boom blossomed, and oil was $100 a barrel, an enormous amount of money flowed to the sector. These companies benefited from being at the nexus of the shale boom, providing critical infrastructure to move the vast volume generated by the expansion in oil and gas production.

A beautiful narrative arose about America's energy independence and the sector became particularly attractive to retail investors. Many of these companies offered high yields that were tax-sheltered. All with the promise of low-risk, toll-taker, business models.

Given the popularity of these firms among yield hungry individuals, they had nearly unlimited access to capital in which to fund their growth projects. Wall Street saw an opportunity and helped the industry raise fresh capital, both equity and debt, generating attractive fees in the process.

Then oil and gas prices plummeted, and it became apparent not all firms were low risk toll-takers. Some were heavily indebted and had commodity-price exposure. Many were paying distributions to investors that exceeded the cash they were earning. Essentially, they were borrowing money to pay distributions.

As the price of oil plummeted below $30 a barrel, share prices in the sector were hit hard, falling by more than 50% from late-2014 until the sector bottomed in February 2016, using the Alerian (NYSEARCA: AMLP) exchange traded fund as a proxy. This had the understandable effect of disillusioning many individual investors.

By the summer of 2016, prices had recovered some 50% from the February bottom, but recent weakness in the sector means we are back to the lows set some 2-years ago.

The catalyst for the recent decline was a ruling by the Federal Regulator that is seen to be anti-business.

The ruling was surprising, given that the decision-makers are Trump appointees, and the ruling does not seem to support infrastructure development.

There is a 30-day period for the industry to comment on the ruling and so, the decision can be modified. In any event, reaction to the decision has been extreme and probably unduly negative.

The major issue facing many midstream companies has nothing to do with their businesses, as fundamentals are sound. It is that they are good businesses wrapped in problematic legal structures. Many are publicly traded partnerships. As a taxable individual, a partnership structure can be attractive as the company's tax benefits pass directly to you. It also allows for a higher level of income to distribute to owners.

The problem with publicly traded partnerships is that it restricts ownership. Energy partnerships should not be owned in IRAs, and they cannot be owned by most institutional investors. As a result, some companies are looking at their legal structure with an eye to changing to a C-Corporation.

The long-term optimistic case for midstream companies is straightforward. First, the need for energy infrastructure will continue in the US for decades, if not longer. Second, the low-risk, toll-taker businesses in the sector are easily identified. Finally, many firms are self-funding, earn more than their cost of capital and own assets that would be difficult to replicate. There is scope for compounding value creation over the long term.

The following three companies all have investment grade debt ratings.

Kinder Morgan (NYSE: KMI) is the largest midstream firm in North America and converted from a partnership to a C-Corporation a while back. They own 80,000 miles of pipelines, including the only one that serves the West Coast of Canada. They also own other assets: terminals, barges and so forth.

Kinder Morgan took on too much debt during the boom years and has been focused on protecting its balance sheet. They are self-funding and much of their cash flow is used to invest for growth and pare down debt, which is why the projected dividend is only about 4%. The stock trades for less than tangible book value.

The best midstream company by all accounts is Enterprise Products Partners (NYSE: EPD). This is a Master Limited Partnership and is widely admired for its efficient scale and diverse operations across the midstream energy value chain. They have raised their distribution to unitholders on average by 6% every year for more than a decade. Currently, the yield is roughly 7%.

The firm in the sector with probably the greatest upside potential is Boardwalk Pipeline (NYSE: BWP). This partnership owns critical infrastructure in the movement of natural gas but many of the pipelines pre-date the shale boom. So back in 2014, the partnership announced they needed to spend a significant sum to modify their system to reflect new realities. They needed to fix what they owned, and they needed to spend money to benefit from growth opportunities. They also said they would self-fund most of the Capex. This enabled them to keep their investment grade credit rating. It also resulted in a cut to the annual distribution from $2.13 a unit to $0.40 where it has remained.

Boardwalk is 4-years into a turn-around that is now in late-innings. They own three major natural gas pipeline systems with stable cash flows and attractive growth opportunities. The distribution per unit is currently low but they should earn $1.20 this year. Loews Corporation, the Tisch Family holding company, controls 51% of the company and is why management can afford to take the long view. The units sell at a 40% discount to tangible book value. I believe Boardwalk is the most undervalued company in the most undervalued sector of the market. Notably, management has generally delivered as promised. Like Enterprise Products, Boardwalk is a Master Limited Partnership and generates a K1 every year for investors.

Investing for “The Singularity’

You do not need to be a Sci-Fi nerd to believe machine intelligence will eventually be more powerful than human intelligence, or to think Futurist Ray Kurzweil might be on to something when he describes how revolutions in genetics, nanotechnology and robotics are ushering in a New Age for humanity, in what he calls ‘The Singularity.’

‘The Singularity’ is more commonly thought of as the time when machines become smarter than people. I mention it because I believe 'The Singularity' is related to the thesis that the bull market in stocks might end in a melt-up phase. A melt-up is when an expensive market is driven ever higher, propelled by compelling stories, not fundamentals, as investors stampede into stocks for fear of missing out. During a melt-up, gains tend to be large and transitory, as melt-ups typically precede melt-downs. Earlier this year, adherents to the melt-up thesis included Jeremy Grantham of GMO and Legg Mason’s Bill Miller.

Companies that do best during a melt up are the poster children for that bull market. They feed the narrative things are different this time and serve as ‘proof’ a new era is upon us, two important conditions necessary for a Bubble, according to Robert Shiller in his seminal book, Irrational Exuberance.

In the late 1990s, the bubble narrative which led to the mother of all melt-ups had to do with the Internet transforming everyday life. This time around, I believe a compelling story will involve the information revolution, and the implicit assumption ‘The Singularity’ will be achieved in the not-so-distant future.

The thesis is straightforward. The internet-of-things (IoT) is advancing at lightning speed, creating an economy that is intensely connected.

This connectivity has two important components. First, connectivity is spawning an unimaginable amount of data. Second, machines are harvesting the data and, critically, are constantly learning from it (artificial intelligence, or AI). Both trends are accelerating exponentially. At the same time, Moore’s Law remains: https://en.wikipedia.org/wiki/Moore%27s_law

Relatively soon, when machines become smarter than people, the transformational nature of the information revolution will become apparent. Industries from transportation, to energy, to our physical workspace will be disrupted.

What Amazon (AMZN) has done to retail is a taste of what lies ahead. As an example, transportation will become a service and car ownership will no longer be necessary. Indeed, cars will become a liability, a plaything for the rich, as is the case for horses today.

Self-driving cars necessarily means electric cars and that requires more copper and lithium. Pipelines to high-cost oil wells will become stranded assets. Transportation-as-a-service also involves fewer cars, and plummeting demand for parking spaces and car insurance.

An obvious way to invest for 'The Singularity' is to own the FAANGs. I believe an even more straightforward way, with an inherent margin-of-safety, is to own Softbank Group (SFTBY), a company with the stated and credible aim of "leading the information revolution." Softbank Group is a Japanese holding company run by the experienced and charismatic Masayoshi Son, an ethnic Korean, raised in Japan and educated at Berkeley.

On the surface, Softbank may look like a second-tier telecom holding company, owning a majority of Sprint (S), with some interesting technology investments on the side, such as their 28% ownership stake in Chinese eCommerce behemoth, Alibaba (BABA). Masayoshi Son recently firmed up commitments to start a $100 billion investment vehicle, the Softbank Vision Fund to specifically invest for 'The Singularity.' As a veteran of the investment management business, I marvel at Son's ability to create a firm half the size of the venerable Carlyle Group (CG), in just a matter of months.

The Archimedean point for Softbank is their chip design business, ARM. Think of ARM as the epicenter of the IoT while their telecoms business represents an infrastructure play on which to drive their Vision.

All other assets they own are made to benefit from long-term trends. Alibaba in eCommerce. Uber in transportation. WeWork in commercial real estate. Value investors should note, Softbank's shares trade below NAV, using a sum-of-the-parts analysis.

Late-Cycle Investing

Every recession for the past half century has been preceded by a big rise in commodity prices, such as oil, metals, wheat and so forth. As an actionable concept, there is complexity in this theme.

Commodities are rightfully viewed as speculative because trading them involves leverage. To get exposure, therefore, many own companies that are commodity based. The problem with this approach is you run the risk of having the right thesis, but the wrong vehicle. Management often respond to supply/demand dynamics after the fact and use cash-flow generated during good times to increase capacity (buying high) and jettisoning assets when the cycle is poor (selling low). This destroys shareholder value. A way around this conundrum is to own Royalty Companies and Streaming Assets. For more detail, please see my blog at Forbes:

https://www.forbes.com/sites/greatspeculations/2018/01/30/ideas-for-late-cycle-investing/#ffa5bf329d51