BARRACK YARD ADVISORS

Current Anchors

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Investor sentiment numbers revealed too much optimism in early February. In the same way everyone agrees a temperature of 95 degrees is hot, anyone looking at those readings would conclude the stock market was positioned for short-term disappointment.

Sentiment is a contrary indicator at the extremes and the numbers were extreme and noteworthy. They suddenly became widely known. They were even mentioned on the radio. I figured a drop of something like 5% or 10% from those levels would not be a surprise, based on that one data point alone.

I did not trade-the-market, nor did I did change my strategy based on this insight. The point here is to keep those sentiment readings in mind as you hear pundits talk about the coronavirus being the cause of this week's downdraft in share prices. There is much chatter that assumes a Global Pandemic with serious economic consequences is the only explanation. There could be other reasons.

Admittedly this week's big drop in stocks could reflect rational concerns about a global pandemic, as the conventional wisdom says. Think about the potential havoc caused by a global pandemic. Millions could perish and the economy decimated. In the natural world it is up there with California earthquakes in terms of potential for death and destruction. "The Big One" is coming, we just do not know when it will strike because of randomness. It could be in 2-days, 2-months, 2-years, 2-decades, or 2-centuries. There is no way to know.

No one knows how the current outbreak may disrupt the real economy. There is a gamut of opinion among thoughtful people. As the media reminds us, it is easy to envision how we get to a severe economic downturn if a pandemic ensues. Sales will plummet. Bankruptcies will follow. Misery will spread like wildfire throughout the entire global value chain.

Then again, there are others who convincingly argue this too shall pass. The damage done to the global economy will be transitory. Governments will step-in with ever more financial engineering tricks and provide emergency loans so payrolls can be met. The markets will soon be done discounting whatever lies ahead in the real economy, and share prices will stabilize, setting the stage for the eventual resumption of the Bull Market.

To quantify what might happen under different examples, the well-regarded consultants at Oxford Economics are brave enough to take a stab. Their original base-case called for GDP growth of 1.7% in the US this year. They have now lowered that number to 1.5%, assuming we avoid a global pandemic.

Should there be a pandemic, but it is confined to Asia, Oxford believes our economy will grow by 1.3%. Finally, in the event of a global pandemic, they believe the American economy will contract by 0.1% in 2020.

In other words, a mild recession going into next year.

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I have no opinion on how things will play out, nor do I know the causes the current swoon in stock prices. The coronavirus could be the culprit. Equally, it could simply be a "correction" of the prevailing optimism mentioned. Then again, the fall in the market could reflect other problems no one is discussing. It is anyone's guess.

The key is not so much to debate "the why," but focus instead on how we should think about and react to what is happening. The framework I use is inspired by a concept that Charles Ellis calls the 'paradox of investment management.' It is an error all investors commit at some point and it is to be avoided at all cost.

The paradox: ***funds with long-term objectives that are both feasible and important are often managed to short-term objectives that may neither be feasible nor important.***

Here is the framework. There are four components. First, the long term feasible. Second, the long term important. Third, the short term feasible. Fourth, the short term important.

#1 - THE LONG TERM FEASIBLE.

Our goal is to own enduring businesses that can double the value of our invested capital in roughly 7 or 10 years, including dividends.

Is this still feasible?

Some background. The way to win in the stock market is to benefit from the magic of compounding. The way to go about doing this is threefold.

First, you need financial strength in a company because there will be bad times. Next, you need to pay a reasonable price for your stocks because that increases its yield. Finally, you need the business to be perennially profitable because profits spawn the ultimate source of investment returns.

Profits allow two things. They enable current dividends to be paid and they allow a company to make long term investments. The money kept in the business for investment is referred to as retained earnings.

An example of what I am discussing. Let us say a company earns a dollar of profit. Ideally it might pay a dividend of 30 cents. That money is paid to you directly. The remainder in this example is 70 cents and that amount represents retained earnings. You own that money, but it is kept by the company to invest in the business.

It is the compounding effect of these two elements, the dividends and retained earnings, that ultimately drive long-term returns. It is the stock market's "secret sauce." Nothing else!

Real life recent examples that align with the hypothetical. Despite stocks in general being expensive, three perennially profitable companies have been added to your portfolio. Each possess the attributes mentioned. They enjoy solid investment grade debt profiles. They were acquired at prices so undervalued that their dividend yield on cost is over 4 ½%. They keep roughly 60-70% of profits for investment.

Those profits have grown nicely over the years…

Two of the firms are Japanese trading companies, Mitsubishi Corp and Sumitomo Corp. Think of these firms as diversified holding companies like Graham Holdings, Jardine Matheson or Pargesa/GBL. The third company is Dwayne Johnson.

Sorry! I mean the other Rock, Prudential Financial, the diversified life insurance and investment management provider.

Bottom line. I remained convinced our rate-of-return goal remains feasible, given the reasons mentioned. I acknowledge our holdings could easily languish in price, or even become more undervalued, for a long time. But if we are patient and use common sense, the dual benefits of compounding dividends and compounding retained earnings should get us to our goal.

#2 - THE LONG TERM IMPORTANT:

To repeat, there are only two things that matter for investors in stocks: dividends and retained earnings. Nothing else. To benefit from these two factors, you have only one option and that is to keep your stocks. This is the long-term important.

The concept of receiving a cash dividend payment is straightforward. You own a stock and cash is credited to your account from time-to-time.

Retained earnings are a less visible benefit. In a well-run business it is by far the greatest benefit. You may not think about it, unless you read regulatory filings, but this is <u>your</u> money. Managers can use your money to feather their own nest, if they are crooks. They may squander this money, if they are incompetent. Or they may help you achieve your financial goals, if they are good investors.

Many of our businesses are run by managers who are excellent investors. Warren Buffet is the most famous, but the list includes Tom Gaynor at Markel, Johann Rupert at Richemont and Carl Icahn, among others.

When I was young and started my career with Dean Witter, I was told Dean Witter's success was due to being conservative in good times and aggressive in bad times. The money to implement this strategy came from retained earnings.

Here is the point. We could be on the verge of a Bear Market. Who knows? The important thing is that many of our businesses have the cash and the financial wherewithal to be aggressive in bad times, because they have been conservative during the good times. For instance, Buffett has over $100 billion and Rupert has proportionally an equal amount waiting for investment.

Instead of worrying about the quoted value of their company, great CEO/investors like Buffett and Rupert are looking to make investments they understand at attractive yields. That is how they will leverage upside during the next cycle and we as shareholders can go along for the ride.

This is tied to an adage: it is during bear markets that you truly make your money, contrary to how it may feel at the time. I add the caveat: assuming decision-makers in the businesses you own are good investors.

#3 - THE SHORT TERM FEASIBLE:

Determining if the effects of the coronavirus will permanently destroy investment returns for equities is not feasible. Period.

It is also not feasible to know how much bad news has already been factored into the price decline. For example, Jardine Matheson owns vast swarths of Hong Kong and has significant consumer businesses in China, yet its share price is higher than it was a couple of months ago. Go figure…

In times like these, the only short-term feasible is controlling your emotions and making sure you do not fall prey to the paradox of investment management.

#4 - THE SHORT TERM IMPORTANT:

This is in no way a forecast, but let us say, for argument's sake, that shares plummet another 40% from here. How will you feel?

I can tell you I will feel bummed-out in the extreme. Also, because I do this for a living, I will be conscious of not making investment decisions based on those feelings.

Feelings are not important. What is important is to be businesslike and remember the source of investment returns.

Hint: it is not the stock market.
