April 8, 2015

Negative Feedback Loops

"No matter how cold the winter, there's a springtime ahead." – Pearl Jam

With the first quarter now history, the S&P 500 boosted its streak of consecutive quarterly gains to nine—the longest such streak since the 1990s. In contrast to the 1990s, this quarter's gains were rather modest, with the S&P advancing 0.88%. The largest, most interesting and consequential moves were witnessed in currency and international markets. The US Dollar registered just shy of a 9% advance (as measured by the DXY index), its strongest performance since the "Lehman Quarter" in 2008 when a global flight to safety sent our currency soaring. We also saw legitimate "green shoots" emerge across the European region for the first time since their crisis deepened. Markets in Germany and Italy soared over 20% on the quarter, with the Stoxx Europe 600 adding just shy of 16%. These returns, when translated into US Dollars are less than what European investors experienced, though we believe springtime is unquestionably here for the European continent after a protracted, dark economic period.

We have often written about positive feedback loops—self-perpetuating cycles that accelerate and expand into booms and busts—and less so about negative feedback loops. When markets are trending distinctly in one direction, then positive feedback loops are a more meaningful descriptive force. Further, on the micro level, we are constantly looking for companies with positive feedback loops as tailwinds. Despite this asymmetry in our dialogue, negative feedback loops are an equally (if not more) important force in markets. A common colloquial synonym for the negative feedback loop is regression to mean or regression to trend. Markets as equilibrium-seeking entities are constantly impacted by negative feedback loops.

A recent example is the oil price collapse: as prices stayed elevated for a long time, producers increased production and new technology increased the available supply, thus pushing prices back towards a more rational equilibrium (see our October 2014 commentary for more detail on how this works).[1] On the micro/firm level, this happens when a cyclical firm earns a high return on capital, signaling to potential competitors that a big profit opportunity exists. When new competitors emerge, they capture for themselves a portion of this excess return, resulting in a lower level of economic profit (earnings in excess of cost of capital) captured by each individual company. Eventually all excess return is competed away, and typically exit barriers in any given industry lead to an oversupply and subsequently negative returns for each individual firm.

While the constructive shift in European policy over the past half-year has helped stimulate the region's economies, an equally meaningful force has come from the self-calibrating mechanisms (aka the

[1] http://www.rgaia.com/october-2014-investment-commentary-flooded-in-oil/

negative feedback loops) inherent to economies. It is a simple rule of thumb that human instincts and modern-day necessities can only be postponed for so long. This is what Warren Buffett was hinting at when he said “People may postpone hitching up during uncertain times, but eventually hormones take over” with regard to the inevitably of household formation growth and a recovery in U.S. housing demand.[2] In other words, the recovery of certain core economic goods is a “when, not if” question. Economic uncertainty is an unfortunate cause for delaying individual life goals, but it cannot be a reason for postponing core desires in perpetuity. At some point people simply say “enough is enough, I am doing this already” (whatever this may be). European economies had stagnated for so long now that certain necessities simply could not be postponed any longer.

We cannot minimize some of the very real hardships felt by far too many people during economic crises. Certain portions of the population simply cannot make ends meet and thus suffer harsher consequences than anyone should in this day and age of global wealth. We are specifically speaking about classes of the economy who have a degree of stability with regard to the basics of life, but cannot fathom making certain key decisions in the face of uncertainty. This pullback in economic activity amidst uncertainty is what Keynes called “the paradox of thrift.” This paradox is a force that compounds the positive feedback loop in the wrong direction. Liquidationists believe the self-calibrating forces we are speaking about so far in this commentary are enough on their own to restore the economy to growth. While this topics is worthy of a longer conversion, economies are far too complex for one force alone to change the trajectory of a massive body in motion. As we have consistently emphasized, stimulus of the monetary and fiscal variety is necessary to rejuvenate a depressed economy. Without stimulus, the weakest in society would be too vulnerable to increasingly poor outcomes. Equally important, without these negative feedback loops kicking in, stimulus could never go very far on its own.

The progress in Europe is not just in capital markets; rather, it is observable in actual economic data already. One of the first important data points we track to identify such inflection points turned positive at the end of 2014 and was a notable point in our 2015 Outlook: “We see evidence of upcoming growth with several of the continent’s weakest markets experiencing rising car sales for the first time in over half a decade.”[3] When cars reach a certain age (typically about 15 years) they are no longer reliable for transportation purposes. As individuals *en masse* delay auto purchases, a nation’s car stock ages. When this reaches a certain point, the negative feedback loop kicks in by essentially forcing (rather than merely encouraging) those with too old a car to seek a replacement. This auto example is illustrative of a demand cycle in one of the more economically sensitive durable goods, with repercussions that ripple through the entire economy. Meanwhile, the same forces are at work in many household, commercial

[2] http://fortune.com/2012/02/25/buffett-on-housing-was-dead-wrong-but-still-believes/
[3] http://www.rgaia.com/december-2014-investment-commentary-our-2015-investment-outlook/

and industrial settings as infrastructure ages and must be retired. Replacements can only be put off for so long.

When you combine these negative feedback loops with a steady dose of monetary stimulus and a declining currency (which stimulates export demand), you have the makings for springtime in Europe and the commencement of a positive feedback loop in the opposite direction. As Soros' has taught us, these inflection points tend to be some of the most powerful moves as negative numbers get replaced by positive numbers. Think of it this way: in moving from 3% growth to 5% growth, 2% is added to the rate; however, in pivoting from 2% contraction to 2% growth, your differential is a whole 6%. It doesn't take a whole lot of improvement from a negative environment for the pendulum to swing quite far in the opposite direction.

A Flower Blooms in ING (An early spring tulip, if you will)

We first bought shares in ING Groep in May of 2012. This past month, we doubled down on our holdings. While ING's price per share is considerably higher now, the risk is materially lower and the reward opportunity remains lush. This is one of our single favorite ways to capitalize on the recovery in Europe and further exemplifies a situation where both the micro and macro forces compound to create an asymmetric opportunity.

ING today is a completely different company than the one we bought in 2012, and this is by design. When the U.S. housing market collapsed, what had formerly been a global financial powerhouse became just another bailed out institution. As a condition for ING's bailout (imposed by the Dutch Government and the ECB), the company had to repay 50 cents for every $1 of capital injected. Moreover, the company had to agree to divest nearly all of its non-European core banking operations. This included ING Direct in the U.S., its Asian Insurance operations, the U.S.-based asset manager (now trading as Voya Financial), the European Insurer (now trading as NN Groep), and more.

These were far more onerous terms than anything witnessed in the U.S. and global investors steered clear of the company's shares for that reason. Harsh as they may be, the value proposition was too good to pass up. Further, when the asset disposition process started, the path to value realization was highly uncertain. Consequently, the company was trading at a steep discount to its tangible book value. Fast forward from May 2012 to today and many things have changed. First and foremost, ING realized tremendous value in the disposition of its assets, having sold some of its most valuable pieces at premiums to book value, while spinning off vibrant stand-alone companies and trimming stakes opportunistically as prices appreciated.

Prominent bank analyst Mike Mayo has argued both JP Morgan and Bank of America should break up because the sum of the parts would be worth much more than the whole is today.[4] ING is the most distinct case globally where this has happened and the process has been managed adeptly throughout. As a result of the successful dispositions, ING was able to repay their bailout to the Dutch government earlier than expected. As a result, what remains today is an over-capitalized bank that earns decent returns on equity (in excess of their cost of capital). ING was once again able to pay a shareholder dividend—this was formalized as of February.[5] Management has signaled a 40% payout ratio, which based on the quarter-closing price of $14.61 amounts to a 3.8% yield on expected 2015 earnings. Plus, with a tier 1 capital ratio of 13.59%, low leverage, and healthy stress test results, there could even be room for a special dividend.

The move to reinstate the dividend is huge on two fronts. The obvious impact is that recommencing the dividend opens the shares up to a broader universe of investors—those who require income/dividends. Considering this will be an ample yield in a world where many countries are at the zero-bound, such a yield on a safe, almost boring bank is nice. The not so obvious part is the role returning capital will have on the bank's ratios. Too much cash, whether it be on a balance sheet or in a portfolio, can be a drag on performance. Considering one of the biggest critiques of ING today is that they are "too boring" a company without assets in high growth areas anymore, and a pristine balance sheet, the return of capital to shareholders would be a very real boost to returns on capital and thus equity. Banks are valued based on how much they can earn on each dollar they have, so earning the same amount on fewer total dollars should lead to a better multiple.

Interestingly, another condition of the bailout will soon be lifted: as of November 2015, ING once again will be allowed to make acquisitions. is the company is much farther along its recovery and transformation than many European peers. Banks around Europe remain depressed valuation-wise and cheap, though loaded with uncertainty. Some are only now beginning large-scale dispositions. ING will be in excellent shape to act strategically and grow its core European bank operations. Stated most succinctly, 2015 will be the year this company pivots from a dispositive, de-risking strategy to an income and growth strategy.

[4] http://fortune.com/2015/03/26/bank-of-america-break-up/

[5] http://www.ing.com/Newsroom/All-news/Press-releases/PR/ING-Bank-posts-2014-underlying-net-profit-of-EUR-3424-million-Dividends-reinstated-with-EUR-0.12-per-ordinary-share.htm

What do we own?

The Leaders:[6]

Fiat Chrysler Automobiles (NYSE: FCAU) +40.9%

Fanuc Corp (OTC: FANUY) +32.8%

Howard Hughes Corp (NYSE: HHC) +31.6%

The Laggards:

America Movil (NYSE: AMX) -7.8%

Groupe SEB (OTC: SEBYF) -3.0%

Siemens AG (OTC: SIEGY) -1.0%

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-7800. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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[6] All gains (losses) are from date of purchase (sale) within quarter, if applicable. All gains (losses) on international securities are in U.S. dollar terms.