April 12, 2016

You Can't Smooth the Lumps

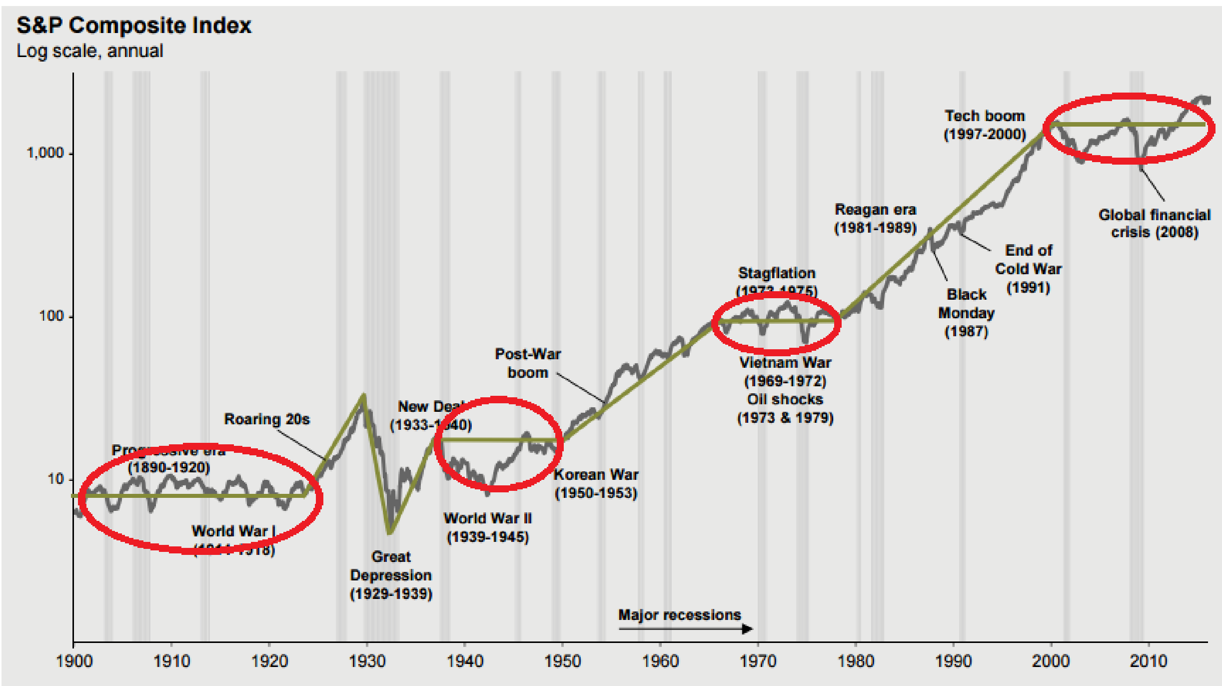
"Charlie (Munger) and I would much rather earn a lumpy 15 percent over time than a smooth 12 percent." – Warren Buffett

We called February a "tale of two halves" and the same can be said of the first quarter. The S&P finished the quarter up 1.3% after selling off by 10.7%. The Russell 2000 ended the quarter down 1.5% after dropping 16.6% in straight-line fashion to start the quarter. The reversal was led by a bounce in last year's most down-trodden sectors: energy, mining and industrials. The 10 year Treasury yield ended 2015 at 2.27%, but headed steadily lower to close the quarter at 1.78%. The staples and utilities sectors stayed strong throughout the quarter's volatility as a proxy for the move in rates. Valuations in the staples are really starting to concern us, and we will speak more to this point in future commentaries.

Take your lumps along the way:

The lead quote from Warren Buffett is perfectly suited for a conversation about this past quarter and the "lumpy" nature of returns in the stock market. Over the very long run, individual stocks and stock markets follow the path of earnings; however, in the short run, there can be significant disparities between an earnings stream and its trading price (this applies equally to indices as it does to common stocks). This disconnect is embodied in the multiple investors are willing to pay for a given earnings stream. When investors are enthused (concerned) about the future, this multiple rises (falls). Multiple compression is the phenomenon whereby earnings continue to grow while the multiple investors are willing to pay contracts. Oftentimes multiple compression results in an extended period of range-bound, sideways price action for a security.

The following chart from JP Morgan offers a great visualization of multiple compression in action:[1]



Source: FactSet, NBER, Robert Shiller, J.P. Morgan Asset Management.
Data shown in log scale to best illustrate long-term index patterns.
Past performance is not indicative of future returns. Chart is for illustrative purposes only.
Guide to the Markets – U.S. Data are as of March 31, 2016.

J.P.Morgan
Asset Management

We highlighted the relevant portions in red. Notice that the market traded sideways for years at a time. There were four such periods in the U.S. markets since 1900, with the most recent one having lasted from 2000 through 2013. While the price action hardly felt sideways in real-time—with two crashes in the midst—the improved perspective that hindsight offers highlights this period for what it is: multiple compression.

People love saying that "the stock market has averaged 6.7% real returns over the last hundred years." This is good and we encourage such a long-term perspective. At the same time, this view must be grounded in reality. Returns are anything but linear. Bernie Madoff's hedge fund returns were the closest example of linear returns that we've seen in a century, and we all know how that result was achieved.

[1] https://am.jpmorgan.com/blob-gim/1383280028969/83456/jp-littlebook.pdf

Ultimately market returns are very lumpy. *Time alternates between rewarding investors and testing their patience*.

Since the end of 2013, we have argued that markets rallied too far in the short-run and were due for a breather, with the most likely path being a sideways period.[2] We felt 'sideways' was more likely than an outright decline for one key reason: big declines typically happen alongside a turn in the economy, and the economy has been accelerating and improving throughout this entire sideways period. Oil threw a small curveball in this assessment, as the decline in oil-related investment threatened to throw the economy into recession. *Our thesis that the tailwind to consumer spending wrought by cheaper oil would ultimately outweigh the investment decline is finally looking like the most likely path.*

Don't depend on a straight line in your path:

Per Wikipedia, path dependence in markets "explains how the set of decisions one faces for any given circumstance is limited by the decisions one has made in the past, even though past circumstances may no longer be relevant." Path dependence is a concept from physics, borrowed by economics. One application to markets is the notion that the trajectory a price takes is determinative of the underlying's value in the future. The trajectory also can influence the decisions stakeholders make with regard to their own economic choices or the asset itself.

This relates directly to the idea that markets move in lumpy fashion. An investor who expects a smooth 6.7% annualized real return cannot expect to earn that return in accordance with any calendar. If however the investor plans on spending a portion of his or her investment assets each year, premised on a linear return, the path markets take would very much matter. Were markets to drop before rising, there is the potential for a shortfall relative to a need right away. *Further, in selling to meet the spending need in the face of the initial drop in asset prices, this investor would be in line to fall short of the 6.7% real return from their starting point even if markets did in fact deliver this return over the long run.*

This would be so even if markets went sideways instead of down to start, but the result is even more pronounced when initial losses are incurred. Some numbers will help make clear why this is true. Let's say we have two investors, each with $1,000,000 to invest. Each also will spend $100,000 at the end of every calendar year. For simplicity's sake, let's also assume the expected return is 6.7% annualized (leaving aside real or nominal considerations) and that there is no tax obligation. Investor 1 was blessed with the capacity for straight-line 6.7% annualized returns, while Investor 2 must face Mr. Market's fluctuations along the way, yet still, for the purposes of this write-up, he is guaranteed 6.7% annualized returns over "the long

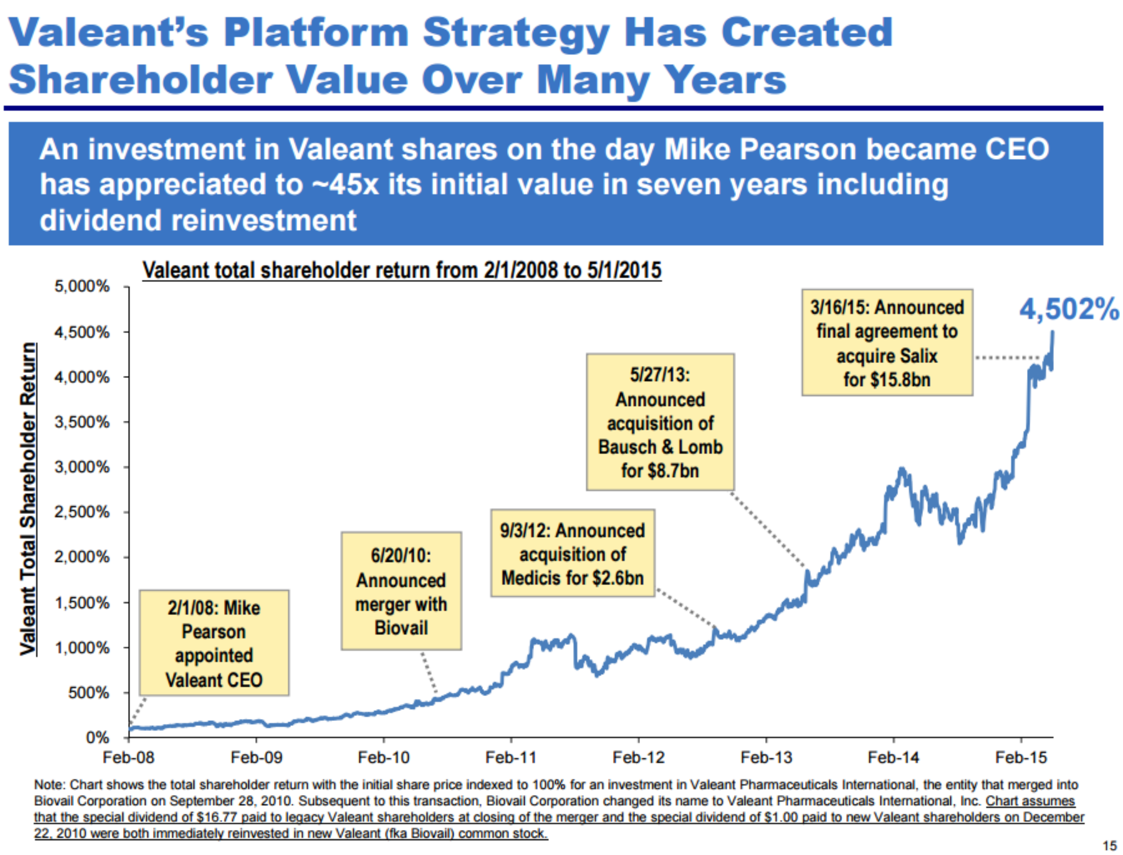
[2] http://www.rgaia.com/december-2013-investment-commentary-our-2014-outlook/

term.” In year one, Investor 1 earns $67,000 in income. After spending the $100,000 he will be left with $967,000. Investor 2 meanwhile is dealt bad luck for year one and loses 10%. At the end of the year, after spending $100,000, Investor 2 is thus left with $800,000.

In year two, Investor 1, with a 6.7% gain and $100,000 expense, is left with $931,789. Investor 2’s luck reversed and he earns a 26.5% return. This is the exact return needed to offset last year’s 10% decline and return to the 6.7% annualized pace Investor 2 is guaranteed. After the 26.5% gain and the $100,000 expense, Investor 2 ends the second year with $912,000. This amount is $19,789 less than Investor 1. Even if from here on out both investors earn a smooth 6.7%, Investor 2 would end up behind Investor 1. The path thus consequentially changed the outcome for these two different investors. We take the concept of path dependency very seriously when constructing portfolios for clients who may be vulnerable to its consequences.

We are also attuned to path dependency on the company level when we do our bottoms up analysis. So far this year, hardly a day goes by without a headline pertaining to Valeant Pharmaceuticals (NYSE: VRX). This stock in many respects is the perfect embodiment of path dependency in action. In May of 2015, Bill Ackman made a presentation entitled “45x” at the Ira Sohn Investment Conference in New York. This number represented the spectacular returns earned by two “platform companies” (Jarden and Valeant) up to that point in time.

Here is the chart introducing Valeant in Ackman's slide:



Valeant generated the 45x return for shareholders who held the company from February 1, 2008 to May 1, 2015. The stock continued to trade higher into early August 2015, before its chart turned into a cascading waterfall.

Here is what the Valeant chart looks like from May 1, 2015 through the end of Q1 2016:

Note that the stock is down 87.88% in the above timeframe. Much ink has been spilled over Valeant, and we could continue to write about this company and its stock ad nauseam. Since your time is sparse, we will focus on what we think is the important and broadly applicable take-away. Both the rise and fall in Valeant were directly related to the path dependency inherent to its business model. Leaving aside some of the secondary sources of growth, Valeant's primary means for achieving its growth target was via acquisition. In order to finance these acquisitions, the company used a combination of equity and debt. As the stock price rose, Valeant had a growing "currency" in the form of its shares to use for acquisition financing. With a rising stock price, also came increased debt capacity. On its ascent, each acquisition by Valeant further boosted its share price. Each extra boost in its stock price created greater equity and debt capacity for financing future acquisitions. This enabled the company to make larger acquisitions every step of the way—as is evident on Ackman's slide above highlighting the main events in Valeant's history. As a result of its success, investors priced in growth premised on Valeant's continued ability to make value-enhancing acquisitions.

For a variety of reasons, Valeant's stock price started falling. It started slowly and subtly. The stock kept falling and the narrative and sentiment eventually started turning sour. A moment of truth occurred in October 2015 when Roddy Boyd of the Southern Investigative Reporting Foundation unearthed some unscrupulous practices happening at the company's wholly owned, specialty pharmacy Philidor.[3] From that point on, it became clear that Valeant would be essentially incapable of completing another acquisition until it patched some holes in its trove of businesses.

The exposure of problems at the company alongside a falling stock price categorically changed the fundamentals of the business. This is important to grasp, for it was not the business that changed, thus pulling the stock with it—as is typical in the stock market. Instead, it was the stock dragging the business down. We think this would have happened to the company irrespective of what the precise catalyst was. Why? First, these problems precluded another acquisition, thus "pricing out" any potential growth via M&A from the stock. Second, they precluded the company from using its existing practices to squeeze out growth from their products. Third, all of these factors collectively forced doctors, patients and the other health system stakeholders to question whether they should even use Valeant's treatments at all when safe alternatives were possible.

These factors all led to a second big moment of truth in March, when the company reported earnings and guidance that missed consensus estimates by a significant amount.[4] The forces at work here, whereby the stock price influences fundamentals and vice versa is something we covered with respect to MLPs, oil and ETFs. This relates back to George Soros' notion of reflexivity and the prevalence of positive feedback loops, another physics concept adopted by finance to better understand financial markets. We are speaking about these concepts again here, because this quarter was exceptionally volatile in financial markets and Valeant is a widely covered story in the media. Both factors have created sympathy selling in our holdings that are in the same sector as Valeant—Teva Pharmaceuticals (NASDAQ: TEVA), Sanofi Aventis (NYSE: SNY) and Vertex Pharmaceuticals (NASDAQ: VRTX). None of these stocks share the features that have impacted Valeant on the way down and it is only a matter of time before the strong fundamental backdrop for our holdings reasserts itself.

[3] http://sirf-online.org/2015/10/19/hidden-in-plain-sight-valeants-big-crazy-sort-of-secret-story/

[4] http://www.cnbc.com/2016/03/15/valeant-pharmaceuticals-reports-fourth-quarter-2015-earnings.html

What do we own?

Returns reflect US dollar denominated returns over our holding period.

The Leaders:

GrubHub Inc (NYSE: GRUB) +26.9%[5]

Priceline Group (NASDAQ: PCLN) +17.7%[6]

PayPal Holdings Inc (NASDAQ: PYPL) +6.6%

The Laggards:

Vertex Pharmaceuticals (NASDAQ: VRTX) -36.8%

DXP Enterprises (NASDAQ: DXPE) -23.0%

Exor SpA (BIT: EXO) -21.6%

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 516-665-1945. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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[5] Position commenced intra quarter
[6] Position commenced intra quarter

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