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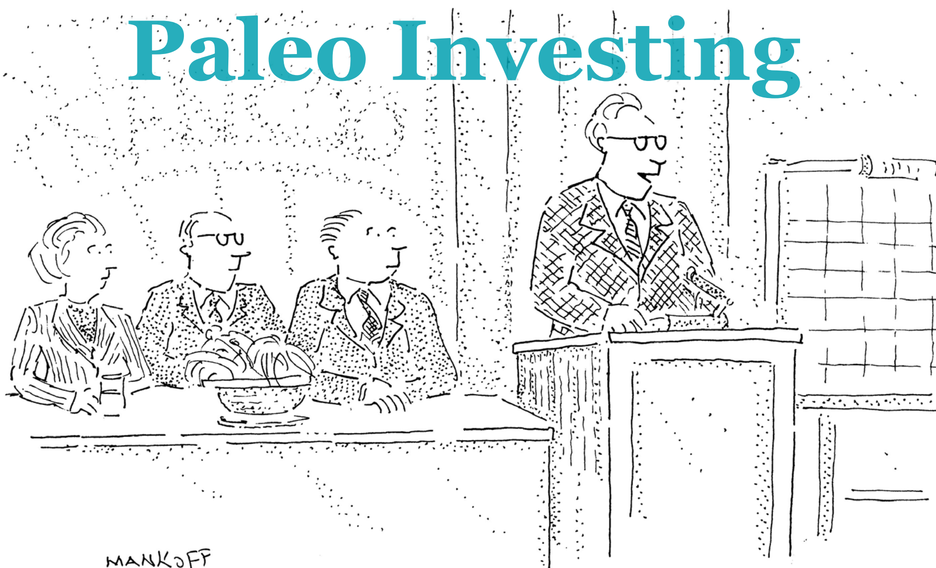
Paleo Investing



"And so, while the end-of-the-world scenario will be rife with unimaginable horrors, we believe that the pre-end period will be filled with unprecedented opportunities for profit."

I have resisted writing this Letter for a few weeks because I did not want to denigrate the intelligence of or the working relationship with our clients by even suggesting it was appropriate to comment on two weeks of stock market movement. I am impressed and incredibly pleased with our client base in that the topic of the two calls we did receive from clients in August was "So I suppose you want more money here." Thank you.

While I admit to being terribly fond of witticisms that may or may not be at all additive to the approach of identifying and purchasing undervalued securities, I think this one applies in all shades: What have investors learned from history? Apparently not a damn thing.

Yes, it is a sad fact of life that we are swimming in useless information whose value is often equivalent to the price and ease of obtaining it. And yes, it is simply a historical fact that markets tend to rise in more of a randomly methodical way. When they do periodically get crushed (a.k.a. "correction"), they tend to get crushed in an avalanche of price movement that appears to be out of the blue but is in fact the result of a long march of obviousness that now beholds itself in broad daylight. And yes, it is also a well-documented behavioral factoid that our brains are innately "loss adverse" and thus we feel the pain of a decline in an asymmetrically disproportionate fashion relative to the enjoyment of the upside.

And that explains most of August in the financial markets. I will throw in the Chinese decision to allow the Yuan to depreciate as something of materiality that actually did change. As is often the case, small changes can have disproportionate short-run effects in markets that trade with a huge amount of leverage, and that is what most clearly defines currency markets. Is it new information that the Chinese have habitually lied about their economic statistics since Nixon played ping pong? Nope. Is it really new news that the Chinese have wildly over-built capacity in most of the world's old school commodities? Nope. Is it really that controversial to suggest that China is a large country still growing into its size as far as regulation, economic statistics, laws, etc., and thus its ability to print a GDP number two weeks after a quarter-end is a political statement rather than a financial one? (The US takes a month and then another year revising it.) Nope. Oh, and aren't cheaper Chinese imports and lower commodity prices good for the rest of us? Yup.

Besides what I call the "silly stocks" in tech and bio-tech, the biggest sector crush was in the world of cyclical companies. The global economy is sluggish and China was simply the last of the BRIC's to throw in the towel. And as one finally gets to apply something everyone learns in calculus, the 2nd derivative does apply here: less Chinese growth means a decline in the rate of change of global growth. And while I may not own a company that sells a lot to China directly or is directly involved in the production of commodities impacted by a collapse in Chinese demand, I am sure I own a bunch that sell to the multinationals that are selling directly to the Chinese. It is crucial to understand that US exports to China are less than 1% of our GDP and what remains a distant glimmer in the eye of most US businesses is the 1990's aphorism of "if every Chinese citizen bought one _______, we would have it made in the shade."

But we argue the following—a key to good long-term investing is to correctly appreciate the difference between a cyclical problem and a secular problem. If you get that differential right, you can make a lot of money. Cyclical problems are by definition inherently buyable, and that's precisely where we have been focusing our time over last few weeks. And while the classic definition of "value" might seem to some to involve buying the cheapest, most leveraged cyclical company the day before it doesn't go bankrupt (and then crowing about it in Barron's), that is not in any way necessary here given some of the recent travails of some pretty decent businesses whose cashflow cannot be predicted with a straight-edge ruler.

The scariest thing about the "Chinese plunge" in my mind was the story that Chinese police arrested several hundred people including prominent financial journalist Wang Xiaolu of Caijing Magazine who apparently "confessed" to penning a fake report on July 20 that was "based on hearsay and his own subjective guesses without conducting due verifications." Applying this standard to Wall Street, which is pretty much the Elizabeth Warren Presidential tag-line, would have a devastating impact on life as we know it.

I also find it somewhat amusing that per our last Strategy Letter, it is politically popular in the US to bash corporate finance techniques, yet not so in China. Four Chinese regulatory agencies have issued a joint statement "encouraging" listed companies to hand out more dividends, buy back their own shares, and carry out more mergers and corporate restructurings to boost slumping share prices.

Back at the El Segundo ranch, we generally do what we always do—research and learn about new and old companies, attempt to reasonably value them, and then compare our rough estimates with the exactitude offered by quoted prices listed on global exchanges. The obvious occurred in August: more securities reached levels which improved their absolute and relative (to fixed income) risk/reward. We did what we do and stepped in and selectively purchased more of what we own and like, as well as some newer ideas. We will do more of the same if the Value Restoration Project continues.

While it can be self-deprecatingly fun to describe ourselves as the "dumb guys" of the investment business because we are long-only and equity-oriented, I would argue to any large foundation or endowment that we are blessed with several structural advantages that make us a proper choice to take advantage of severe downturns:

1. We don't have debt.
2. We don't use leverage.
3. We don't have a high water mark.
4. We are talent dense and don't employ a rabid bunch that will desert the firm if they realize their bonus might be down in a year.
5. We fish in the right ponds—small cap and value.
6. We have a process and an intellectual structure that enables us to see a price decline as an opportunity, not as an anxious moment that causes us to doubt our entire position.
7. We have been careful about the clients with whom we work.

Going forward, we remain uncertain about the future. Every investor should recognize the high likelihood for periodic bruises, but the biggest issue surrounds how your brain and your portfolio are positioned to take the inevitable bruises and then get right back up. This is 4th or 5th time since 2009—depending on how you count—that the financial markets are swinging wildly between "things are ok" and "we are in deflationary hell that will take all of us with it." There remains nothing inherently wrong with the strategy of hitting it up the middle and leaning against each extreme. Our early summer Strategy Letter noted that "hedge fund short-selling is at an all-time low." Now we have "academic" papers on Quantitative Approaches to Tactical Asset Allocation being the most highly downloaded on hedge fund websites. (It focuses on a market-timing technique to "help investors smooth volatility in their portfolios while remaining in profitable positions—and protecting themselves should the bubble burst." Thank God someone finally figured that out for us.)

We continue to think that our biggest risk is the one for which we simply have no history whatsoever to study: that being the unwinding of the quantitative easing experiment currently in its 6th year. The main problem is not about prognosticating when and by how much the Fed should or will raise interest rates, it's that we seem to have abandoned the idea that it is markets that should be determining the correct level of prevailing interest rates. The world's formerly smartest men seem to be doing a fine job of mucking it up in China. I have no idea why Washington is going to be any better at it.

— Jeffrey Bronchick, CFA | Principal, Portfolio Manager

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