



# Q2 2016 MARKET REVIEW & OUTLOOK

Morgan Creek Capital Management



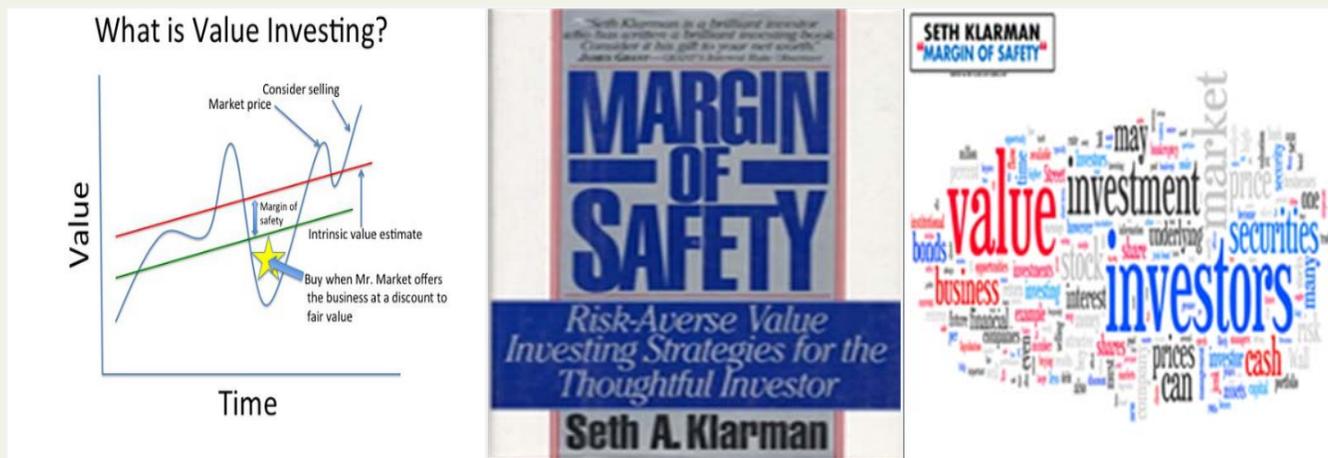
MORGAN CREEK CAPITAL MANAGEMENT

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# LETTER TO FELLOW INVESTORS

## THE VALUE OF VALUE



Source(s): fool.com, amazon.com, futureblind.com

Contrary to recent media coverage, Seth Klarman is not most well known for being another billionaire who has just changed party loyalties in the current Presidential race, but rather for his incredible investing acumen that has generated 16.4% annual compounded returns for his investors over a remarkable thirty-three year career as the Chief Investment Officer of the Baupost Group. For all of you pulling out the calculators, yes, this amazing track record has compounded \$1 into \$150. Klarman grew up outside of Baltimore, the son of a college professor and a high school teacher, which helps explain his reputation for being incredibly intelligent, but it takes more than intelligence to be a great investor. Growing up near Pimlico Race Course there are rumors that he gained an interest in numbers at the track (as well as a love of race horses which continues today) and decided to attend Cornell and study math. However, as one who personally changed majors three times, this author can attest to the fact that college plans often change. Thanks to his early interest in the “stock pages,” perhaps, or some other influence (mine was a girl), he ended up following his father’s footsteps and graduated with high honors and a degree in economics. One of my favorite sayings is, “life is a series of happy accidents,” and Klarman had the fortunate experience of having an uncle who helped him get a summer internship at Mutual Shares (the legendary Value Investment firm founded by Max Heine and later run by Michael Price). At Mutual Shares Klarman was “inoculated” with the Value Investing bug, and he returned to the firm after graduation. Although he left after only eighteen months for Harvard Business School, Michael Price said in an interview that “Seth left us as a true believer”. At HBS, Klarman experienced another happy accident when he took a Real Estate class with Professor William Poorvu who immediately recognized Klarman’s intellectual abilities, later recalling in an interview that “He was the smartest person in the class,” and, “I realized he was a special guy.” Klarman graduated from HBS as a Baker Scholar (top 5% of the class). He was then invited to lunch one day by Poorvu where the professor explained that he and some associates had just sold their business interests. They planned to set up a family office to manage the “considerable sums” of money, and they wanted him to join. In 1982, Poorvu, Howard Stevenson, Jordan Baruch and Isaac Auerbach formed Baupost (an acronym using the first two letters of their four last names), and hired Klarman to manage their \$27 million fortune (roughly \$70 million in 2016 dollars) for a modest \$35k salary. From those humble beginnings, Baupost has grown to be one of the largest, and most successful, hedge funds in the world with \$30 billion in assets at the last count.

The original plan was for Klarman to be the portfolio manager and Stevenson to serve as part-time President, since he was still teaching Entrepreneurship at Harvard. Baupost would then allocate the capital out to other managers. However, a problem quickly arose when the principals began to meet with investment firms. After just a few meetings they made two observations. First, there was a disconnect between the way the managers described how they managed their own money and that of their clients. Second, the young protégé, Klarman, was asking routinely insightful questions that were often more impressive than the portfolio managers pitching them. Poorvu recalled in the interview how he was drawn to Klarman's "curiosity and desire to explore things in depth," his "fearlessness, in that he was not afraid to challenge anyone." The group quickly decided that they would change the investment model of Baupost and Klarman would be the actual portfolio manager. Jim Grant (author of the famous Grant's Interest Rate Observer newsletter) later described Klarman in a similar fashion in a profile, saying he was "ferociously smart, notoriously prickly and not one to engage in many soft preliminaries in a business context." Grant went further to tell a story of how brokers at Goldman Sachs, afraid to endure Klarman's barrage of questions on their investment ideas, would often choose not to answer the phone if the Caller ID flashed Baupost's name on their screens, essentially forfeiting a potential commission in order to avoid Klarman's fierce intellectual prodding. Armed with this intelligence and Value discipline instilled in him by Heine and Price, Klarman came to the conclusion that the best way to compound wealth was to avoid losing money and keep the power of compounding working in your favor (Baupost has only had three negative years in thirty-three, and none of them were significant). In order to not lose money, his differentiating insight was that an investor couldn't traffic in the most widely covered (and therefore over-owned and over-priced) names on Wall Street, but had to focus on buying those out of favor names he calls "bargains." Klarman has described bargains as securities where "you are buying a big discount, buying a margin of safety." Another key element of the philosophy was that an investor had to be patient in waiting for things to "go on sale," and be willing to hold cash when securities (and markets) were overpriced. Perhaps one of the most remarkable things (among many) of the Baupost track record is that it is routine for them to hold 30% to 50% in cash while they are looking for things to buy. To generate the types of returns they have for over three decades with a huge percentage of the portfolio in cash offers a strong challenge to the traditional mantra that portfolio managers should be fully invested at all times. When one of Klarman's chief lieutenants retired last year, he discussed the use of cash in his farewell letter saying, "*one of the most common misconceptions regarding Baupost is that most outsiders think we have generated good risk-adjusted returns despite holding cash. Most insiders, on the other hand, believe we have generated those returns BECAUSE of that cash. Without that cash, it would be impossible to deploy capital when we enter a tide market and great opportunities become widespread.*" In other words, cash has protective and option value, keeping portfolios safe during dislocations and providing liquidity to buy bargains with high margins of safety after the corrections occur.

The concept of margin of safety is so important to Klarman and his Value investment style that he penned a book in 1991 with the simple title *Margin of Safety* (pictured above). This book has achieved a nearly cult-like status as one of the "Bibles" for Value Investors. Furthermore, due to its limited printing (only 5,000 original copies and has never been reprinted) copies now sell on Amazon and eBay for prices between \$1,000 and \$2,000 (depending on condition). There are many theories on why there have not been more printings. Some say the publisher didn't do a very good job (three different editors) while others think that Klarman was a relatively unknown hedge fund manager in 1991 (Baupost only had \$400 million in assets) so there wasn't much interest. Still others are of the mindset that Value investing was on the outs at the time since many Value managers had suffered during the recession. Whatever the case, *Margin of Safety* remained an obscure tome for many years and, unfortunately, the Baupost performance for the next decade didn't help much with its popularity. Value investing fell increasingly

out of favor during the 1990's bull market leading up to the Tech Bubble and Crash. Now many people would have been quite pleased to compound capital over the next ten years at nearly 13% (taking the \$400 million to \$1.3 billion just on performance). Alas, the S&P 500 had one of the most spectacular decades in its history over that period and compounded at more than 15%, and no one wanted to talk about Value in 2000. At Baupost, the last two years of that period were the most challenging with losses in the low teens in 1998 and a single digit return in 1999, and Klarman concluded his year-end letter by saying, ***“The last two years have been difficult ones for The Baupost Fund. We are disappointed but not disillusioned, and remain confident that a fundamentally-driven, disciplined value investment approach will deliver good results with limited risk over time. We appreciate your patience and support and look forward to a period of improved performance.”***

Just how great was the aversion toward Value in 2000? A story might help illustrate. Klarman is a disciple of another legendary Value investor, Jeremy Grantham, much as we are at MCCM. I was CIO at UNC at the time and was making the case to the Investment Committee in early 2000 that we should be rotating away from Growth (which had wildly outperformed in recent years) and move some capital toward Value (which had underperformed). In fact, the recommendation was to give money to GMO, Jeremy's firm, for their Value product. Jeremy is famous for the incredible accuracy of his forecasts for asset class returns, but they tend to be very contrarian (by their nature since they are based on mean reversion). My Chairman didn't want to hear any more about Value strategies. He particularly didn't want to hear any more about Jeremy's prediction that the S&P would have a negative return for the next decade, and said, “Mark, you are not allowed to use the letters, G, M, or O in a sentence in this room again.” As it turns out, Jeremy was precisely right, the S&P 500 compounded at a stunning rate of negative (1%) from 2000 to 2010 (let that sink in, a decade of negative returns from the U.S. equity market). What you probably don't know is that Klarman compounded at an astonishing 17% for the same period (remember that the decade from 2000 to 2010 included two declines greater than 50%). Suddenly everyone wanted to hear about Value. *Margin of Safety* became a not-so-instant classic. Klarman became a more widely known hedge fund manager, and Baupost's assets swelled to \$22 billion. Keep in mind that over that period some legendary hedge funds were forced to close up shop (some in 2000-2002 and more in 2008-2009). All the while Baupost grew at an astonishing rate, tripling assets from 2002 to 2008 and doubled assets again from 2008 to 2010 (they actually raised \$4B in 2008 while other marquee names shuttered). With a little math here one might realize that compounding at 17% for a decade means you end the period with nearly five times as much money as you started with, so most of the increase in AUM was organic growth. As of the end of 2015, Baupost has generated the 4<sup>th</sup> largest amount of gains for investors of all hedge funds at \$22.6 billion (behind only Dalio, Soros and Tepper). One last element of the discipline that Klarman follows at Baupost is their propensity to return money to investors if they believe that the investing environment is unfavorable. They have returned capital on numerous occasions, with the latest being a \$4 billion distribution in 2013.

Circling back to *Margin of Safety*, there are many good reviews/analyses of the book available so we will not recreate the wheel here by diving too deeply into the contents of the manuscript itself. We will rather follow our traditional format of integrating quotes from Klarman assembled from various sources that will tell a story of how this great investor thinks about the philosophy of investing, the investment business and the current market landscape. However, we do want to start off by establishing the core concept of margin of safety as the cornerstone for Value investing as we make our case for *The Value of Value* given today's challenging investment environment. Klarman begins the book acknowledging that ***“Value investing is not being discussed here for the first time”*** and, in fact, the original concept for margin of safety belongs to Benjamin Graham and David Dodd (considered by many to be the founding fathers of Value Investing) who wrote the seminal work on Value Investing, *Security*

*Analysis*, in 1934 (original copies sell for nearly ten times as much as *Margin of Safety*). As illustrated in the graphic above, Price and Value are two very different things. The Price of something is what a buyer is willing to pay a seller, while Value is the intrinsic worth of that item. In the markets, investors should only buy stocks, bonds, or other assets when the Price is meaningfully lower than the Value. The difference between the two is the Margin of Safety, and limiting yourself to only buying assets when there is adequate margin of safety is how you protect yourself from the cardinal sin of investing, losing money. Klarman said he wanted the book to be a manual for investors, not on how to invest, but rather how to think about investing. He wanted to elucidate a thoughtful approach to selecting the best securities across the capital structure (both stocks and bonds) in a risk-averse framework that will ensure long-term compounding of wealth to help investors avoid the disastrous results experienced by following an undisciplined approach.

When asked why he would give away his investing secrets in a book, Klarman quipped that the Value investing legends like Graham and Buffett had articulated their brilliant Value philosophies for years and if investors would not heed their wisdom, they were unlikely to listen to him. In talking about his expectations for the limited impact of his book, Klarman went on to say, ***“Warren Buffett once wrote that value investing is like an inoculation, it either takes or it doesn’t, and when you explain to somebody what it is and how it works and why it works and show them the returns, either they get it or they don’t. Value investing is not a concept that can be learned and gradually applied over time. It is absorbed and adopted at once, or it is never truly learned.”*** The other challenge is that the investment business is set up to promulgate the exact opposite approach to investing, encouraging lots of activity (more commissions), discouraging the use of cash (which generates less fees) and the industry spends a lot of money to create the image that sitting around waiting for securities to go on sale is a fool’s errand. Klarman further explains how giving away all his ideas would not lead to less opportunity for him and Baupost clients in his quote, ***“Value investing requires a great deal of hard work, unusually strict discipline, and a long-term investment horizon. Few are willing and able to devote sufficient time and effort to become value investors, and only a fraction of those have the proper mind-set to succeed.”*** Hard work, discipline and patience are indeed virtues, but we can all cite plenty of examples in our lives where we know what is good for us (eating right, exercising, building relationships) yet we can’t consistently muster up these virtues to achieve success. After a very challenging 2015 Klarman summed this challenge up again in his year-end letter by writing, ***“Did we ever mention that investing is hard work, painstaking, relentless, and at times confounding? Separating relevant signal from noise can be especially difficult. Endless patience, great discipline, and steely resolve are required. Nothing you do will guarantee success, though you can tilt the odds significantly in your favor by having the right Philosophy, Mindset, Process, Team, Clients, and Culture. Getting those six things right is just about everything.”*** Let us explore those elements to discover *The Value of Value*.

### Klarman on Philosophy

Investing has been called the last liberal art, so talking about Philosophy seems an apt way to begin our discovery process. One of the things I really appreciate about Klarman’s approach is summed up in his quote, ***“The real secret to investing is that there is no secret to investing.”*** Value investing is not some deep, dark secret available to only a privileged few, but rather a broadly available and easily accessible construct that anyone can attempt to practice. We use the term “attempt” intentionally here because ***“Value investing is simple to understand but difficult to implement.”*** As we mentioned above, there are plenty of pursuits in life that are simple in concept but challenging to continuously commit to over time. Furthermore, Klarman advises those that

have now checked the boxes on understanding and commitment and are working their way down to returns that ***“while some might mistakenly consider value investing a mechanical tool for identifying bargains, it is actually a comprehensive investment philosophy that emphasizes the need to perform in-depth fundamental analysis, pursue long-term investment results, limit risk, and resist crowd psychology.”*** And if anyone has scratched returns off their list, put a little star around patience in all capital letters, and now checked comprehensive philosophy, there still might be a more fundamental requirement. Klarman is of the mindset that you might have to be born with the capacity to accept the philosophy entirely. ***“It turns out that value investing is something that is in your blood. There are people who just don't have the patience and discipline to do it, and there are people who do. So it leads me to think it's genetic.”*** In other words, no matter how many times you read books on the subject, no matter how many great Value investors' habits you study and seek to emulate, no matter how much you want to be a Value investor, it may not matter. While this is a fairly strong statement and my first reaction is to say that anything can be learned (nurture beats nature), admittedly, throughout my career it has been rather easy to pick out true Value investors, as they do tend to be different than other investors. My own personal experience is that I have always been a Value investor at my core, and whenever I have tried to alter my approach (like trying to buy growth stocks at triple digit multiples) the experience has been uncomfortable and quite challenging.

Klarman sums up the philosophy in five simple words, ***“Value investing is risk aversion.”*** He goes on to say, ***“In contrast to the speculators preoccupation with rapid gain, value investors demonstrate their risk aversion by striving to avoid loss.”*** It is not news to speak about avoiding loss being at the core of investing success. Roy Neuberger said it first that there were three rules to managing money and Klarman reminds us that Warren Buffet paraphrased Roy saying, ***“The first rule of investing is ‘Don't lose money,’ and the second rule is, ‘Never forget the first rule.’”*** An important clarification, however, is that ***“this does not mean that investors should never incur the risk of any loss at all. Rather ‘Don't lose money’ means that over several years an investment portfolio should not be exposed to appreciable loss of principal.”*** We know that the investing legends (Soros, Robertson, Steinhardt) were right around 58%, so there were plenty of times when they would lose money, but Soros said it best. ***“It's not important whether you're right or wrong, what's important is how much money you make when you're right and how much money you lose when you're wrong.”*** At Baupost the same approach applies, ***“We continue to adhere to a common-sense view of risk, how much we can lose and the probability of losing it. While this perspective may seem over simplistic or even hopelessly outdated, we believe it provides a vital clarity about the true risks in investing.”*** In the end, risk is not a temporary movement in the price of an asset (volatility), but the permanent impairment of capital. The absolute size of the loss is also determined not only by how much capital is at risk, but rather, by the probability that a real loss will be incurred. Finally, a loss that many don't think about properly is the loss of purchasing power to inflation over time (for example a bond may return your principal, plus a fixed interest rate, but if inflation exceeds that rate, you incur a loss).

When confronted with the prospect of loss, ***“there are only a few things investors can do to counteract risk: diversify adequately, hedge when appropriate, and invest with a margin of safety. It is precisely because we do not, and cannot, know all the risks of an investment that we strive to invest at a discount. The bargain element helps to provide a cushion for when things go wrong.”*** As we summarized previously, ***“A margin of safety is achieved when securities are purchased at prices sufficiently below underlying value to allow for human error, bad luck, or extreme volatility in a complex, unpredictable and rapidly changing world.”*** There are more things that can go wrong in any investment than you can predict or even imagine given the

dynamic environment into which we deploy capital. Having a philosophy that integrates a process for dealing with errors, luck, fortune, volatility and complexity is critical for success. Klarman points back to the source in his reminder that ***“by investing at a discount, Benjamin Graham knew that he was unlikely to experience losses.”*** This is an extremely powerful statement. There are obviously a number of places where error could disrupt the process, but assuming good analysis and the disciplined application of bargain purchasing, the *probability* of loss can fall exponentially.

Interestingly, Klarman would have us believe that, again, simplicity reigns over complexity and that there is no rocket science involved. ***“Value investors are not super sophisticated analytical wizards who create and apply intricate computer models to find attractive opportunities or assess underlying value.”*** Of course there are those that do use supercomputers and teams of PhDs to identify value, but Klarman is saying that it is not necessary. Of critical importance to the discipline is that fact that ***“there’s no such thing as a value company. Price is all that matters. At some price, an asset is a buy, at another it’s a hold, and at another it’s a sell.”*** While this sounds simple enough, the deeper essence of the statement runs counter to a long-held belief on the efficiency of markets. In fact, ***“Value investing is predicated on the efficient market hypothesis being wrong.”*** The EMH contends that the current price of a security is an instantaneously accurate reflection of all available information. Thus, there is never any mispricing. Klarman expounds on the opposing ideologies in saying, ***“The stock market is the story of cycles and of the human behavior that is responsible for overreactions in both directions. I think markets will never be efficient because of human nature.”*** John Burbank, of Passport Capital, always says that ***“Price is a Liar.”*** Those pendulum swings of market overreaction move prices into ranges where it is clearly more appropriate to buy/sell depending on the level of discount or premium to intrinsic value. The great opportunity then for Value investors (and the opportunity cost of those ascribing to the EMH) is that the extremes of human behavior will push prices to extremes. Those that have been diligent in their work determining intrinsic value of securities have the chance to find bargain or take profits with each passing swing.

One of the challenges for implementing the Value philosophy is that ***“Value investing by its very nature is contrarian. It is, at its core, the marriage of a contrarian streak and a calculator.”*** On average, humans are uncomfortable contrarians. Evolution has taught us that it is warmer in the center of the herd. However, Klarman stresses the importance of leaving the herd. ***“The overwhelming majority of people are comfortable with consensus. Yet distancing yourself from the crowd is an essential component of long-term investment success, because over the long run, the crowd is always wrong.”*** Words like “overwhelmingly” and “always” might raise some eyebrows, but the data backs up these contentions over the long-run. The majority of investors underperform primarily because of their unfortunate propensity to follow the crowd right over the cliff when valuations get crazy and FOMO (fear of missing out) takes over. Furthering his point Klarman notes that ***“avoiding where others go wrong is an important step in achieving investment success. In fact, it almost assures it.”*** Having the ability to step away from the masses and not only to avoid their misfortune, but actually to benefit from the crowd going wrong is an elegant concept. It makes sense mathematically that if there is a large cohort that loses money by pursuing an inferior option (chasing the hot dot or selling after a large decline) then those that take the opposite side are choosing the superior option. The real key to success in this regard is to have inculcated the Value philosophy, practice discipline and have a process that ensures that you will indeed end up on the other side of the crowd. In other words, ***“the fundamental principles of value investing, if they make sense to you, can allow you to survive and prosper when everyone else is rudderless.”*** Critically, the principles have to “make sense to you,” and perhaps even more importantly, you must have a predisposition toward Value as a core philosophy in order to capitalize on the advantages they afford.

***“The hard parts of Value investing are Discipline, Patience, and Judgment. Investors need Discipline to avoid the many unattractive pitches that are thrown, Patience to wait for the right pitch, and Judgment to know when it is time to swing.”*** Buffett is famous for his quip that *“the stock market is a no-called-strike game.”* Instead, you can simply sit with the bat on your shoulder until the “fat pitch” comes along that you want to hit. Alas, even with the herd in the dugout, standing alone in the batter’s box, ***“most institutional investors feel compelled to swing at almost every pitch and forgo batting selectivity for frequency.”*** What should be a relatively straightforward idea, to duck out of the way of the wild pitches and only swing at the pitches you know you are good at hitting (if you can’t hit the high heat, wait for the low and away), confounds most investors who hit well below the Mendoza Line (batting average below .250) In fact, the average investor earned 3.4% the last twenty years versus a balanced portfolio which earned 7.5%. Klarman makes a point that not only can you have patience with the current pitcher, but there will be different pitchers in the future. ***“One of the biggest challenges in investing is that the opportunity set available today is not the complete opportunity set that should be considered. Limiting your opportunity set to the one immediately at hand would be like limiting your spouse to the students you met in high school.”*** This concept can become abstract in short order in that we obviously don't know whether the opportunity set tomorrow will be better or worse, but we can be reasonably sure that there will be more interesting opportunities at some point in the future. Buffett offers up a slightly more digestible metaphor with the adage of a bird in the hand as better than two in the bush. The question then is how sure are you that there are two birds still in the bush, and how long will it take you to get them out successfully if you let go of the one in your hand. The trouble that Klarman points to is that the decision is not one versus two but all the catchable birds and the bushes in which they are hiding, throughout the expansive forest of the markets, over the course of our career long hunt.

Klarman contends that ***“once you adopt a Value investing philosophy, any other investment behavior starts to seem like gambling.”*** Again the logic is difficult to argue against in that buying things with a large margin of safety seems far superior to buying something at a price well above intrinsic value where you are reliant on a “greater fool” to pay you even more in the future. There is a fundamental appeal in taking an investment approach rather than a speculative approach to markets. That appeal is elucidated in the following description, ***“Speculators are obsessed with predicting: guessing the direction of stock prices. Every morning on cable television, every afternoon on the stock market report, every weekend in Barron’s, every week in dozens of market newsletters, and whenever business people get together. In reality, no one knows what the market will do; trying to predict it is a waste of time, and investing based upon that prediction is a purely speculative undertaking.”*** The incessant need for the media to explain every wiggle in the stock market and the constant pressure to have talking heads make predictions about what the markets will do tomorrow, or next week, or next year is counterproductive and not very helpful in terms of compounding wealth over the long term. In fact, one could argue that this relentless stream of babble causes more harm than good as it inspires activity for activity’s sake, over-trading and a loss of focus on the appropriate investment horizon. Media hype turns investing into a popularity contest where the things that get the most attention attract the most interest from speculators. Unfortunately, ***“the strategy of buying what’s in favor is a fool’s errand, ensuring long-term underperformance. Only by standing against the prevailing winds, selectively, but resolutely, can an investor prosper over time.”*** Taking the “in favor” argument to its illogical extreme, the markets today have set records for inflows into passive strategies (Index Funds and ETFs - so called “Smart Beta,” my new favorite oxymoron), but ***“to Value investors the concept of Indexing is at best silly and at worst quite hazardous. Warren Buffett has observed that ‘in any sort of a contest, financial, mental or physical, it’s an enormous advantage to have opponents who have been taught that it’s useless to even try.’ I believe that over time***

***Value investors will outperform the market and that choosing to match it is both lazy and shortsighted.***

The problem apparent to us today is that Klarman is a lonely voice (hopefully this letter will inspire some others), alongside Jeremy Grantham, urging investors to follow a Value philosophy. As in 2000, these pleas are falling on deaf ears, and it is at times when a strategy is most loathed and reviled that it is likely to outperform. We are rapidly nearing that time.

Value has been out of favor for a number of years and the vitriol may be close to reaching a crescendo as Klarman felt compelled to write in his 2015 year-end letter, ***“bottom-up bargain hunting, which requires fastidious research, endless patience, pattern-recognition skills derived from hard-won experience, and the application of sound judgment didn’t prove profitable for us last year.”*** What makes this passage more interesting to me is that it was a challenging year for all investment strategies, as the World Index was negative, the S&P 500 was only barely positive (thanks to dividends) and the average hedge fund was negative, so the fact that investors in a fund that has produced teens returns for thirty-three years needed to be reassured summons up some Shakespeare from last quarter, *“Something is rotten in the state of Denmark.”* To remind us of what Value investing really is, a longer passage from another letter provides an outstanding summary, ***“it is important to remember that Value investing is not a perfect science. It is a discipline with an ongoing need for judgment, refinement, patience, and reflection. It requires endless curiosity, the relentless pursuit of additional information, the raising of questions, and the search for answers. It necessitates dealing with imperfect information knowing you will never know everything and that that must not prevent you from acting. It requires a precarious balance between conviction, steadfastness in the face of adversity, and doubt keeping in mind the possibility that you could be wrong.”*** The terrific trio of Discipline, Patience and Judgment are back again, but other critical characteristics of a Value approach emerge here: Reflection, Refinement and Curiosity. These are essential elements of the philosophy, and I am particularly struck by the word *relentless* in describing the pursuit of information. One of the hallmarks of great investors is that they can make effective decisions with incomplete information in order to capitalize on outstanding opportunities. The last sentence is my favorite given my core belief that *conviction* is the most important attribute of the most talented investors. Although the addition of *steadfastness* when faced with adversity and the healthy sense of doubting which reminds you of your mortality captures the essence of why Value investing is a liberal art (and not a perfect science).

I also was struck to find this quote from Klarman (again given his superior track record) that ***“occasionally we are asked whether it would make sense to modify our investment strategy to perform better in today’s financial climate. Our answer, as you might guess, is No! It would be easy for us to capitulate to the runaway bull market in growth and technology stocks. And Foolhardy. And Irresponsible. And Unconscionable.”*** I admire the strength of the response and the vehemence in the choice of the final three words, Foolhardy, Irresponsible and Unconscionable. These words are incredibly strong and a powerful reminder of the depth of commitment that Value investors have to their (genetic) code. An equally powerful message emerges from the following passage, ***“I know of no long-time practitioner who regrets adhering to a value philosophy. A Value investor who embraces the fundamental principles would never abandon this investment approach for another.”*** It appears that like the Sorting Hat in Harry Potter, an investment philosophy chooses you and there is no going back. Klarman accepts both his nature and the benefits it has engendered in his portfolio in saying, ***“Interestingly, we have beaten the market quite handsomely, although beating the market has never been our objective. Rather, we have consistently tried not to lose money and, in doing so, have not only protected on the downside but also outperformed on the upside.”*** Seth told us above that there was no secret to investing, and he is right. Simply embrace *The Value of Value* and the performance will take care of itself. Writing this

summary I am reminded of the old golf tip, *“Swing slower and learn to live with the greater distance”*.

### Klarman on Mindset

Zig Ziglar, a famous author and motivational speaker (*Born to Win*), says that *“your attitude, not your aptitude, determines your altitude.”* In essence your mindset determines your success. Klarman would agree and he speaks and writes extensively on the importance of a Value mindset to an accomplished investor. He believes one of the challenges we face is that *“Investing is the intersection of economics and psychology. The analysis is actually the easy part. The economics, the valuation of the business isn't that hard. The psychology, how much do you buy, do you buy it at this price, do you wait for a lower price, what do you do when it looks like the world might end, those things are harder. Those you learn from experience and by having the right psychological makeup.”* Again, we hear that a significant component of Value investing (the actual analysis) isn't hard, but having to manage the psychological component is very challenging indeed. Having the right mindset, the right “psychological makeup” is the key to success. The good news is that achieving that mindset is possible, the bad news is it requires a lot of experience (read overcoming mistakes). As Klarman revealed above, the three of the key psychological characteristics that great investors share are Discipline, Patience and Judgment, but also Persistence (to always seek to improve) and Resilience (the ability to shrug off failure and begin anew). All that said, *“to be a Value investor requires a resolute focus on risk aversion rather than maximizing immediate returns, as well as an understanding of history, a sense of financial market cycles, and, at times, extraordinary patience.”* The number one psychological characteristic of Value investors is Risk Aversion, full stop. All of the behavioral research shows that the pain of loss exceeds the thrill of gain by a 2:1 ratio and that should imply that just about anyone *could* be a Value investor. Alas, we know from the DALBAR Study that individual investors are anti-Value investors over time, meaning that they repeatedly buy the most expensive assets and sell the cheapest assets leading their portfolios to underperform dramatically. Over the past twenty years, buying and holding stocks (100%) would have delivered 8%, buying and holding bonds (100%) would have yielded 6.5%, a 60/40 Stocks/Bonds portfolio rebalanced annually would have yielded 7.4%. Yet the average investor in mutual funds achieved only 3.4% (a stunningly bad result from constant performance chasing). As a point of comparison, the average Endowment (following a model with Value roots) returned 9% and the top ten Endowments returned 12% over the same period. Klarman's response to this phenomenon is, *“while no one wishes to incur losses, you couldn't prove it from an examination of the behavior of most investors. The speculative urge that lies within most of us is strong; the prospect of a free lunch can be compelling, especially when others have already seemingly partaken.”* That “speculative urge” is a psychological characteristic in all of us that we must fight in order to reach our full potential as great investors. B.F. Skinner did a great deal of work on trying to discern why human beings seemed hard-wired to want to speculate (gamble), and found that the behavior was linked to a concept called “sporadic reinforcement.” In essence, by winning only occasionally, the desire to participate in that activity actually increases. Capital markets are incredible sources of sporadic reinforcement as odds are skewed against you (no to different than Vegas), but only slightly worse than 50/50 so that you win often enough to keep playing (and eventually lose a great deal as the DALBAR data shows). Worse yet is the feature that somewhere somebody won big in the markets. This knowledge of available opportunity makes the desire to speculate even greater. Klarman summarized this sensation perfectly. Said another way, there is nothing so damaging to your net worth that seeing a friend get rich. When others have good fortune, we want it too, and we will speculate in order to make it happen. Taking this point further, *“it can be hard to concentrate on potential losses while others are greedily reaching for gains and your broker is on the phone offering shares in the latest “hot” initial public offering. Yet the avoidance of loss is the surest way to ensure*

***a profitable outcome.***” Something to keep in mind next time you are offered a “great deal.” If I was George Soros and someone from a brokerage firm called me with a “hot” IPO, I would probably take it (he pays enough commissions to warrant getting the best deals), but by the time I get that call (let’s just say my commission ledger is ever slightly smaller), the best way to avoid a loss is to pass. Always remember Neuberger’s three rules, *“Don’t lose money. Don’t lose money. Don’t forget the first two rules.”*

***“If you are predisposed to be patient, disciplined and psychologically appreciate the idea of buying bargains, then you’re likely to be good at it. If you have a need for action, if you want to be involved in the new and exciting technological breakthroughs of our time, that’s great, but you’re not a value investor, and you shouldn’t be one.”*** A psychological appreciation of bargains is such a powerful idea. Bargains are gifts that may be infrequent, but they are valuable. If you have a need for more frequent activity and excitement, Klarman says it very clearly that you don’t have the mindset to be a Value investor. There are obviously other styles of investment, and all he is saying is that if you don’t have the right temperament, you should find the strategy that works best for you. If you have the natural propensities Klarman has described for us thus far, the rules of engagement are very simple. ***“To a value investor, investments come in three varieties: undervalued at one price, fairly valued at another price, and overvalued at still some higher price. The goal is to buy the first, avoid the second, and sell the third.”*** It is not enough to seek fairly valued assets you must restrict yourself to ones that are on sale and avoid speculation in the frothy part of the market. Furthermore, if the assets you own reach a price higher than your ascribed intrinsic value, you must sell. Ben Graham said *“Price is what you pay, Value is what you get,”* and Klarman expounds on this relationship in saying, ***“value in relation to price, not price alone, must determine your investment decisions. If you look to Mr. Market as a creator of investment opportunities (where price departs from underlying value), you have the makings of a value investor. If you insist on looking to Mr. Market for investment guidance however, you are probably best advised to hire someone else to manage your money.”*** I am here again reminded of Burbank’s distrust of price. A related that and important point is that ***“investors frequently benefit from making decisions with less than perfect knowledge and are well rewarded for bearing the risk of uncertainty. The time other investors spend delving into the last unanswered detail may cost them the chance to buy into situations at prices so low they offer a margin of safety despite the incomplete information.”*** Markets move fast today and the ability to gather every last piece of information to build the perfect DCF model to create an estimate of intrinsic value is challenging. Sometimes the bargain is so good and the margin of safety is so high that it pays to move quickly, even in the absence of perfect information. It is better to be approximately right, rather than precisely wrong.

So you think you have the psychological makeup and mindset to be a Value investor? There is a simple test to find out. ***“Here’s how to know if you have the makeup to be a Value investor. How would you handle the following situation? You own a great business (like P&G) in your portfolio and the stock price goes down by half. Do you like it better? Do you reinvest dividends? Do you take cash out of savings to buy more? If you have the confidence to do that then you’re an investor. If you don’t, you’re a speculator, and you shouldn’t be in the stock market in the first place.”*** Let’s walk through this one a bit. Is Klarman saying you can only be a good investor if are willing to double down on my losses? Didn’t Paul Tudor Jones say *“Losers Average Losers?”* These questions are valid, but Jones was speaking to a different arena. In the world of trading the quality of the company is not the essential characteristic of the asset. Rather, the important judgment is on the prospective collective actions of other traders in the short-term. Inherent to these explanations is the difference between trading and investing, which is a line that can be blurred in common speech or even in the naming of firms. Klarman is talking about investing, and importantly, investing only in assets purchased with a margin of safety. Thus, if Mr. Market marks down such an asset, by definition, your margin of safety has grown, and you are

compelled to buy more. The keys here are diligence in the determination of the true value of the business and then remaining steadfast in your discipline. ***“Successful investors tend to be unemotional, allowing the greed and fear of others to play into their hands. By having confidence in their own analysis and judgment, they respond to market forces not with blind emotion but with calculated reason.”*** My boss at my first investment firm believed in this concept so wholeheartedly that he had coffee mugs made with *“Invest Without Emotion”* emblazoned on them. Ben Graham said the same thing (and Buffett is credited with it all the time) *“Be greedy when others are fearful and fearful when others are greedy”*. Klarman puts a modern spin on the wisdom, saying ***“successful investors, for example, demonstrate caution in frothy markets and steadfast conviction in panicky ones.”*** Continuing to reiterate how this mindset defines how well an investor will fare over time, saying ***“indeed, the very way an investor views the market, and its price fluctuations, is a key factor in his or her ultimate investment success or failure.”*** Taking it back to some of the Philosophy above, we know that the crowd is always wrong over the long-term, so being able to step away from the pack at the inflection points is one of the most critical determinants of investment success.

I talk about #Edge all the time on Twitter (@markyusko if you are new to the game), and I have tweeted an abundant collection of psychological characteristics and character traits that define how successful people (those with Edge) live their lives. As I have touched on previously in this letter, I find *Conviction* to be the biggest Edge (particularly in panicky markets), but Klarman has a different view. ***“The single greatest edge an investor can have is a long-term orientation.”*** I have created my own Catch-22 here. If I give up my conviction that Conviction is the greatest Edge and agree with Klarman on long-term orientation, then do I lack conviction? Allow me digress for now in the comfort of the notion that, if two people always agree, one is unnecessary. I concede that investors who embrace a long time horizon have a gargantuan advantage over more short-term oriented investors. The data shows (rather conclusively) an extraordinary positive correlation between the time horizon of investors and their performance (Endowments crush individual investors over 3:1 over past twenty years). Speaking again to the inherent nature of the value mindset Klarman emphasizes that ***“a value strategy is of little use to the impatient investor since it usually takes time to pay off.”*** The challenge of having a long time horizon is waiting to see investments to fruition. In the instantaneous world we live in today, having patience is all the more challenging. One of the biggest changes I have witnessed in investing over the three decades I have been involved in the endeavor is the incredible shrinkage of time horizons. Investors, as well as Boards and fund managers, can have very little patience in a world of 24/7 media coverage and instantaneous access to online information. One of the other problems that the constant barrage of information creates is the mirage that everything that is urgent is really important (it isn't). One of the best ways to deal with this issue is to disengage and focus on longer-term information sources. Klarman says it very clearly, ***“I don't have a Bloomberg on my desk. I don't care.”*** One of my favorite lines in investing is that “if you want to be a good investor talk to everyone, if you want to be a great investor, talk to no one.” Independent thinking is the best way to achieve outstanding returns and disengaging from the daily noise and focusing on the long-term signal is what makes Value investors great.

One of the last areas of a Value mindset that is critical is the ability to balance the Conviction to take a position with the continual willingness (and discipline) to reevaluate your position, seek disconfirming evidence and constantly challenge your assumptions to make sure your original thesis (and analysis) is still sound. Klarman says ***“successful investors must temper the arrogance of taking a stand with a large dose of humility, accepting that despite their efforts and care, they may in fact be wrong.”*** A true Value investor takes a position that is materially different from the consensus and in that very act there is an element of arrogance in the belief that you

have better information, better insight, superior analytical skill or some other edge worthy of taking that contrarian position. The fact always remains that no matter how diligent your research, no matter how thorough your analysis and no matter how strong your Conviction, you could be wrong. For most people the fear of being wrong restricts them from taking an unpopular or controversial stand. Perhaps this is why there are so few truly intrepid Value investors. Stated simply, ***“the only way for investors to significantly outperform is to periodically stand far apart from the crowd, something few are willing, or able, to do.”*** Michael Steinhardt called it a “Variant Perception.” He defined VP as a view that is *materially* different from the consensus, that you believe has an above average probability of being correct. According to Steinhardt, they made all their big returns when they took a Variant Perception that turned out to be right. For many, the fear of standing out negatively overrides their desire to stand out positively. However one of the more important and amazing facts of investing is that you do not have to always be right. If your resistance to variance has reached a level of portfolio paralysis remember that even the Legends of this business were wrong only slightly less than they were right. In a dynamic world, things change and as often as not you will have to change your original thesis in order to maximize returns. Klarman chimes in here too, ***“In investing it is never wrong to change your mind. It is only wrong to change your mind and do nothing about it.”*** The second part of this quote is the most important. You have to do something about the change, you have to take action, sell something you are long, or cover something you are short. Lord Keynes famously quipped when confronted by someone in the audience during one of his speeches that he had said something different the week before, “When the facts change, I change my mind. What do you do, sir?” Informed action is an #Edge. One addition here is that good investors do the first order change (sell what they own or cover what they are short), but great investors reverse their positions (go short what they were long, go long what they were short). Alas, even the greats can falter here. Sebastian Mallaby tells a great story in his book *More Money Than God* of a phone call between a young Stan Druckenmiller and George Soros. After nimbly switching a much smaller portfolio from long to short, Druckenmiller received a call from a broker telling him that a seller was dumping huge amounts of shares. Knowing his friend’s long position, Druckenmiller called Soros to share the news but was met with uncharacteristic, almost tired. Only that weekend when reading Barron’s did Druckenmiller learn that his future boss was the elephant unloading shares.

Having a Value mindset is another difficult proposition disguised by simple descriptions. Perhaps the most important attribute of a Value mindset is having the ability to do nothing when there is nothing to do.

### Klarman on Process

Society today is focused on outcomes. What grade did you get on that test? Which team won the game? What return did you get on that investment? There is a disproportionate emphasis placed on outcomes because they are easily measured, A+ or B-, Yankees or Red Sox, 6% or 11%, but what is missing is an analysis of “why” the outcome occurred. Is there an underlying process that will enable similar performance in the future? Taking this idea to its logical conclusion, Klarman says, ***“The way to maximize outcome is to focus on the process.”*** If you are disciplined about attending class, attentive to completing assignments thoroughly, and steadfast in your resolve to put in the necessary time to prepare for an exam, you are more likely to see more A’s than B’s. If a team has strong coaching, a disciplined practice schedule, and rigorous game day preparation, there are likely to be more W’s than L’s. If an investor buys bargains with a margin of safety, is diligent in staying alert for changes in the thesis and disciplined in selling when price approaches fair value, there is likely to be more Alpha than Beta. In fact, ***“All an investor can do is follow a consistently disciplined and rigorous approach and over time the returns will come.”*** When return is the primary goal there is a tendency to take excessive risk (buying assets at unattractive

prices), and future returns are usually unsatisfactory. Take the current environment and the search for yield as an example. The market is driving prices of risky credit to unnaturally high levels. Kicking discipline to the curb, “Investors” have resorted to rationalizing purchases of high yield credits (once more aptly referred to as “junk”) at *not so high* yields because they are so desperate for yield in a ZIRP world. At current prices, these “investors” have no margin of safety and any increase in default rates will result in large losses.

***“In the financial markets the connection between a marketable security and the underlying business is not clear-cut. For investors in a marketable security the gain or loss associated with the various outcomes is not totally inherent in the underlying business, it also depends on the price paid, which is established by the marketplace. The view that risk is dependent on both the nature of investments and on their market price is very different from the concept of Beta.”*** Returning to the equity markets, we see this conundrum over and over when investors rationalize paying a very high price for an asset. In their response, “but it is a great company,” these investors reveal their inadequate processes of fundamental analysis. Their error is either in their disregard for the concept of a margin of safety or in their reckless valuation that somehow creates a higher intrinsic value for the security than the already high price at which it is trading. When I was teaching the Applied Investment Management class at Notre Dame, I once had a student make a proposal to buy a consumer goods company at an exorbitantly high price. Upon further prodding he replied, “Coke is a good company” (Despite the fact that the Coca-Cola Chairman Don Keough was the Chairman of the University’s Board of Trustees at the time, this student’s inadequate process did not earn him a good grade). Howard Marks says it best, *“There is no investment good enough that you can’t mess up (censored) by paying too high a price”*. The problem with paying too high a price for an asset is that you eliminate the chance that anyone following a sound investment process would buy that asset from you in the future. To this point Klarman warns, ***“If an asset’s value is totally dependent on the amount a future buyer might pay, then its purchase is speculation. Only if an asset has cash flow or the likelihood of cash flow in the near term and is not purely dependent on what a future buyer might pay, then it’s an investment.”***

Utilizing this delineation between speculation and sound investment, the next phase of the investment process we will explore is how to search for and source opportunities. Klarman earlier told us that the valuation part of the process was the “easy part” and he goes further, saying ***“While knowing how to value businesses is essential for investment success, the first and perhaps most important step in the investment process is knowing where to look for opportunities.”*** There are myriad types of investments across multiple asset classes, and there are a vast number of “experts” who are more than happy to help you find great investments (for a small fee, of course, but more on that later). The Endowment Model (which we follow at Morgan Creek) is a comprehensive approach to investing that encompasses all asset classes, and not entirely different from the model at Baupost. ***“We have a flexible approach. We will look at all asset classes.”*** One of the challenges of investing, however, is that ***“great investments don’t just knock on the door and say, ‘Buy me!’”*** You have to have a disciplined process that allows you to monitor lots of areas of potential interest, one that incrementally searches for new information to help you determine when the right moment is to act. ***“At Baupost, we constantly ask: ‘What should we work on today?’ We keep calling and talking. We keep gathering information. You never have perfect information. So you work, work and work. How you fill your inbox is very important.”*** There is an element of randomness in the process of sourcing in that you never know when, or where, the next great idea is going to come from. It is critical to have a broad network of relationships (particularly with expertise in various industries) who you can turn to for advice and counsel when vetting ideas. Being able to “optimize the randomness” is an

important skill for successful investing. This ability has become even more important in recent years as the pace and volume of information to process has grown exponentially. We have discussed in previous letters and webinars that in the earlier era of investing the best information was derived from superior access to information, but in the Age of the Internet synthesis of readily available information and creativity to maneuver correctly are the most critical skills. One tool that Klarman discusses from his training at Mutual Shares is to, ***“literally draw a detailed map-like an organization chart-of interlocking ownership and affiliates, many of which were also publicly traded. So, identifying one stock led him to a dozen other potential investments. To tirelessly pull threads is the lesson that I learned from Mike Price.”*** Given the success of Michael Price over the years, we would endorse trying to emulate some of his process for unearthing great Value opportunities. Another idea is to ***“watch your competitors not out of jealousy, but out of respect, and focus your efforts not on replicating others’ portfolios but on looking for opportunities where they are not.”*** One of the biggest problems today is crowded trades, particularly on the short side. When everyone is leaning to one side of the boat, it has always been a great idea to move to the other side. With the benefit of history as an example, one might examine the mass of portfolios from a bubble year (say 2000). The frequency of technology names at this point signals the likelihood of poor valuations (worst ever). Whereas the absence of allocations to emerging markets, would suggest the likelihood of attractive valuations (all-time lows). Finally, Klarman (and Steinhardt) say, ***“We like investments to have a catalyst, which reduces dependence on the market. For example, Distressed Debt inherently has a catalyst, maturity.”*** When you make investments with a focus on a specific event (or similar catalyst) your process takes on a superior focus and moves away from a dependence on the changing tides of markets.

Having a broad investment mandate and flexible investment process is liberating. When you only have a hammer, you treat everything as a nail. When you have an entire toolbox, you can add value to many things. But ***“It is crucial in a sound investment process to search a mile wide and then dig a mile deep when you find something. Also, never stop digging for information.”*** Klarman pushes this idea further saying, ***“My view is that an investor is better off knowing a lot about a few investments than knowing a little about each of a great many holdings. One’s very best ideas are likely to generate higher returns for a given level of risk than one’s hundredth or thousandth best idea.”*** Value investing is about concentration, concentration of effort to source ideas, then concentration of attention to evaluate the best opportunities, and finally concentration of the portfolio into only the superior assets where you have highest Conviction (greatest margin of safety and most specific catalyst). There is another very important point about the Value investing process that originates from the Grandfather and Father of Value investing, ***“as Graham, Dodd and Buffett have all said, you should always remember that you don’t have to swing at every pitch. You can wait for opportunities that fit your criteria and if you don’t find them, patiently wait. Deciding not to act is still a decision.”*** In a sound investment process you will unearth lots of potential ideas. You will do meaningful analysis on a small subset of those ideas, and you should ultimately only convert a tiny fraction of those into actual investments. Having the discipline to wait for only truly exceptional opportunities before deploying capital is a hallmark of the very best investors. There is, however, one necessary element of a Value investment process that differs from the rest, the ability, and, more importantly, the willingness, to hold cash while you are waiting for those opportunities to materialize. ***“Graham’s wonderful sentence is, an investor needs only two things: Cash and Courage. Having only one of them is not enough. Courage is a function of process.”*** The courage to act, to take advantage of an opportunity comes from a sound process. This is most evident for Value investors because, by definition, you must act in a manner that is different from the consensus. The benefit of having cash is two-fold. First, it is fully liquid so you can act swiftly. Second, and more importantly, it doesn't require you to sell some other investment to make room in the portfolio. The burden of always being fully invested is that you must constantly “choose among your children,”

and any parents reading this know what a conundrum that presents.

So where do the best investment opportunities come from? Klarman's view is that they arise from dislocation. ***"If only one word is to be used to describe what Baupost does, that word should be "Mispricing". We look for mispricing due to over-reaction. We are big fans of fear, and in investing it is clearly better to be scared than sorry."*** We touched on the inadequacy of the efficient market hypothesis in the Value Philosophy section. Markets are prone to boom/bust cycles and (as I will illustrate later) emotional roller coasters primarily because they are simply the collective actions of the human participants. When people are afraid they make less thoughtful decisions. ***"Always look for forced urgent selling. When people give away stocks based on forced selling, or fear, that is usually a great opportunity. Generally, the greater the stigma or revulsion, the better the bargain."*** Fear's stifling of price creates an even greater margin of safety given unchanged company fundamentals. Most of the best investments I have made in my career have been when I stepped up during a market dislocation and bought incredible bargains from someone forced to sell. Whether it was Real Estate assets being liquidated from the RTC in the early 90's, Russian equities after the default in 1998, distressed energy and telecom assets after the Tech Wreck in 2002, distressed debt (of all kinds) after the Global Financial Crisis in 2009, or Commodity related equities earlier this year, the pitches will come right over the plate if you have the patience to wait for the catcher to signal the bargain. In each of these cases, Klarman's wisdom has rung true; the more people hate a market (and subsequently the more forced sellers there are) the better the bargain and the greater the realized returns. Klarman offer a good explanation for this phenomenon saying, ***"Bad things happen, but really bad things do not. There is no amount of bad news that the markets cannot see past. Do buy the dips, especially the lowest quality securities when they come under pressure, because declines will quickly be reversed."*** We did a webinar in our Around the World with Yusko series (#ATWWY) on this concept recently entitled "Soros' First Law: Worse a Situation Gets, Less it Takes to Turn Around and the Greater the Upside." Soros would concur with Klarman's qualification here of how bad markets really can get. Markets are forward looking, even when a situation becomes extreme, the markets can see through to a restructuring or reorganization that will lead to brighter days ahead (and brighter fortunes for those intrepid investors who buy the surviving securities). This is not a widely appreciated point, I have spoken of this before in the particular context of companies reaching verge of bankruptcy but avert the actual event. When this occurs the equity acts like an option, and the returns are phenomenal. There are myriad examples of this type of behavior after every recession or crisis (like Brunswick Corp in 2009), but we don't even have to go that far back to see great examples. This February there was an abrupt turn in the commodity markets, and of the number of companies on the verge of bankruptcy that were saved, the equity returns have been amazing (Glencore GLEN.LN, Freeport-McMoran FCX, Chesapeake CHK).

One of the reasons that bargains emerge is that investors don't have an adequate strategy for managing through crisis. ***"It is crucial to have a strategy in place before problems hit. Value investing (buying stocks at an appreciable discount from the value of the underlying businesses) is one strategy that provides a road map to successfully navigate not only through good times but also through turmoil."*** The biggest problem for traditional investors (and the biggest advantage for Value investors) is that most investors buy assets at too high a price (little or no margin of safety) and are quick to sell when the market moves against them. I have said time and again that investing is the only business I know of that when things go on sale people run out of the store (and the cheaper the price falls, the farther they run). When it comes to buying bargains, ***"Sometimes buying early on the way down looks like being wrong, but it isn't. You must buy on the way down. There is far more volume on the way down than on the way back up, and far less competition among buyers. It is almost always better to be too early than too late, but you must be prepared for price markdowns on what you buy."*** Early has been

called the “euphemism for wrong.” However, when you have done the work to understand the intrinsic value of a particular asset and only begin to buy when there is an adequate margin of safety, a little extra cushion provided by sellers who are the last to leave the party is just fine. (Remember Klarman’s test with P&G) Despite espousing the strict unemotional discipline we have already described at length, Seth does recognize the pressing realities that can weigh on the human inside the investor. ***“When you buy bargains and they become better bargains, it is easy to start to question yourself, which can impair your judgment. Real or imagined concerns about client redemptions, employee defections can greatly influence behavior away from rational.”*** It is bad enough to have a position move against you if it is your own capital, but when you are running a fund as a fiduciary for client capital there are multiple other concerns that conspire to impair your judgment. When you are concerned about losing clients over short-term volatility or worried about losing talent on the team if there are lower incentive fees for some period, you can lose your objectivity.

Such times challenge even the most disciplined. These are the times when you have to force yourself to pick up the company coffee cup and read the motto aloud. When you have done the work and you own something from a position of strength these concerns can be mitigated. Klarman says, ***“It sounds kind of crazy, but in times of turmoil in the market. I’ve felt a sort of serenity in knowing that if I’ve checked and rechecked my work, one plus one still equals two regardless of where a stock trades right after I buy it.”*** Being able to maintain that unemotional state during times of turmoil is what gives Value investors one of their biggest edges to consistently producing long-term returns. If you, like many, have yet to reach such numerical serenity, perhaps poetry might serve as a more transitional substitute. Rudyard Kipling’s poem, *If*, warrants a full slow read, but for those away from their personal libraries, here are a few apropos lines I particularly enjoy. ***“If you can keep your head when all about you are losing theirs and blaming it on you, if you can trust yourself when all men doubt you... yours if the Earth and everything that’s in it.”*** Having a process that allows you to maintain a serene state will likely lead to meaningful profits for you and your investors. ***“Do not suffer interim losses, relish and appreciate them.”*** Keep calm and remember your margin of safety, ***“Typically, we make money when we buy things. We count the profits later, but we know we have captured them when we buy the bargain.”*** Buying dollars for fifty cents is an incredibly good way to make a consistent profit, so if the price goes to forty cents in the short-term you can relish the opportunity to buy a little more. While you may not materially realize those returns for some time. There will come a point on a long enough investment horizon that you will be able to cash in the dollar.

Continuing to explore the Value investment process, let’s return to an idea Klarman showed us earlier, avoiding loss. Gating items that don’t provide a sufficient margin of safety, we have more time to really dig into the few opportunities that come along right in our wheelhouse. ***“Value investors will not invest in businesses that they cannot readily understand hence few value investors will own the shares of technology companies. Many also shun commercial banks, which they consider to have unanalyzable assets, as well as property and casualty insurance companies, which have both unanalyzable assets and liabilities.”*** It is good advice for anyone to limit their investments to sectors they can fully understand, but I will quibble a little with those who say that all technology is off limits. Given the cyclicity of the technology business today, we have found that there have indeed been true Value opportunities over the years. The one caveat is obsolescence risk is a real part of the nature if a technology is to be disruptive and that phenomenon can make apparent value disappear quickly (think WINTEL platform companies after the Internet). I love the commentary about the opacity of commercial banks and insurance companies and clearly this creates a fairly high hurdle for a Value investor to get involved. Klarman makes an exception saying, ***“In a crisis, stocks of financial companies are great investments, because the tide***

*is bound to turn.*” I would add that there have been lots of technology companies that have ended up in the Value pile after a crisis (along with plenty of other good companies), and those that must be liquidated from leveraged pools of capital or fund structures become the absolute best bargains.

When thinking about illiquidity, Klarman makes a couple of important points. *“Be sure that you are well compensated for illiquidity (especially illiquidity without control) because it can create particularly high opportunity costs.”* We agree completely that you need to be constantly vigilant to receive an adequate illiquidity premium. Though similar to the hallowed margin of safety in individual securities we believe that significant diligence on specific opportunities and market dislocations we can apply the same Value discipline in the private markets. In fact, we calculate our estimate of the illiquidity premium for each subsector of private investments each quarter to help guide us toward the best bargains. While we believe that a significant portion of a long-term portfolio should be in private investments, we would agree that *“at equal returns, public investments are generally superior to private investments not only because they are more liquid but also because amidst distress, public markets are more likely than private ones to offer attractive opportunities to average down.”* The key phrase here is “at equal returns.” While we see plenty of places that private returns will be meaningfully higher than their public counterparts, we have observed specific areas like large Buyouts where public equities are preferable today. Too much money from the large buyout firms chasing too few deals has spun valuations in this subsector into a frenzy. One other asset class that doesn't have much appeal to Value investors is commodities. *“A commodity doesn't have the same characteristics as a security, characteristics that allow for analysis. Other than a recent sale or appreciation due to inflation, analyzing the current or future worth of a commodity is nearly impossible.”* Though we won't argue this point from a value perspective, there might be opportunities for those with inclinations or natural propensities towards other strategies.

One of the best things about the Value investing process is that the process itself is a form of risk management. Strictly buying bargains when there is a meaningful margin of safety is a very strong form of risk management in and of itself, *“Limit risk with Deep Analysis, Bargain Purchase and Sensitivity Analysis.”* When you have done extensive analysis, particularly based in source information (not others' research) and utilize an extensive network of relationships to help create truly independent analysis, you have the proper perspective to identify assets with a margin of safety. Capitalizing on those opportunities only with a true bargain purchase is the best form of risk mitigation because it protects you from the normal fluctuations in market prices that will oftentimes cause people to “buy high and sell low.” Sensitivity Analysis is critical because *“we deal in probabilities, not absolutes”*, and no matter how deep and strong our analysis is there will always be “unknown unknowns.” You have to think in scenarios (rather than single outcomes) and make sure that even in the downside scenario you have a wide enough margin to protect yourself from making a mistake during a period of emotional turmoil. Klarman speaks strongly on this topic saying, *“Always remembering that we might be wrong, we must contemplate alternatives, concoct hedges, and search vigilantly for validation of our assessments because we are never sure that our thesis will be precisely correct.”* I am reminded here of the old saw in construction “measure twice, cut once.” Constantly checking over your work as well as seeking out perspectives from other sides of the table help to build confidence in your process, and remain necessary event for the master craftsman. Seth also mentioned hedges, a topic we have discussed in depth in previous letters (See Q3 2015 Letter), and we continue to promote as a necessary component of the risk management process.

Reflecting on the Process explored in this section so far, we admit that we have gone into great detail on the buying component. In fact, Klarman himself believes that *“Buying's easier, selling's hard. It is hard to know when to*

*get out.*” Remembering our example of buying into discounted currency purchases above, one might ask what is so hard about selling them back when the market reaches a dollar. The challenge is that when the price looks like par is attainable, emotions again encroach on our objectivity this time on the other end. Greed in times of excess can be as strong as the survival instincts of the fiduciary when the hearth is barren. **“Selling can be a challenge. Many investors are tempted to become more optimistic when a security is performing well. This temptation must be resisted. Tax considerations aside when a security reaches full valuation there is no longer a reason to own it.”** Temptation is exactly the right word. We might tell ourselves that we were too conservative in our original assumptions. We might even convince ourselves that the world has changed, or “it’s different this time,” the old rules that applied when we did the original work no longer apply. We might, and we would be wrong, wrong and more wrong. The message is simple, sell when the asset has reached fair value (maybe even a little before), and never be seduced into thinking that because some greater fool is willing to pay unjustified prices in the short-term that you can deviate from your discipline and process and maximize returns in the long-term. Simply stated, **“Value investors should completely exit a security by the time it reaches full value. Owning overvalued securities is the realm of speculators.”** There is an old Wall Street saying that follows that “Bulls get some, Bears get some, and Pigs get slaughtered.” Klarman would remind us that being a Pig begins with owning an asset above fair value (when the margin of safety has dissipated). Another benefit of following this disciplined process to selling is that it removes the likelihood that you end up holding an asset during a crisis when there are no buyers and prices collapse (taking your paper profits will them). Klarman continues on to say, **“The trick of successful investors is to sell when they want to, not when they have to.”** Selling around fair value possesses a number of benefits for long-term wealth creation. It avoids the potential to get stuck with an asset when the speculative bubble bursts (and all asset values are hurt). It provides the greatest number of buyers, as the crowd will just start ramping up purchases at fair value (Remember how lonely it is to buy at bargain prices. Don’t let that loneliness go unrewarded). Finally, selling an asset at fair value provides precious liquidity to utilize to buy more bargains and begin the cycle anew.

We would be remiss to conclude this section without at least a small note on the role of the short selling in a Value discipline. Many fortunes have been lost trying to simply *do the opposite* of a process in order to short this strategy. That is selling value stocks short if you prefer growth stocks. The problem here arises in the derivation of many of these catchy labels from Index creators. They have limited meaning in the way we are discussing Value in this letter. Shorting is a particular school of art within the larger pursuit of investing, not dissimilar from a separation of the Impressionists from wide swath of painters, and there are few that possess particularly outstanding talent. **“My experience is that short sellers do far better analysis than long buyers because they have to. The market is biased upward over time, because of this bias, short sellers age in dog years.”** My own experience confirms Klarman’s observation. The great short sellers age out early. Other than Jim Chanos, most of the good short managers have shot across the sky as quick and brilliant as the Perseid meteors.

### Klarman on Teams

There are myriad ways to think about how to build an effective investment team, but there are some specific aspects of the Value investment process that require some unique character traits of team members and organizational elements of the team itself. If Value investing is about Discipline, Patience and Risk Aversion those personality traits should be valued in team members. That said, we saw in the analysis of the investment process that **“one must understand the importance of an endless drive to get information and seek value”** so Intellectual Curiosity, Persistence and Resilience are other individual characteristics that are necessary for someone to thrive in

a Value environment. We heard Klarman use words like “inoculate” and “genetic” to describe his belief that Value investors have it in their blood, or are born with the predilection toward a relentless desire to seek out and discover value. He says that at Baupost, ***“we work really hard never to get confused with what we know from what we think or hope or wish.”*** There is a great story I have heard from someone very close to the firm that elucidates this perspective incredibly well. Klarman was talking with one of the Associates and he asked him specifically what he knew about a certain investment they were working on. The Associate began to relate some of facets of the investment and then started to say *“but, in my opinion...”* Klarman cut him off immediately and said, ***“Anyone can offer an opinion. I wasn’t asking you for an opinion. I was asking you if you knew anything”***. This is such a critical vignette to understanding what differentiates the truly great Value investors from the rest. The language, though curt, is rooted in the intent to keep the focus on what those at Baupost actually know, and not to allow conversations about research to devolve into hypothesizing about “think”, “hope” and “wish.” Facts are superior to opinions. An important point on team organization is to ***“avoid organizing investment team into silos”*** which means a focus on generalists versus specialist. We could pen an entire letter on this debate, but in the Baupost world, they want team members to feel comfortable looking anywhere to find new ideas and not to feel pressured to focus on a certain area of specialization if there are no good opportunities (turns out a real estate specialist will always like real estate regardless of valuation). The other important benefit of generalists is there is always the ability to play devil’s advocate when someone is presenting an idea, as no one feels that they can’t offer facts and knowledge into a discussion just because they aren’t designated as the specialist in that sector. This lack of silos doesn’t employees from developing expertise in a particular area (a requirement is to dig very deeply), they do. Perhaps it is better to think of it as being a generalist with a serial specialization depending on what ideas you happen to be working on over time. My guess is that this helps with in their policy for holding cash as well, since no one is consistently calling for the ball when they are double teamed.

One of the differentiating elements of Value investing is that the process is more focused on events. We have discussed above the reasons and rationale for these biases, but another primary reason is related to individuals and their lack of ability to forecast future events. Klarman believes that ***“people should be highly skeptical of anyone’s (including their own) ability to predict the future, and instead pursue strategies that can survive whatever may occur.”*** Buying assets at bargain prices when others are forced to sell results in an investment that is not dependent on market directionality or the collective activities of many other market participants. What matters is that the proper analysis is performed to establish a significant margin of safety to allow you to own the asset regardless of what happens to the market as a whole. At the risk of redundancy we reiterate the following line excerpted from a larger quote in the Philosophy section to remind ourselves that ***“In reality, no one knows what the market will do. Trying to predict it is a waste of time, and investing based upon that prediction is a speculative undertaking.”*** We have seen time and time again the market confound the pundits and predictors. It will rally when everyone is convinced it will fall, and it will crash when everyone believes the good times will never end. John Maynard Keynes famously commented, *“The market can stay irrational longer than you can stay solvent.”* We know the perils of trying to take a position that is dependent on short-term market moves. The beauty of the Value philosophy is that it removes the need to predict market and moves the portfolio positioning from speculation (risky and dangerous) to investment (prudent and sound). Not investing based on a market view doesn’t mean that you can completely ignore the broad markets and economy, but checking the mail for invitations and joining in the party are two different things. Klarman is predictably less delicate. ***“We worry top-down, but we invest bottom-up. Macro worries are like sports talk radio. Everyone has a good opinion, which probably means that none of them are good.”*** It is far easier to perform from the bottom-up based on facts, so there is a strong tailwind to the pure Value investor who has the discipline to stay focused on companies,

assets and securities rather than dropping below 10,000 feet to predict interest rates, government movements and corporate actions.

### Klarman on Clients

Among the six facets that Klarman says you have to get right to have a successful investment organization he forwards one is most critical, ***“Having clients with a long-term orientation is crucial. Nothing else is as important to the success of an investment firm.”*** As we have gleaned from Klarman already, the major key to most success in investing is a long time horizon, so it is not surprising that the clients must follow suit. We have seen throughout this letter that a predilection toward speculation shows us that ***“individual and institutional investors alike frequently demonstrate an inability to make long-term investment decisions based on business fundamentals.”*** Instead, people make decisions based on emotion and sentiment, following the consensus into the mediocrity of poor returns. ***“Short-term performance envy causes many of the shortcomings that lock most investors into a perpetual cycle of underachievement.”*** The aforementioned DALBAR study reveals that the average holding period for investors continues to shrink, and that results continue to fall relative to the available opportunity set. Although emotions tend to dominate short-term decisions, the real culprit is the constant attention to short-term performance metrics by the media, governing boards and investors themselves. There was a great study written by Michael Mauboussin (author of *The Success Equation*) that showed that people who looked at their portfolio every day underperformed those that looked at their portfolio annually by seven percent (a huge difference). What we know is that ***“frequent comparative ranking can only reinforce a short-term investment perspective.”*** What we can also understand from the perspective of the manager is that ***“it is understandably difficult to maintain a long-term view when, faced with the penalties for poor short-term performance, when the long-term view may well be viewed from the unemployment line.”*** The risk of losing clients because of short-term performance will incent managers to focus more on short-term performance, which we have shown time and again in this letter has a dreadful impact of long-term performance. Klarman takes a hard line here and says, ***“Be indifferent if you lose your short-term clients. Remember they are your own worst enemy.”*** Clearly that is easier to say when you have a \$30 billion fund than when you have a \$30 million fund (and every client matters). The truth for any manager though is that time spent explaining performance and soothing emotions of short-term oriented clients is time away from the Value investment process that will yield strong long-term results. Klarman expounds upon the optimum client-manager relationship saying, ***“At the worst possible moment, when your fund is down because cheap things have gotten cheaper, when you need to have capital, you need to have clients who will actually love the phone call and, most of the time (if not all the time) add, rather than subtract, capital.”***

In the absence of those types of client relationships, manager behavior is sub-optimal as ***“pressure to produce over the short term (a gun to the head of everyone) encourages excessive risk taking which manifests itself in several ways; a fully invested posture at all times, the use of leverage, and a market centric orientation that makes it difficult to stand apart from the crowd and take a long term perspective.”*** The reflexive nature of this cycle is unmistakable. The lack of strong client relationships (and thereby client education) serves to change manager behavior, and usually makes inferior long-term results. One of the most troubling of these behaviors comes from the bias against cash and the resulting overinvestment by managers (even when the opportunity set is poor). Klarman picks up on another reflexive outcome here as ***“the inability to hold cash and the pressure to be fully invested at all times means that when the plug is pulled out of the tub, all boats drop as the water rushes down the drain.”*** The collective actions of the managers (prompted by the lack of long-term clients) leads

to an exacerbated fall when the markets finally break and move back toward fair value. On the flip side, right after the collapse, the fears of losing clients over poor short-term performance leads to more bad behavior. ***“When managers are afraid of redemptions, they get liquid. We all saw how many managers went from leveraged long in 2007 to huge net cash in 2008, when the right thing to do in terms of Value would have been to do the opposite.”*** When things go on sale, you are supposed to buy with both hands (hard to do when they are tied). As Buffett said (I think he actually said this first) “when it is raining gold, put out buckets, not thimbles.” The problem is that if the manager fears losing clients they must raise cash to pay our redemptions when what they should be doing is having “the phone call” to convince clients to add more capital. In essence, following a Value strategy will lead to these types of conundrums as we know that ***“the cost of performing well in bad times can be relative underperformance in good times.”*** If we follow the discipline of selling into rising prices at or near fair value, then every time the market overshoots, there will be a period of relative underperformance. Klarman sums it up nicely, ***“Investors need to pick their poison: Either make more money when times are good and have a really ugly year every so often, or protect on the downside and don’t be at the party so long when things are good.”*** We know that if we take care of the losses, the gains will take care of themselves, so we choose Value.

### Klarman on Culture

The culture of a firm is critical to its success and the culture of a Value oriented investment firm is that of Risk Aversion. Baupost has built that culture, and has successfully achieved outstanding results for over three decades. Klarman says, ***“As value investors, our business is to buy bargains that financial market theory says do not exist. We’ve delivered great returns to our clients. We have achieved this not by incurring high risk, as financial theory would suggest, but by deliberately avoiding or hedging the risks that we identified.”*** I am particularly fond of the line about buying things that financial market theory says don’t exist (clearly 16.4% compounded for 33 years would beg to differ) as it reminds me of the joke about the Finance Professor who wouldn’t pick up the \$20 bill in the street saying, “If it was there, someone would have picked it up already.” Great returns aside, the risk taken to achieve the returns is more important. ***“Investors should always keep in mind that the most important metric is not the returns achieved but the returns weighed against the risks incurred.”*** There are plenty of strategies that can promise significant returns, extreme concentration in a volatile, illiquid, equity, convergence trading in fixed income markets with incredibly high (40X) leverage or any number of derivative related strategies with high embedded leverage, but all of these strategies have some prospect of significant loss of capital. The worst part is that there is risk of true loss of capital (not just a temporary write-down). Another issue Klarman warns about is, ***“We are not so brazen as to believe that we can perfectly calibrate valuation; determining risk and return for any investment remains an art not an exact science.”*** Even with a great team and great process, mistakes happen and things change. One of the problems is that ***“Unlike return, risk is no more quantifiable at the end of an investment that it was at its beginning. Risk, simply cannot be described by a single number. Intuitively we understand that risk varies from investment to investment: a government bond is not as risky as the stock of a high-technology company. But investments do not provide information about their risk the way food packages provide nutritional data.”*** If only it were so simple as to read a warning label or a risk metrics guide attached to every potential investment you evaluate. Risk takes many forms, and we have said for many years that you can’t eliminate risk, you can only change its form (like energy, you can convert heat energy into light energy). A Value investor can remove much of the market (Beta) risk from an investment, but simply converts that risk into security specific risks such as modeling risk or event risk. These are the worst risks because it is always the bullet you don’t see that kills you. Similarly, not all risks are created equal, ***“The risk of an investment is described by both the probability and***

*the potential amount of loss. The risk of an investment (the probability of an adverse outcome) is partly inherent in its very nature. A dollar spent on biotechnology research is a riskier investment than a dollar used to purchase utility equipment. The former has both a greater probability of loss and a greater percentage of the investment at stake.*” Investing is all about probabilities and possibilities, we like to put ourselves in positions where probabilities are in our favor, understanding that we cannot eliminate all the possibilities of untoward outcomes along the way.

In thinking about risk, some lessons from the Value investment Process and Philosophy are critical to understand and appreciate. First, *“Risk is a perception in each investor's mind that results from analysis of the probability and amount of potential loss from an investment. If an exploratory oil well proves to be a dry hole, it is called risky. If a bond defaults or a stock plunges in price, they are called risky. But if the well is a gusher, the bond matures on schedule, and the stock rallies strongly, can we say they weren't risky?”* In other words, the outcome does not change the underlying character of the opportunity. Unfortunately, you wouldn't know just from listening to the conversations of investment professionals today. Everyone talks about the winners as if they were always a sure thing and losers as if it was clear all along that they wouldn't work out. Nothing could be further from the truth. Most times, there was a great deal of uncertainty at the time of the investment and there were multiple potential outcomes. One of the most misunderstood aspects of investing is how to appropriately determine a priori what the expected outcome should be (possible outcomes multiplied by the probabilities). Many investments held to this standard would never be attempted (so we would never get to judge the outcome). Back to Value 101, *“Risk is not inherent in an investment it is always relative to the price paid. Uncertainty is not the same as risk. Indeed, when great uncertainty (such as in the fall of 2008) drives securities prices to especially low levels, they often become less risky investments.”* So much time is spent analyzing the unpredictable and trying to make sense of an inherently uncertain world that investors oftentimes miss the most important developments that occur right before their eyes. When the world is uncertain investors react in a certain way, they sell. That selling causes prices to fall, which increases the margin of safety and makes those assets more attractive (not less). We have seen this movie over and over, and the perception is precisely the opposite. Consensus believes that the higher a price moves, the more attractive it is and the lower the price goes, the less attractive it becomes and acts in a corresponding way (to the delight of true Value manager who happily sell them overvalued assets and buy undervalued assets from them).

*“The best protection against risk is knowledge of what you're doing.”* A culture of risk aversion arises from a culture that has a strict work ethic and a constant focus on the acquisition of knowledge (rather than opinion). It is okay to take your time to really evaluate opportunities and miss a few “hot deals” along the way. At Baupost, the mantra is, *“We prefer the risk of lost opportunity to that of lost capital.”* There will always be another investment opportunity to evaluate, and it is far more important not to make a mistake that imperils capital than to try and make every investment that comes along. In the end though someone will always do the deal you pass on (sometimes it will even be a good investor) and having a process rooted in *“patience and discipline can make you look foolishly out of touch, until they make you look prudent and even prescient.”* Culturally, having an ability to tolerate long periods of time where you sit and wait is much harder than it appears, particularly *“in a world in which most investors appear interested in figuring out how to make money every second and chase the idea du jour.”* Jesse Livermore famously quipped that *“I made all my money from my sitting”* and Klarman would agree saying, *“There's something validating about the message that it's okay to do nothing and wait for opportunities to present themselves or to pay off.”* Thus, Patience is not only a virtue, but the cornerstone of a Value culture and the bedrock of the Value structure.

## Klarman on the Investment Business

Klarman has some very harsh words about the perils of engaging in the Investment business. He says “*Wall Street can be a dangerous place for investors. You must do business there, but you must always be on your guard. The standard behavior of Wall Streeters is to pursue maximization of short-term self-interest.*” Again we see the short-term problem rearing its ugly head. The problem is that the Street (for now, but things are changing) is necessary for the investment business to function. So the words to the wise are “*If you transact business with Wall Street with these caveats in mind, you can prosper. If you depend on Wall Street to help you, investment success may remain elusive.*” One facet of investments we always look for is alignment of interests. There are some places where alignment has improved, but there are still places where the potential is largely untapped. Unfortunately, Klarman believes “*The average person can’t really trust anybody. They can’t trust a broker, because they are interested in commissions. They can’t trust a mutual fund, because they are interested in gathering and keeping assets. Wall Street Analysts’ recommendations may not produce good results due to the pressure placed on these analysts to recommend frequently, rather than wisely.*” The title of Fred Schwed Jr.’s book *Where Are the Customers Yachts?: or A Good Hard Look at Wall Street* comes to mind here, as the incentives in the traditional investment business remain poor. We have actually observed that doing the opposite of big brokerage firm research views might be a more profitable strategy given the poor track record of these Analysts’ recommendations over time.

The place to really be cautious, however, is in the markets where financial engineering is taking place. Klarman makes the point that “*Financial innovation can be highly dangerous, though almost no one will tell you this. New financial products are typically created for sunny days and are almost never stress-tested for stormy weather. Securitization of subprime mortgages almost perfectly fits this description.*” There is some logic to this in that the purpose of financial innovation is to create new products to generate revenue for the firm. Those revenues are collected up front (and tied to volume) so the incentive is to make/sell as many as possible, regardless of the outcomes. The question you should always ask is, “Who is taking the other side?” In most cases they are larger, better capitalized and have superior information than you do. Worse yet is the problem that the very models that are used to create the derivatives have the wrong bias. “*Do not trust financial market risk models. Despite the predilection of some analysts to model the financial markets using sophisticated mathematics, the markets are governed by behavioral science, not physical science.*” Mathematics is logic-based and behavioral finance is emotions-based and never the two shall meet. The models will never be able to model just how irrational the individual players (that make up the markets) can be, so they will always miss the “tail events”. The real danger comes when you add gasoline to the fire by using leverage. Klarman warns about the potential dangers of fire starting, saying “*I really think you need not to be greedy. If you’re greedy and you leverage, you blow up. Almost every financial blow up is because of leverage.*” Gordon Gekko (Michael Douglas) in the original *Wall Street* movie famously quipped, “Greed is Good,” and a whole generation of investors had to learn the hard way in two great wipeouts (2000-2002 and 2007-2008) that just about every financial calamity is caused by, triggered by or exacerbated by, leverage. He goes further to say “*beware leverage in all its forms. Borrowers (individual, corporate, or government) should always match fund their liabilities against the duration of their assets. Even if you are unleveraged, leverage employed by others can drive dramatic price swings. Sudden unavailability of leverage in the economy may trigger an economic downturn.*” The key point here is that you don’t actually have to borrow any money to be victimized by leverage. You can be exposed by simply owning securities where the price is being artificially levitated by market leverage. Subprime bonds were the best example of this concept, and once again the best way to manage that specific risk is not to get involved. If you do

get involved, you had better sell when you can, not when you have to (and everyone else is trying to get out the same door). Credit is a wonderful thing in many ways, so long as it is expanding. However, when credit creation slows (or worse reverses), things can get ugly in a hurry (and it won't be different this time).

### Klarman on the Current Investment Environment

One of the biggest challenges to investing is overcoming the “conventional wisdom” that has been created by an industry designed to sell securities (primarily stocks) to investors. Klarman reminds us that ***“The prevailing view has been that the market will earn a high rate of return if the holding period is long enough, but entry point is what really matters.”*** We have covered this point numerous times in this Letter. The entry price you pay for an asset class (or security) determines the future returns. Bonds are simple. Whatever the prevailing yield on the ten-year bond is on the day you purchase them is the return you can expect for holding for ten years. That is if you buy a ten-year bond yielding 2% today, you should not expect to make 7.5% (no matter how badly you need to make 7.5%). Equities are a little tougher (but not much). You get the current dividend yield, you get inflation over the holding period, you get real EPS growth (historically 2%, GDP growth minus 1%) over the holding period, and you get multiple expansion/contraction. That's it. If you buy when yields are high, inflation is high and multiples are low (like 1982), you make solid returns, if you buy when yields are low, inflation is low and multiples are high (like 2000), you make dismal returns. From 1982-1991 you made 13.5% (5.5% + 4% + 2% + 2%) while from 2000-2009 you lost (2.4%), yes you lost money for a decade in U.S. stocks (1% + 2.3% + 2% - 7.7%). Simply stated, investors paid too high a price in 2000, and future returns defied conventional wisdom. So why do investors continue to buy an asset at an egregiously high price when future returns are likely to be poor? Unfortunately, because the conventional wisdom is still that *“you can't get fired for buying IBM.”* ***“Because investors are not usually penalized for adhering to conventional practices, doing so is the less professionally risky strategy, even though it virtually guarantees inferior performance.”*** This is a very serious conundrum. How can a strategy that is very risky for wealth preservation and growth (fiduciary standard) be perceived as a less risky professional strategy? Klarman has an answer for us in saying that ***“Targeting investment returns leads investors to focus on potential upside rather than downside risk. When targeting a desired rate of return, even an eminently reasonable one, investors should focus on risk.”*** Risk can only be ignored at the investors' peril, and we have seen time and again how a myopic focus on the returns that can be achieved (or more appropriately the returns that were achieved, past tense) has led to ill-advised investment decisions. One of the biggest problems that investors face when they don't follow a Value discipline and they look to Mr. Market for information on valuation is that all they see is the price (the specific act Klarman already defined as speculation). Further, ***“The latest trade of a security creates a dangerous illusion that its market price approximates its true value. This mirage is especially dangerous during periods of market exuberance.”*** Soros provides great perspective on this topic in his quote, *“Most investors begin from the premise that the current price is right. We believe the opposite, we start from the premise that the current price is wrong”.* Soros' view comes from his contention that security prices fluctuate with human emotion, moving between extremes of under and over valuation, and spending very little time in the middle around fair value. When times become exuberant, the added problem of FOMO causes investors to be even more emotional. The price dislocations can become very extreme and bubbles will form.

The next part of the problem for investors is the collective actions of the participants involved in the asset bubble tend to accelerate in concert in order to keep the music playing. We have seen historically that ***“when excesses such as lax lending standards become widespread and persist for some time, people are lulled into a false sense of security, creating an even more dangerous situation. These excesses will eventually end, triggering a***

*crisis at least in proportion to the degree of the excesses.*” Newton’s Third Law states that for every force, there is an equal and opposite force (for every action a reaction), and the larger the bubble builds, the greater the impact of the bursting. The problem is that there are very few people to turn to for words of warning as the bubbles develop because of bad incentives (everyone is making hay while the sun is shining, no matter how gloomy the forecast for tomorrow). Worse still, *“almost no one will accept responsibility for his or her role in precipitating a crisis: not leveraged speculators, not willfully blind leaders of financial institutions, and certainly not regulators, government officials, ratings agencies or politicians.”* There will be plenty of people holding things that resemble a pin at the end of the cycle, but no one will admit to being anywhere close enough to the bubble to actually have caused the pop. Klarman offers some “good” news along these lines, *“The government can always rescue the markets or interfere with contract law whenever it deems convenient with little or no apparent cost. We are probably doomed to a lasting legacy of government tampering with financial markets and the economy, which is likely to create the mother of all moral hazards.”* The fact that we should somehow feel safe because the government can arbitrarily change the rules of the game or how we keep score in the middle of the game is lost on this author. Although given that much of what the government does is to shift costs between generations (at little cost to them), it is easy to see how these actions could persist. Again, the inherent problem seems to be the bigger the bubble becomes, the bigger the calamity when it pops. When we step back and remember the primary purpose of those in power is to stay in power, it becomes easier to see why these trends will run longer than they otherwise should. *“The government (the ultimate short-term-oriented player) cannot withstand much pain in the economy or the financial markets. Bailouts and rescues are likely to occur, though not with sufficient predictability for investors to comfortably take advantage. The government will take enormous risks in such interventions, especially if the expenses can be conveniently deferred to the future.”* In the end, Klarman laments the fact that while we are likely going to be living in a world of bail-outs and intervention for the foreseeable future, the inability to predict their likely path and duration will make it difficult for investors to profit. We know from Incentives 101, if there is little cost to a particular path, that path will be chosen, and in this case that path leads to a significantly riskier world in which we must navigate.

So if things are becoming more risky, why do so many people say that things are under control and even getting better? Klarman reminds us that *“when a government official says a problem has been “contained,” pay no attention.”* The current level of “All is Well” admonitions from all types of participants in the financial markets reminds me of the famous last scene of *Animal House* when the Omega pledge played by Kevin Bacon is standing in the middle of the panicking crowd attempting to escape the a disrupted parade saying, *“Remain calm, all is well”* right before he is trampled into the sidewalk. Like the famous line from Shakespeare, *The lady doth protest too much, methinks*, if things were so good, why do you feel the need to tell me they are so good? The biggest issue that we see in the current hermetically sealed (read bubble) environment is that *“it’s incredibly important to note that when you don’t allow failure, you get more failure.”* When you try to eliminate the normal business cycle through massive QE stimulus, you actually end up with much larger problems because the natural selection mechanism is turned off and really bad companies are allowed to get bigger before they finally fail (they always eventually fail). Klarman reminds us that *“in most situations, everything appears fine until it’s not fine, until (for example, no one shows up at a Treasury auction).* Think of the actual visual of a bubble popping, everything looks beautiful as the bubble floats across the sky the light making rainbows in the glycerin walls, and then poof (without warning) it disappears. Klarman gets very specific about the coming U.S. crisis, *“There is an old saying (actually Hemingway wrote in *The Sun Also Rises*), ‘How did you go bankrupt?’ And the answer is, ‘Gradually, and then suddenly.’ The impending fiscal crisis in the United States will make its appearance in the same way.”* Perhaps bankrupt is too strong a word in the context of the U.S. government given all the tools

at their disposal and the massive assets they own (or others that could be seized), but the idea that a crisis is likely to occur is not farfetched given the stress on the system from very poor fiscal decisions over the years. We have to always remember that ***“Things that have never happened before are bound to occur with some regularity. You must always be prepared for the unexpected, including sudden, sharp downward swings in markets and the economy. Whatever adverse scenario you can contemplate, reality can be far worse.”*** Just because we didn't live through the Great Depression doesn't mean it could never happen again. Just because we didn't live through the German Hyperinflation doesn't mean it couldn't happen again. Just because many of us paid little attention to the Japanese markets crisis that has been grinding on now for 27 long years (Nikkei still down (58%) from the peak in 1989) doesn't mean it couldn't happen here. We have to remember the words of Denis Waitley (author of *The Psychology of Winning*) and always, ***“Expect the best, plan for the worst and expect to be surprised.”***

So when we think about the current investment environment, particularly on the heels of the strong rebound from the depths of the February lows (when fear was back for the first time in years), there has been a growing cacophony trumpeting the death of active management, hedge funds and Value as a discipline. There has been increasing confidence that passive strategies are the only valid ways to invest and investors have poured record amounts of money into Index Funds and ETFs, particularly into, “Smart Beta,” which is a troubling term given that Beta is, by definition, rules based. This is not necessarily a reflection of the intelligence of the investor, but of the formula of the strategy. The media backlash against hedge funds has reached levels we haven't seen since early 2000 (when smartest investors were short the Tech Bubble), and a handful of high profile pensions have announced that they are “killing their hedge fund programs.” Finally, Value firms (like the venerable GMO) are back in the news (for all the wrong reasons) as investors cry foul about recent returns and question the intelligence of those who practice the Value discipline. Baupost has not been immune to these assaults, and Klarman has written the perfect response. ***“In a rising market, everyone makes money and a value philosophy is unnecessary. But because there is no certain way to predict what the market will do, one must follow a value philosophy at all times.”*** We certainly don't know when the fiscal crisis will occur, or when the debt burden of companies will become too great (might be there in energy), or when the loss of faith in Central Banks will trigger the proverbial *bank run* in the markets. But we do know (with some certainty from decades of experience) that when speculators buy assets with no appreciable margin of safety future returns will be well below average (and may even be negative). Another compelling point is that ***“Nowhere does it say that investors should strive to make every last dollar of potential profit. Consideration of risk must never take a backseat to return.”*** It turns out there is also no rule that says you must be fully invested at all times. There is no rule that says you must buy assets when the upside potential to downside risk ratio is heavily skewed to the downside. There is no rule that mandates that an investor to abandon Discipline, Patience and Judgment and buy just because everyone else is buying (or more accurately, because rule based Index Funds and ETFs that are not allowed to think are buying). A reasonable investor would not buy a company with no growth, no dividend and little prospect for either in the future, but “dumb” (read rule-based) money must buy that security (regardless of price) and is not allowed to hold cash. One thing we know about peaks in demand for passive strategies is it has guaranteed that you have the maximum exposure to precisely the wrong asset class at precisely the wrong time (Tech in '00, Financials in '07, and Energy in '14).

There is intense pressure for investors to stay fully invested at all times (primarily due to a mistaken belief that cash is not an asset), and that pressure increases in direct proportion to the danger of taking just such a position. At Baupost, they prefer a more intelligent approach saying, ***“The near absence of bargains works as a reverse indicator for us. When we find there is little worth buying, there is probably much worth selling.”*** As

securities reach fair value and the market as a whole becomes increasingly overvalued (by whatever valuation measure you care to use), the smart thing to do (a requirement of the Value process) is not to buy more (which an Index Fund does), but rather to sell and go to cash. Klarman states it quite clearly, ***“Hold cash when opportunities are not presenting themselves.”*** Harkening back to the section on Clients, herein lies yet another point of tension between making the proper investment and keeping clients happy (and you employed as a manager). Jeremy Grantham has written extensively over the years about “Career Risk” being the most difficult risk to manage and we have shown Klarman to have agreed in earlier quotations. There is a Baupost urban legend related to this issue that is worth perpetuating here (although I have it on good authority that it really happened). In the year leading up to the Global Financial Crisis, Baupost was becoming increasingly unable to find bargains in the craziness of the subprime boom so they began to raise cash aggressively. They were early in their caution, so the *cash drag* began to weigh on relative returns in the final buying panic. A concerned client called Klarman to express his displeasure that the Fund was so heavily invested in cash and asked *“why am I paying 2% and 20% for you to hold cash?”* In a very calm manner, Klarman replied something along the lines of, ***“If you think you are paying me those fees to hold cash, you should redeem immediately. You are paying us 2% and 20% to know when to hold cash and when to invest, when to take risk and when to retreat to the sidelines. You are paying us those fees to know when is the right time to press the best possible risk/reward. But since you feel this way, I will waive the usual lock-up restrictions and wire your cash to you in the morning.”*** There was stunned silence on the other end of the line for a few seconds and then a sheepish reply, *“Never mind, we’re good”*. One other point on cash is important. Cash means cash. ***“Do not accept principal risk while investing short-term cash. The greedy effort to earn a few extra basis points of yield inevitably leads to the incurrence of greater risk, which increases the likelihood of losses and severe illiquidity at precisely the moment when cash is needed to cover expenses, to meet commitments, or to make compelling long-term investments.”*** The whole purpose of having cash is to protect assets during the downturn (which can’t be achieved if you take credit or duration risk) and to have the liquidity to strike and buy bargains when they appear (which you can’t do if your cash is stuck in a gated fund like the “Third Avenue Freeze Out”).

Finally, when investing in a dangerous environment like the one today, you have to prepare for the crisis before the actual event occurs. You have to put up the canned goods and firewood before the snow comes, which means you have to take time away from the summer fun and do some hard labor in order to weather the oncoming storms. In portfolio terms, ***“Hedges must be in place before a crisis hits. One cannot reliably or affordably increase or replace hedges that are rolling off during a financial crisis.”*** Staying with the settler analogy, imagine trying to go find food, or dry lumber, under a two-foot blanket of snow. The problem is actually worse in a financial crisis as many of the counterparties that you may rely on for hedging will find themselves in a crisis of their own and will cease to make markets in certain hedges. So if you were counting on being able to purchase them during the crisis you will be disappointed. Even if those products did continue to be made available, the pricing becomes prohibitively expensive because demand skyrockets when everyone actually notices the snow on the ground (versus the bargain prices you can pay for insurance when everyone else was at the beach). The importance of moving to a more hedged posture (more cash, less invested, more overlays) in advance cannot be overstated. ***“Conservative positioning entering a crisis is crucial: it enables one to maintain long-term oriented, clear thinking, and to focus on new opportunities while others are distracted or even forced to sell.”*** The genius of the Value investing strategy is that it allows you to rest easy and even profit while everyone else is panicking and being forced to liquidate. Holding cash is one of the most calm-inducing elements of the Value discipline because it allows you to spend less time worrying about declining investments (real cash doesn’t decline) and more time picking through the wreckage for the bargains that will generate future excess returns during the next Value cycle.

Many investors (most notably Stan Druckenmiller and George Soros in recent years) have also added another form of disaster protection to their portfolios, gold. Warren Buffett is not a big fan of gold (a rock you dig up on one side of the world and bury on the other) and Klarman dismissed commodities earlier from the list of suitable assets for Value investors. That said, the nature of the current debt related risks that have emerged in the global markets has precipitated a slight change in perspective. ***“Gold is unique because it has the age-old aspect of being viewed as a store of value. Nevertheless, it’s still a commodity and has no tangible value, and so I would say that gold is a speculation. However, because of my fear about the potential debasing of paper money (paper money not being a store of value) I want some exposure to gold.”*** Add another great investor to the long list of people who view gold as the ultimate currency and worthy of a role in a wealth preservation portfolio.

To conclude Klarman’s views on the dangers of the current market environment, we come back to a central tenet of the Value discipline, Risk Aversion. ***“When all feels calm and prices surge, the markets may feel safe, but, in fact, they are dangerous because few investors are focusing on risk.”*** When the consensus believes that the only direction for markets is up and volatility has become a distant memory, there is a distinct calmness in the markets that emanates from the good feelings of investors making money as prices rise. Consensus investors will confuse that calm with safety. Hyman Minsky created the Financial Instability Hypothesis, which explains how an economic system moves from Stability to Fragility to Crisis over time. In essence, the absence of something (market volatility) actually creates its presence in the future and the longer you go without a particular event (financial crisis brought on by excess debt) the larger the impact of the event will be when it finally occurs (crash). When investors become myopically focused on short-term return and begin to ignore (or worse dismiss) the potential risks the likelihood that we have moved from Stability to Fragility is clear and we are only a catalyst away from Crisis. No one knows precisely when the storm will hit, but we need to prepare well in advance in order to be in a position to survive. Klarman has said that ***“Investing today may well be harder than it has been at any time in our three-plus decades of existence.”*** On this point we would concur wholeheartedly, but we find strength to meet the current challenges in understanding *The Value of Value* and in applying the wisdom from one of the truly great long-term investors of our time to our portfolios today.

Last quarter’s letter was based on the wisdom of Shakespeare and the last paragraph seems to fit here again (reprinted as it appeared).

### ***Shakespeare on the Endgame***

***“The game is up”*** (*Cymbeline*) Pretty simple really, that which cannot go on any longer, will stop. ***“In time the savage bull doth bear the yoke.”*** (*Much Ado About Nothing*) Nothing lasts forever and time brings even the most powerful animal/trend to an end. Bull Markets, like Bulls themselves, ultimately come to an end and the yoke of valuation can be put off for a while, but eventually all will succumb. ***“Well may I get aboard. [He sees a bear.] This is the chase. I am gone forever! [Exits pursued by a bear.]”*** (*Winter’s Tale*) Amidst the 118,406 lines of Shakespeare’s works, a dream of being pursued by a bear seems to apply quite nicely to the markets today. ***“Awake, dear heart, awake. Thou hast slept well. Awake.”*** (*The Tempest*) It is time to wake up from our slumber and face reality, it has been a good ride, but now it is time to play defense and preserve capital. ***“There’s small choice in rotten apples.”*** (*Taming of the Shrew*) Shakespeare had a knack sometimes (ok, actually not very often as his writing is pretty dense) of saying things very simply, but with a little more flair that average conversation to keep things memorable. Rather than say there weren’t many good options, the image of a bushel of rotting apples assaults more of the senses and hammers home the point of the message, that when a situation has

become rotten, any choice is a bad one. This is the place we find ourselves in today in the equity markets, always lots of choices, but now the bunch is bad and while one bad apple still doesn't spoil the whole bunch (thank you Donnie Osmond), a bad bunch of apples does call for making the smart choice, none. ***"I would give all my fame for a pot of ale, and safety."*** (*Henry V*) Sometimes safety is the only thing you should be searching for (that and beer). We would argue that one of those times is upon us. ***"Let go thy hold when a great wheel runs down a hill, lest it break thy neck with following it."*** (*King Lear*) Once the trend actually changes, don't cling to the old notions, as it will break you, simply move out of the way. ***"A horse, a horse! My Kingdom for a horse."*** (*Richard III*) On the battlefield, the most common of items can become extremely valuable if they suddenly fall in quantity. In the investment market the same is true, liquidity only exists when you don't need it and in extreme situations (investment battles) the cost of liquidity (if you can get it at all) rises exponentially. ***"Better three hours too soon than a minute too late."*** (*The Merry Wives of Windsor*) When the stakes are high and downside in great, being early is definitely better than late. Not quite Shakespeare worthy, but it does rhyme. Mark Twain reminds us that *"history doesn't repeat, but it rhymes"* and we believe that some #2000.2.0 history is about to repeat and while we may have been a little early, that is OK. ***"But, soft! Methinks I do digress too much,"*** (*Titus Andronicus*) (Please excuse me for making the point too many times.) So from Shakespeare back to the Artist Known as Prince for some concluding words of wisdom, which seem very important in the investment environment we find ourselves in today. ***"I was dreamin' when I wrote this, so sue me if I go 2 fast. But life is just a party, and parties weren't meant 2 last. I was dreamin' when I wrote this, forgive me if it goes astray. But when I woke up this mornin' coulda sworn it was judgment day. The sky was all purple, there were people runnin' everywhere. Tryin' 2 run from the destruction, U know I didn't even care. Cuz they say two thousand zero zero party over, oops out of time. So tonight I'm gonna party like it's 1999."***

It seems that Bill the Bard and Prince would concur with Seth Klarman that the party is over in the current investment environment, the margin of safety has dissipated, and investors should *"get thee to a nunnery"* (read cash) to protect capital in the short-term and provide liquidity to buy the bargains that are sure to come again in the future, much to all Value investors' delight.

## SECOND QUARTER REVIEW

It is summertime and a third quarter has dropped into the slot to keep the roller coaster ride running with the ups and downs growing ever larger and more frequent as the ride continues. Before we lower the safety latch and get going, let us take a tour of the various thrill rides around the world as the theme park of global equity markets has experienced continued volatility over the past three months. In the U.S., 2016 started off with a terrifying drop (worst first five days ever), but by the time the ink dried on our Q1 letter, the S&P 500 was right back where it started. We wrote last quarter *“The nice thing about roller coasters is that after every down (no matter how steep and scary) there is an up (and you always end up in the same place in the end) and the S&P 500 careened off the bottom like it hit a spring and surged 12.6% to 2,060 by the end of the quarter (less than 1% from where it began the New Year and nearly exactly the same spot (2,059) it was at the end of 2014).”* The roller coaster ride continued in April with some choppy bumps that made us think we were back on the moguls of Q4’15, dropping from 2,065 to 2,040 and back to 2,097 by the end of May. Things were pretty quiet for most of June with only a couple of tilts in the track until the Brexit vote on the 23<sup>rd</sup> when the S&P 500 took a stomach lurching nose-dive and dropped (5%) in two trading sessions to hit 2,000 on 6/27. Suddenly every carnival barker in the theme park came out of their tents shouting for markets to “Step right up!” and win the oversized stimulus hanging right there waiting. Just as riders had enough time to look over and see the big fuzzy prizes the cars whipped off the 2,000 mark, climbing 5% back to 2,099 to end the quarter. The move during the second quarter was rather muted at only 1.9% (2,099/2,060) but riders were feeling euphoric as the coaster surged another 3.6% to 2,175 over the first three weeks of July before cresting the hill and leveling off for the final week. The bulls argue that the chain lift (Central Bank liquidity) is fully engaged and the lift hill has a way to run, while the bears argue that the chain lift is disengaging here and we are in for another swift

descent. To see where the ride ends up insert another quarter about mid-Autumn.

Across the Pond, the Eurocoaster has not been nearly as much fun as the American Flyer. In fact, we wrote last time that *“normally with roller coasters the larger the drop, the bigger the ascent on the other side, but European equities didn’t follow that blueprint,”* and Euro Stoxx 50 Index has been making a series of lower highs since peaking in April of 2015. While the Eurocoaster followed the rest of global equity markets down for the first half of Q1 and careening off the bottom sharply, the subsequent ascent was truncated. We wrote in our last letter, *“the thrills weren’t over yet and the cars sped down some more in the first week of April to hit a low of 2,872, careened back up to 3,152 two weeks later and headed down in the last week to finish at 3,028, down (6.7%) for the CYTD.”* European stocks fell another (3.6%) in the first few weeks of May and the Euro Stoxx 50 Index hit 2,919 before turning up 5.9% to 3,090 to finish the month. Alas, when the chain lift let go on May 30<sup>th</sup>, the Eurocoaster had the wildest ride in the world during June plunging (9.5%) to 2,797 on 6/14, bouncing 8.6% to 3,038 on 6/22, crashing (11.2%) to 2,697 on 6/27 (following the Brexit vote), and then catching another chain lift back to 2,864, where it finished the month down (7.3%). As the rhetoric from central bankers got louder and the new Prime Minister in the UK chose not to enact Article 50 (the official Brexit trigger) immediately, the chain lift clicked higher in July and stocks rose all the way back to 3,000 on 7/27 before slipping back a little to finish the month at 2,991 (now down (8.5%) for the year). As we discussed last quarter, the key to roller coasters is that you end up in the same place after every loop and the Eurocoaster has been stuck on the same level for even longer than the U.S. In fact, the Euro Stoxx 50 Index is not only at the same level it was to begin 2014 but the ups and downs have delivered the cars back to the same spot as in September 2008. While there has been some return from dividends, the price has been the same for the better part of a decade.

Two quarters ago we described the Samuraicoaster as a *“truly motion sickening ride,”* as the steepness of the declines and rises were exacerbated by BOJ Governor Kuroda-san’s unwillingness to expand the QQE program. However, it was his seemingly ill-advised decision to shock the word with a Negative Interest Rate Program (NIRP) on 1/29 that made the ride’s safety latch feel more like a sword. We wrote last quarter that, *“the Nikkei ... plunged a frightening (16.3%) from 17,865 on 2/1 to 14,952 on 2/12 before careening off the bottom along with all the other global equity coasters.”* At the last writing, the Index had finished April at 16,666 *“when Kuroda-san sat on his hands again (some might say his hands were tied...) with respect to more stimulus.”* The Samuraicoaster caught the chain lift on May 2<sup>nd</sup> and peaked on 5/31 at 17,235, up 6.7% off the bottom as hope emerged yet again for Kuroda-san to pull out the stimulus bazooka. No such luck for coaster riders. The day after the Brexit vote the next plunge took the Nikkei all the way back down to the exact bottom (14,952) hit in February. Yet, in July rumors began to circulate that Ben Bernanke was taking the helicopter to Tokyo to explain how to really grease the wheels and the chain lift fully engaged on the front end of the month. The cars rose all the way up to 16,810 on 7/21 (a 12.4% increase) before releasing the coaster to settle at 16,569 to end the month. As we mentioned last quarter, *“after being one of the best performing equity markets since 2012, the Samuraicoaster is now resting at the same spot as it was at the beginning of November 2014, right after the big Kuroda Halloween Surprise when he expanded QQE for now what appears to be the last time.”* There have been many theories as to why Kuroda-san has been hesitant to expand the stimulus program and buy more securities in the markets. As we noted, *“perhaps the simplest explanation is that they already own 1/3 of all the Government Bonds (JGBs) and 1/2 of all the ETFs in Japan.”* The BOJ met during the last week of July and Kuroda-san disappointed markets by announcing that the money was staying in the chopper and stimulus would only be increased modestly (by doubling of pace of buying ETFs) until the BOJ convened a special

meeting in September to perform a “comprehensive assessment” of their policy initiatives. Reading between the lines, it appears that the BOJ is concerned that what they have been doing is not achieving the desired results and rather than do more of what is not working simply to appease the markets, they are going to try to find a plan that will achieve their goal of achieving 2% inflation. The issue for those investors still on the Samuraicoaster is the question of who is minding the track. With the Yen surge likely to hurt profits in the near term, will the next hill on the Nikkei thrill ride be a real screamer?

The most harrowing roller coaster rides in the world since the commodity peak in 2011 have been in the Emerging Markets where the scrEEMcoaster had made six thrilling laps around a track filled with giant drops and rises from May 2012 to May 2015 only to wind up back in the same place before flying down a gigantic slope, falling (34.8%) from 43.02 to 28.03 on 1/20 this year. We described last quarter how *“something changed in the middle of Q1 as the U.S. Dollar peaked, Oil began an epic rebound off the \$26.21 low on 2/11 and EM equities began to surge all around the world. From the mid-January bottom, EEM has surged back to 34.25 to end the quarter and then followed the rest of global markets lower in early April before jumping back up to 34.12 to finish the month.”* The scrEEMcoaster lived up to its name in early May as EM equities plunged (7.3%) to 31.64 on 5/19 and then just as quickly ran right back up 9% to 34.53 on 6/8 and spent the rest of June in a nausea inducing set of quick turns, dropping (5.3%) to 32.69 on 6/14, surging back 6.3% to 34.76 on 6/23, sliding back down (7.3%) to 32.23 on 6/27 before finally catching the chain lift up to 12.3% to end July at a new high for the year at 36.20. We mentioned last time how there appears to be, *“a very different rhythm to the scrEEMcoaster than the other global equity thrill rides.”* Instead of making a series of lower lows and lower highs, EEM is making higher lows and higher highs. Even the wildest ride of them all in 2015, China’s Dragoncoaster, has settled down and recovered very nicely since the lows of late January.

We noted last quarter that from the 2,656 low on 1/28, that “with some volatility, the Chinese Index rose steadily over the course of the past three months to finish April at 2,938, up 7.3%.” There was one slight drop in May when the SHCOMP (Shanghai Stock Exchange Composite Index) fell (4.5%) in the first few weeks to a low of 2,807 on 5/19, but the Dragoncoaster was hooked in tightly to the lift hill for the next two months, rising 9% to a peak of 3,061 on 7/13 before falling (2.7%) to finish the month at 2,979. The best ride at the carnival in 2016, despite the cancellation of their actual Carnival due to budget woes, has been Brazil. We noted last time that, “the Canarinhocoaster (little canary, for the iconic yellow soccer jerseys) that is the Ibovespa Index had plunged from 58,052 last May to 37,497 (down (35%) in eight months) at the end of January, but the equity market caught the chain lift and never looked back, rising an astonishing 44% all the way back to 53,911 at the end of April.” The Canarinhocoaster crested the lift hill at the end of April and fell sharply in May, down (10.1%) to 48,471, jerked riders over a few bumps in June to 49,245 on 6/27 and then was firmly back on the chain lift surging 16.4% to a new high for the year at 57,308 to end July, up an astonishing 52.8% from the January low. While those eye-popping returns are in local currency, the Real has recovered quite substantially from the carnage over the past few years. Despite this, the MSCI Brazil Index managed a stunning 13.9% gain in USD in Q2 and is now up an equally stunning 60.9% CYTD through July.

Let’s look more closely at performance within the U.S. equity markets during Q2 from a size and style perspective as a solid outcome for the overall market (the S&P 500 Index up 2.5%) masks some weakness within certain segments of the market. Generally speaking, it was a good quarter for domestic equities across the capitalization spectrum and small caps finally gained some traction as the Russell 2000 outperformed the broader markets for the first time in nearly a year, rising 3.8%. We mentioned last quarter how small caps were trailing the broader markets and noted, “micro-cap stocks were the worst performers in

Q1, dropping (5.4%) for the quarter and (13.1%) for the TTM (compared to a positive 1.8% for the S&P 500 over the TTM). The huge spread between large-cap growth (up 5.7%) and small-cap value (down (7.7%)) indicates that there is significant stress in the equity markets and that a defensive posture would be advisable in the months ahead.” That defensive posture was a good thing for the first six weeks of 2016, but equity markets have stabilized since mid-February and the trends have begun to reverse. Large Growth (RTop200G) was only up 0.2% in Q2 versus Small Value (R2000V) that were up 4.3%. While the TTM returns still favor Large Growth, up 4% versus down (2.6%), the gap is closing. Microcaps are still the worst performers over the TTM, down (12.1%), but have rallied nicely in Q2, rising 4%. We wrote in Q1 that, “so far in 2016, the growth/value dynamic has been very confusing as there was essentially no difference in the large-cap segment, while in the mid-caps and small-caps, value turned around and beat growth.” That trend continued in Q2 as the Value Indices all outperformed their Growth counterparts. The large-cap spread for the CYTD is 4.1%, while mid-cap and small-cap spreads are both 7.7%. We hypothesized last time that, “the primary reason for the change is the recovery in commodity related names this year after oil began to recover in mid-February. It is possible that there is a meaningful shift underway in global equity allocations to favor more value and cyclical names. While this shift doesn’t fit exactly with a slowing global economy and stress in the financial sector, this trend will be worth monitoring very closely in the months and quarters ahead.” The trend clearly bears watching and while the latest miss on Q2 GDP (1.2% versus expectations of 2.6%) runs counter to the idea of a recovery favoring cyclical stocks, the capital flows are definitely moving toward Value names, with some sectors showing very strong performance.

Digging down into the performance of the sectors of the S&P 500 there is some corroboration of the Value shift as Energy and Telecom were the leading sectors in Q2, up 11.6% and 7.1%, respectively. Other sectors

that would normally lead when Value is in favor - Financials, Materials and Industrials - were more subdued in Q2, rising just 2.1%, 3.7% and 1.4%, respectively. If we look at CYTD data, things look a little more robust with Energy up 13%, Telecom up 24.4%, Materials up 13.5% and Industrials up 10.4%. The only wrinkle in the story is that Financials continue to languish (a result of being Dodd-Franked), up only 0.6% CYTD. We wrote in January that, *“most importantly for the sector data was the shift in momentum in December when all of the Defensive sectors were back on top with Staples, Utilities, Healthcare and Telecom rising. That trend was exacerbated in January as the Bulls lost control of the equity market and the Defensive sectors surged while the Growth sectors were severely punished.”* What seemed a little odd in Q2 was that despite the media narrative that the broad Bull Market was alive and well, these defensive sectors continued to lead the overall markets as Telecom, Utilities, Healthcare and Consumer Staples took four of the top five slots and were up 7.1%, 6.8%, 6.3% and 4.6%, respectively. If we extend out to the CYTD period it is very clear that the defensive safe havens of Telecom and Utilities are crushing everything else, up 24.4% and 21.7%, respectively (versus 7.5% for the S&P 500). However, Healthcare and Consumer Staples are toward the bottom of the pack, up 5.1% and 9.2%, respectively. Further, Growth related sectors like Technology and Consumer Discretionary had very tough Q2s, falling (2.8%) and (0.9%) respectively and while the CYTD numbers are better (up 7.4% and up 5.2%) they are clearly toward the bottom of the sector group. Lastly, we have discussed the significant momentum in the commodity recovery in recent months and the falling dollar has been a modest tailwind, but we warned that quarter that *“any change in the Dovish tone from QEen Janet will take the air out of the commodity recovery in a hurry.”* Q2 had some modest drama surrounding Fed signals that they would raise rates in June or July, but the Brexit vote and falling growth in the U.S. put that genie back in the bottle. When it became clear that rates would continue to be on hold the Industrials, Energy and Materials sectors

continued to rally. For the CYTD these sectors are up a robust 10.4%, 13% and 13.5% (well ahead of the SPX), but some recent weakness in oil prices in July put some downward pressure on these sectors in recent weeks. We wrote last quarter that, *“coming into 2016, there was near unanimity (usually a great contrarian indicator) that King Dollar was headed higher and that emerging markets currencies (particularly the Chinese RMB) would continue to plunge. Perhaps our favorite MCCM Surprise was #8 (King Dollar Dethroned) where we made the case that there were far too many investors on the same side of the USD trade and there was a great deal of misunderstanding about the intentions of the PBOC to create a very stable RMB so that their plan to have the yuan included in the SDR portfolio could reach fruition in 2016.”* We have discussed for a while how getting the dollar right was perhaps the most important decision in investing in coming years and as we are of the opinion that King Dollar has indeed been dethroned, we would expect to see commodity related sectors continue to recover and eventually lead the rest of the equity market.

Speaking of the dollar, we said, *“our view, as expressed in MCCM Surprise #2 (Two Wrongs Won't Make It Right), was that the Fed would realize the error of their decision to hike in December and would not raise any more in 2016, thereby providing a tailwind for further dollar depreciation in the New Year and relieving much of the pressure from the Chinese to devalue the RMB.”* So far, so good, as the Fed remained on the sidelines in June and July and recently sent out President Bullard to release more dovish quotes to the media. While Bullard has been a lone wolf within the Fed saying that no more rate increases are necessary and that recent weakness in the U.S. economy was sufficient evidence, he has been more accurate in his commentary than other Fed mouthpieces, so perhaps the narrative from the Fed is moving more toward QEen Janet's dovish demeanor. The recent commentary included the perfunctory *“September is not off the table”* (just to keep the Algos on their toes), but without some serious revision to

the GDP numbers in the coming months, it is tough to see how a tightening bias makes sense with the world's largest economy below stall speed (GDP below 2%). With the Fed on hold, we wrote last time that, *"If the dollar continues to languish for the balance of 2016, the trends in emerging markets equities, commodities and currencies could accelerate rapidly over the course of the year."* DXY was actually up 1% for Q2 and had been up as much as another 2% through mid-July (before the bad GDP print), but recent momentum has turned negative and despite all the predictions that the Dollar would rise in 2016, DXY is now down (1.9%) CYTD. That weaker dollar has indeed provided a tailwind for commodities and emerging markets equities, which we will discuss in more detail below. The second part of MCCM Surprise #2 argued that not only would the Fed put off any rate hikes in 2016, but by 2H16 there was a meaningful possibility that they would have to reverse course from the 2015 tightening (one and done) and be forced to ease again. The biggest challenge for QE IV was that it appears that the Fed is literally running out of bonds to buy so they would have to come up with another way to provide stimulus. The BOJ and SNB solved this dilemma by buying equities and ETFs directly. The Fed is currently prohibited by law from buying stocks (for now...) and it would take a legislative change to make this possible. One thing we have learned since 2009 is to never say never when the Central Banks are involved as they have made a habit over the past few years of doing things that once seemed impossible.

Over the past couple of years we have discussed the linkage between Fed bond purchases (QE) and increases in U.S. equity markets. Our commentary was based on the great work done by Larry Jeddelloh of TIS Group on this phenomenon as he had done analysis that showed how, *"historically every \$100 billion of QE has translated into 40 S&P 500 points."* We have also wrote in Q4 2014 that, *"given U.S. equity markets have been driven by the QE equation since 2009, the cessation of QE this month does beg the question of what happens in 2015? The larger*

*question is, again, how would equities continue to rise?"* With the actual results now in for 2015 and 1H 2016, we have the answer, they really won't. Beyond a few percent of dividends paid, the S&P 500 Index finished Q2 almost where it was in December 2014, around 2,100. We wrote last quarter that, *"we will see if the Fed truly has a third mandate (beyond their stated mandates of employment and inflation) to keep the equity market stable. Yellen has talked tough about keeping the door open to a rate hike in June, but if the #SIMAGA (Sell In May And Go Away) summer doldrums hit and equities fall, expect much backtracking and eventually the discussion of QE IV."* So it took a bolt from the blue in the form of the Brexit vote to elicit the actual reaction, but the response was swift, as global stock markets were falling hard in the days following the UK Referendum (SPX was down (5.4%), Nikkei was down (7.9%) and Euro Stoxx 50 was down (11.2%) in just two days). In reaction, nearly every central banker (not just the Fed) vowed to ease more and magically the equity markets stopped going down and bounced dramatically (as detailed in the roller coaster section above). Clearly the Third Mandate is real. Every time there is even a hint of a correction in the S&P 500, the Fed either puts rate increases on hold or makes noises about QE IV. The new twist to the storyline is that now every time any major market around the world starts to correct the Fed feels compelled to speak or act, although it actually does more speaking than acting. Perhaps the most interesting thing about the Brexit vote and the response is that the vote is clearly a mandate to move away from globalization while the Fed and global central bank coordination seemingly makes more sense in a more global rather than nationalistic world. There will be more to talk about on this topic in coming quarters.

With the potential for a cyclically weaker dollar there are a handful of developed markets (the balance of the EAFE Index beyond Japan & Europe) that always seem to get overlooked by market observers (and these letters) which have in common a historically strong correlation to commodities (in fact their FX are

even called commodity currencies). Canada, Australia and New Zealand have relatively small equity markets so they normally don't warrant much attention, but in 2016, their currencies have turned around sharply versus the dollar and their equity markets have been some of the best performing this year. These markets dramatically outperformed the EAFE Index in Q2, rising 3.4%, 0.5% and 5.9%, respectively, versus a decline of (1.5%) for the benchmark. Adding the solid Q2 to the Q1 returns of 11.3%, 2.1% and 11.6%, respectively, the Commodity Currency Countries are now up 15.1%, 2.6% and 18.1%, respectively, for the first half of 2016. We wrote last quarter that, *"there will likely be some interesting opportunities in these markets if the Dollar weakness persists, so perhaps we will have more to write about them in the coming quarters."* These markets have been quite interesting and we are indeed writing more about them. One of our favorite research groups, 13d Research, thinks that these markets will have a built in currency tailwind for the foreseeable future and that equity returns could continue to surprise to upside as the commodity bull market develops. Given that most managers are underweight this trio, it wouldn't take much of an allocation change from global equity managers to create meaningful price movements in these markets.

European equity markets were hit pretty hard by the Brexit jitters in Q2, falling (2.7%), but there were a handful of markets (primarily the Nordic countries) that eked out positive returns when measured in local currency. However, Super Mario was doing his best to fight back against the surprise 4.8% surge in the euro versus the dollar in Q1, and his efforts to weaken the euro cut the number of markets generating positive returns in Q2 to three (from six) out of the fifteen markets in developed Europe. Belgium, Norway and Switzerland were able to stay in the black in USD, rising 2.3%, 2.4% and 2%, respectively. Surprisingly, the performance of the UK was rather muted despite the fireworks around the Brexit referendum and the FTSE fell only (0.7%). The performance in the rest of Europe was less robust as

France fell (4.3%) and Germany dropped (5.6%), but it was the periphery that really got hammered as concerns about bank solvency reappeared in Spain and Italy. Those markets fell (7.7%) and (10.5%), respectively. Also interesting was how much Austria and Ireland fell, both around (10%) as Brexit confusion and less liquid markets was a bad combination. We wrote last quarter that, *"clearly Super Mario's constant refrain of 'whatever it takes' is beginning to resemble the little boy who cried wolf, as it seems that all of the ECB activity over the past year has been generated very little benefit (either for economic growth, the creation of inflation, or stock prices)."* We have tried to quantify the impact of ECB bond purchases on European equity markets with the TIS Group methodology for QE. After a couple of false starts, we came up with a formula that appeared to be reasonable and concluded that, *"we can recast the formula that for every 100B Euro of purchases you get 20 Euro Stoxx 50 points (significantly smaller than the original calculation)."* However, with over half of 2016 now behind us, it appears that the growing consensus that central bank effectiveness is waning may be correct. With the ECB buying bonds like there is no tomorrow we should have seen a gain of 80 Euro Stoxx 50 points by now, yet we stand at 2,979 on 7/29 and have actually lost 289 points from the starting point of 3,268. While plenty of 2016 remains, the likelihood of the Euro Stoxx 50 surging 419 points from here (up 14%) seems reasonably remote, so it appears we will have to adjust the model again.

One of MCCM Ten Potential Surprises for 2016 focused on Japan and hinged on the key role that BOJ Governor Kuroda would have to play for in order for Japan to remain the *"Land of the Rising Stocks."* Surprise #3 read as follows: *"Save Us Kuroda-san, You're Our Only Hope. BOJ Governor Kuroda surprises everyone at the end of the Japan Fiscal Year and pulls out another bazooka to weaken the Yen and stimulate the economy and markets. The Yen falls dramatically, with USDJPY hitting 135. Corporate profits surge to new record highs and Japanese equities rally hard, finishing the year at 21,000."* The

good thing about Surprises is that they are only supposed to be right (by definition) a little over 50% of the time, so there will be some that are simply wrong. Surprise #3 fits that description as it could not have been more wrong. Not only did Kuroda-san not pull out his bazooka for another round of QQE, he went to the opposite extreme and shocked the world by announcing a Negative Interest Rate Program (NIRP) at the end of January. The about face was stunning (although somewhat less stunning after details leaked out about the Shanghai Detente) and the stated goal of the movement, “to force the banks to lend excess reserves into the economy,” and, “break the grip of the deflationary mindset” was equally stunning in its low likelihood of success given the inertia at the banks for the past two decades (even in a positive NIM environment). In Q2, the MSCI Japan Index was able to eke out a modestly positive return (in USD) as the index slumped (7.8%) in yen during the quarter, but the sharp rally in the yen (as USDJPY moved from 112 to 103) helped U.S. investors this year. With the yen surging so far, so fast, the negative impact on Japan Inc. earnings has been real and there is the risk of a reflexive vicious downward spiral if Abe-san and Kuroda-san don't find a way to stimulate economic activity. The fate of Abenomics hangs in the balance and we expect the BOJ to find a way to do something creative and Abe to take advantage of his mandate after a big win in the recent elections and push through a fiscal stimulus plan.

As we discussed last quarter, *“one interesting development that bears watching is that after some meaningful collateral damage to the mega-banks after the NIRP decision, SMFG and MTU rallied a stunning 35% off the bottom on 2/11 and are still up 20% and 18% respectively after the turmoil of the last couple of days (compared to the Nikkei up only 11%).”* It appears that those rallies burned all the gas in the tank for the banks as they have basically marked time over the past three months and despite the big rally off the bottom through July are still down (16.1%) and (19.1%) CYTD. We have been talking about how cheap these banks are for a while, and though early

observe, the Japanese mega banks are selling at single digit P/E ratios with rising EPS and extremely strong balance sheets. So while we understand that NIRP is bad for financials, there does come a point where all the bad news is already priced in and you have to plug your nose and buy. The Japan managers we work with have expressed frustration with the BOJ and Government decisions in 2016, but continue to see very strong earnings power within a broad swath of companies. ROEs continue to rise and the “Ace in the Hole” in the Nikkei Hold 'Em game is, *“a newfound appreciation by Japanese management teams of Stock Buybacks and the continued unwinding of cross shareholdings,”* which could push EPS even higher as share counts shrink. It takes serious Conviction to be supportive of Japanese equities when the yen is crashing toward 100 and foreigners are selling in waves, but earnings growth is positive (best of the major developed markets) and valuations are back to levels described as “stupid cheap” by one of our favorite Japan specialist managers. That said, on the other side of the trade is a new manager we began working with at the end of last year who has a completely contrarian view of Japan and Japanese equities. He believes that the system is broken and unfixable and that the Nikkei will head back to the GFC lows around 8,000 (clearly a very unpleasant outcome). Given that he was one of the lone wolf voices to call for a strengthening yen last year, we need to be mindful of his view. When it was fashionable to think the USDJPY had “no way out” and was headed nowhere but up (and when our Surprise called for 135), this PM was making the audacious (now prescient) call that the yen would head back to 100. Different opinions is what makes markets, but we must not so quickly forget Klarman's preference for facts. We will be spending a lot of time in the coming months with our Japan managers to determine who actually has done the best work to gain a true edge.

No one has wanted to talk about emerging and frontier markets in the past couple of years, as returns have been abysmal since 2011 as the impact of the

collapse in commodity prices put pressure on EM and FM equities. That said, we have made the case over the last couple of letters that we might be nearing the time to buy “what is on sale” in developing markets. Last fall we referenced the wisdom of one of the great investors of all time and said, *“We could hear Sir John Templeton’s words “Bull Markets are born on Pessimism” and we can feel that pessimism in the markets. Sir John says to buy at the point of “Maximum Pessimism” and we might not be there just yet, but we are likely getting close.”* At the end of 2015 the collective pessimism of investors toward EM & FM was nearing a crescendo and we wrote in January that, *“we are reminded of another great quote from legendary investor George Soros who says, “The worse a situation becomes, the less it takes to turn it around, the bigger the upside.” There is likely one last cathartic move down, but we are also more likely to be closer to the end of this down cycle in EM than the beginning.”* There was indeed one more cathartic move down in the first three weeks of January as EM & FM crashed along with global equity markets as fears of a China devaluation and collapsing oil prices pushed developing markets down further and faster than developed markets. At the bottom on January 21<sup>st</sup>, the MSCI EM Index was down (13.3%) and the MSCI FM Index was down (10.5%). Some Emerging Markets components were much worse, with Brazil down (16.9%), China down (17.3%), Russia down (17.6%), South Africa down (17%) and Greece bringing up the rear (again), down (27.5%). Some of the Frontier Markets components were bad too with Argentina down (8.9%), Saudi Arabia down (20.1%) and Nigeria down (17.4%). That was surely the point of maximum pessimism, and there has since been a dramatic turnaround. We wrote last quarter that *“in March alone, the MSCI EM Index was up 13.2% to erase all the losses from the first six weeks of the year and finished the quarter up 5.7%, well ahead of the Developed Markets.”* Q2 returns were more muted (but still positive) as markets took a pause that refreshes after running hard in Q1. The EM Index was up 0.7% to bring 1H16 returns to 6.4%, and the FM Index was up 0.5% to bring 1H16 returns to

(0.5%) (The Frontier Markets Index was hurt by a high weight in Nigeria, more on that below). The momentum in emerging markets continued in July with the Index jumping another 5% to finish July up 11.8% CYTD to lead nearly all developed markets (Canada and New Zealand two exceptions) and is up more than double the MSCI World Index’s 4.9% gain.

A closer look at the countries within the EM Index reveals quite a bit of dispersion as returns ranged from truly exceptional to rather poor during Q2. At the bottom of the list are Greece and Turkey, down (14%) and (7.9%), respectively. Malaysia fell (5.9%) after a very strong Q1 and Korea dropped slightly, down (1.2%). The best returns continue to come from the markets in Latin America. The MSCI LatAm Index was up 5.3%, but Brazil was up another astounding 13.9% and Peru surged an astonishing 18.2% (to be up 50.1% for 1H16). We wrote about the “worst to first” phenomenon going on in LatAm last quarter saying, *“one of the areas that fared the worst in 2015 (and over the past few years) was Latin American and we wrote last quarter that “LatAm countries did not fare as well during Q4 and the negative equity and currency trends actually accelerated downwards resulting in some truly terrible performance.”* This type of movement always reminds me of the quote from Arjun Divecha (the EM portfolio manager at GMO), who said, “You make the most money in Emerging Markets when they go from truly awful to merely bad.” You would have had to search pretty hard to find a place where things looked more awful than Latin America (particularly Brazil) and we noted last quarter that, *“just when things looked like they couldn’t get any worse, they actually didn’t and markets soared and the MSCI Latin America Index surged 19.1% for the quarter.”* With back-to-back great quarters and a big July, LatAm is now up 32.4% CYTD (with some dispersion of its own). Mexico is the laggard up only 0.6%, Chile is up 18.4%, Columbia is up 18.6%, Peru is up 58.5% and Brazil is now up an eye-watering 60.9%. Some other bright spots in EM during Q2 (although seemingly pedestrian compared to LatAm) were Indonesia up 4.1%, Philippines up

5.8%, India up 3.7% and Russia up 5.2%. Including further gains in July, these markets are up 22.5%, 15.5%, 6.9% and 22.7% CYTD.

Over the last couple of years much of the weakness in EM equity markets was actually EM currency losses from the impact of King Dollar. Persistent strength in the greenback, and consistent fear that the Fed was moving toward a tightening bias, has created a serious headwind for emerging markets currencies, and, therefore, for U.S. investors in EM stocks as well. We discussed last quarter how some of the pressure on EM currencies was being effectuated as, *“there were also a ton of hedge funds who had piled on the short EM FX trade toward the end of 2015, some as a directional play on the dollar strength and some as a proxy for the RMB short which had become very expensive to transact directly as the Chinese fought back in the FX markets.”* At the end of January all of the negativity toward EM currencies suddenly fell away and March saw a record breaking EM currency move as a huge short squeeze engulfed EM FX and currencies of countries like the Fragile Five (Brazil, India, South Africa, Turkey and Indonesia) surged on the short covering. That trend continued into Q2, albeit at a more casual pace, and the weakness in the dollar helped push EM currencies (and therefore EM equities) higher. Eastern Europe has been on a roll for a few quarters now and we wrote last time about the huge moves there courtesy of the FX tailwind, saying *“Eastern Europe enjoyed more strength in Q1 with Hungary rising 17.3%, Turkey surging 21.6% and the MSCI EE Index jumping 15% overall.”* In Q2 Eastern Europe took a body blow from the Brexit vote and the EE Index fell (2.4%), but some countries like Poland and Greece were pummeled, falling (17.5%) and (14%), respectively. Things calmed down in July and markets reversed sharply, leaving Poland up 2.9%, Greece rose 6.4%, Hungary jumped 8.1% and Czech Republic surged 8.4%. Turkey delivered a self-inflicted wound through a dubious coup attempt (some say staged by Erdogan to gain power) and fell (7.9%) in Q2 and another (5.8%) in July. Some EM observers have been saying that Turkey is beginning

to look a lot like Russia during the early phase of the sanctions and that stocks are looking cheap. Russia added to their gains from Q1, rising another 5.2% (to be up 20.7% for the 1H16) and the movement in the RTS Index mirrored the recovery in oil prices. While the Russia RTS Index was strong, the star performer was again Sberbank, which jumped another 26% (on top of the 40% from Q1), but there are emerging signs of a broadening in the Russian equity bull market and some managers we admire have been talking about the retailers (Magnit, X5, Lenta, DIXY) as a buy for the next phase of the recovery. As we mentioned last time, *“the only dark spot in EM was once again Greece, as uncertainty about the Debt restructuring led to wild volatility. There will come a time to buy stocks in Greece again (as assets are just too cheap) and that time may be approaching faster than most anticipate.”* Greece has continued to be a dark spot amidst the breaking dawn in EM, but we believe that they have finally resolved the issues with the EU and the time is now to begin wading back into Greek equities. We would start with the banks, as they will be a leveraged play on the recovery (much in the same way that Sberbank was in Russia).

Perhaps the most popular market to discuss is China, and not a day goes by without some commentary on one of the many bubbles that exist in China (housing, debt, stock market), how all the data coming out of China (GDP growth, Exports/Imports, capital flows) is not real, or how Premier Xi is the second coming of Mao and is trying to consolidate power for his personal benefit. There are myriad prognosticators and pundits who have been claiming for years that China is headed for (the most vocal will say is already in) a hard landing and any minute now there will be a collapse of the RMB and crashes in the equity and housing markets. The most strident will go to the extreme and say the entire Chinese financial system is on the verge of implosion and the carnage will result in massive civil unrest and a meltdown of their entire society. We said last quarter that, *“extreme points of view make good media headlines, but rarely come true, so we will take the under on the total Doomsday*

*scenario. Not that there aren't potential problems to be addressed in China, there are, but we believe that the current Leadership has a robust long-term plan for managing the transition from an Industrial Economy to a Consumer Economy over the coming decades."* Moving from the macro view to the micro view, Q2 was relatively quiet in the Chinese equity markets with the MSCI China Index finishing flat, up 0.1%, while the MSCI China A-Shares 50 Index fell modestly, down (2.3%). China did participate somewhat in the July EM rally, but trailed other markets as MSCI China was up 3.5% and the A-Shares were only up 1.9%. Chinese equities have almost clawed back to flat CYTD as the index is down only (1.4%), but the A-Shares have some work left as they remain down (10.4%). The fears of an RMB devaluation continue to restrict the upside in the equity markets, but as we wrote last quarter, *"our view is that this trade has become consensus and one thing we have observed over the years is that markets rarely take the path of least resistance, but rather take a path that inflicts maximum pain for the majority of investors."* We hosted an *Around the World with Yusko* webinar in April entitled *Yuan A Piece of Me? China Plays Hardball with the Hedgies* where we laid out our case for why there wouldn't be an RMB devaluation in 2016 (too much at stake with getting RMB included in the SDR) and why the hedge funds who were betting on that event would have been better off deploying capital elsewhere. The yuan has indeed been quite stable this year and although it has slid about (2.3%), the costs of putting on the trade far exceeded this move.

With China it pays to take a long-term view and we continue to believe there are tremendous opportunities to make money in the equity markets, the private markets and (increasingly now) the bond markets. The capital markets continue to develop and real interest rates are materially higher in China than other global markets, so we expect to see capital flows move toward Chinese credit in the years ahead. In the equity markets, the correction in Q1 moved P/E ratios of the primary indices back below 10x, which has

historically been an entry point from which significant gains can be earned by investors with the appropriate time horizon. When writing the Q4 letter in January, we stumbled across an interesting Chinese New Year forecast that got very specific about market expectations during the year and we wrote, *"while the early 2016 returns in China have been poor, on the eve of the lunar New Year, the forecasts for the Year of the Monkey indicate that there will be a meaningful rally in the Chinese equity markets in the second half of the year."* As we enter the second half of the year, July has been a solid start and the SHCOMP (Shanghai Stock Exchange Composite Index) spent most of time above 3,000 (before slipping back under at month end) and we will have to see how the rest of the year plays out. These particular forecasts have been surprisingly accurate over the years and there are signs of momentum returning to the China equity markets as market watchers have become more comfortable with the government's commitment to further fiscal stimulus. We have said before that we believe the best approach to investing in China is to make a long-term commitment to building exposure to the sectors and companies that will benefit most from the powerful shift toward consumption in a country of 1.4 billion people. This transition will take some time and a long-term perspective remains essential for capitalizing on some of the best investment opportunities available in the coming years. Our favorite opportunities in Chinese equities over the coming decade will come from the five core sectors that dominated in the U.S. during our own transition from industrialization to consumerism; Technology (e-commerce), Retail, Consumer Staples, Healthcare and Alternative Energy. We mentioned Sir John Templeton's view on bull markets springing forth from pessimism, but the second line from his famous quote applies to China in that "bull markets grow on skepticism." There is plenty of that to go around which will fuel the gains for the intrepid few who take advantage of the boom that is to come in the massive growth of the Chinese middle class.

Frontier markets were mixed in Q2 as the MSCI FM

Index limped across the finish line with a scant 0.5% gain and a scant (0.5%) loss for the 1H16. We noted last time that, *“these markets are not very deep, or very liquid, so the quarter-to-quarter volatility can be quite extreme,”* and that pattern was evident in Q2 as some of the leaders in Q1 (like EE) were the laggards in Q2 (pounded by Brexit fears). Hungary fell (4.7%), the Czech Republic was down (6.1%) and Poland was rocked, plunging (17.5%). As we mentioned above in the discussion of the dollar, markets moved back into “risk-on” mode in July, so the inhuman volatility continued. The winners in Q2 were Saudi Arabia, rising 6%, Argentina, rising 7.4%, Vietnam, jumping 11% and Pakistan, which surged 14.4%. There are some very interesting developments occurring in Vietnam and Pakistan and we expect to see continued strength from these small, but mighty, markets in the coming quarters and years. Africa struggled in Q2 with Kenya down (2.7%) and Nigeria down (11.7%) as continued problems with oil production, religious violence, corruption and a currency devaluation have made Nigeria the problem child within the FM markets family. As we said in Q1, *“Argentina has been one of our favorite markets over the past year as the potential for a new government, settlement of the hedge fund holdout issue and a growing movement for increased internationalization within the country itself pointed to myriad opportunities to make money in the coming years.”* All of the things necessary for investment success seem to be falling into place in Argentina. The bond hold out issue was resolved, newly elected President Macri has made a series of bold moves that are very pro-business, the capital markets have reopened as the first new bond issue was the most over-subscribed issue in bond market history and there have been a wave of new IPOs bringing fresh supply to eager investors. We wrote last time that, *“given the long history of unpredictable behavior in the global capital markets, investors are still hesitant to make meaningful allocations to Argentina,”* and it appears that times (and investor appetites) have changed for the better in this regard. We have contended that the reluctance of global investors to return to Argentina would extend the

investment opportunity (so far, so good) and we expect to see meaningful opportunities to make excess returns in this market for years to come.

Ho-Hum, just another spectacular quarter for bond investors (contrary to all the pundits once again, incorrectly, predicting rates had to rise) as U.S. fixed income markets had a great Q2 as uncertainty about Brexit put the Fed on hold and investors clamored for the safe haven nature of bonds (particularly long Treasuries) and the Barclay’s Aggregate Index was up a solid 1.8% for the period and the Barclay’s Long Treasury Index surged (again) an amazing 6.1%. Those gaudy numbers left the Aggregate Index up 5.3% for the 1H16 (well ahead of domestic equities) and left the Long-Bond Index up a staggering 15.1% for the first six months of 2016. One would think that the doomsayers in bond land who keep saying that bonds are “going to get crushed any day now” must be getting tired of being wrong at this point. Despite the Fed trying to convince the world that they are serious about raising rates, investors continue to basically ignore Ms. Yellen as they know QEen Janet’s true Dovish tendencies. The whole charade is reminiscent of the scene in *Animal House* where Donald Sutherland (as Dave Jennings) tries to convince the class that he is serious about their Milton papers as the students file pass him while he whines, “I’m not joking! This is my job.” We wrote last time that, *“we said in the January MCCM Surprises #2 (Two Wrongs Won’t Make It Right) that QEen Janet would channel her inner dove and not raise rates in 2016.”* Four FOMC meetings down and it’s so far, so good, on the “no hikes for you” mantra. There is still a lot of 2016 left and the Fed has tried to keep fear alive before each meeting in an attempt (lame though it may be) to keep the bubbles they’re inflating across financial markets from getting truly out of hand. We continue to see nothing that changes our stated view that the Fed missed their window to raise rates in 2013 and further, that they are actually more likely to be forced to ease again (QE IV or something stonger) before they tighten. We said last time that the likelihood of more doves and less hawks would, *“make bonds*

*(particularly long bonds) a killer investment in 2016,”* and that prediction has come true as in the upside down New Abnormal world we have been living in since 2000, it appears that doves eat hawks, not the other way around.

Across other fixed income markets, the environment in Q2 was supportive of solid returns for bonds of all kinds as all the dovish rhetoric from global central banks in anticipation of some untoward outcome from the Brexit vote led to a falling dollar, translating into strong returns for U.S. investors in international bonds. The Barclay’s Global Bond Index rose 2.9% (on top of the very strong 6.7% in Q1), boosted by the weakness of the USD relative to JPY and EUR, and the Index is up an incredible 9% for the 1H16. Just for perspective, Global Bonds were down (2.6%) last year with the bulk of the losses resulting from currency losses due to the strength of the King Dollar (it appears King Dollar has lost the throne). Credit markets were even more robust in Q2 as the Barclay’s High Yield Index surged 5.5% as investors clamored for yield wherever they could find it (regardless of credit quality) in a world where 40% of sovereign bonds have a negative yield. Despite the fact that corporate debt levels are at all-time highs and there are many companies with suspect balance sheets issuing bonds, we mentioned last quarter that, *“fears about the ‘Third Avenue Freeze Out’ (a mutual fund that had to suspend redemptions) from last year was so ‘last year.’”* Sure enough, since the bottom in February, there have been record inflows into HY bonds. Normally this kind of rush into an asset class has been a contrarian indicator for future returns, but not so far in 2016 as HY Bond prices keep rising and the yield in “high yield” keeps falling. We went so far in January as to *“agree with Uncle Carl Icahn that there is Danger Ahead in high yield bonds and even made MCCM Surprises #10 (The Bus Stops Here) an homage to Carl’s analogy of the free money party bus careening over a cliff and landing on a ‘Big Black Rock’ (his analogy for the potential for huge damage from Blackrock’s dominance in ETFs which Icahn believes reduces liquidity),”* and we looked intelligent

for the first six weeks of the year, but have looked overly cautious since. Keeping with last quarter’s Shakespearean theme, whenever we experience a move in a market to extreme valuations we seem to hear his words from Merry Wives of Windsor reminding us, “you can be three hours early, but not one minute late.” History is replete with examples of paper fortunes being wiped out quickly when prices adjust to fair value, and when the margin of safety disappears it has historically been a good time to pull the cord and get off the bus.

Perhaps the biggest surprise in the world of fixed income is the emergence of emerging markets debt as the “go to” safe haven trade. The EM debt market has grown dramatically over the past decade and the diversity of issuers, higher real (and nominal) yields and better overall credit quality have attracted huge inflows into the space from global investors. The wave of demand has swamped a fairly ample supply; the JPMorgan EM Bond Index rose “just another” 5.4% in Q2 (on top of 5.9% in Q1) and has now firmly captured the role as a safe haven of choice for global investors in their panicked search for yield. Reiterating something that we believe about core bonds over the long run, we wrote last year that, *“The challenge of owning bonds in the current environment is that three things can happen and two of them are bad; 1) you hold them and inflation chews up your returns because yields are so low; Bad, 2) you hold them and rates rise and you actually lose money; Worse, 3) you hold them and rates fall and you make money; Good (but then we may have other issues to deal with since falling rates are a sign of economic weakness).”* Given the movement of EM bonds into the mainstream, we note that this dilemma now applies to EM debt as well. In many places yield compression has eliminated the margin of safety and the expected return from here going forward is quite unappealing. Granted, given the choice between developed market corporate debt and emerging market corporate debt, we would still favor EM, but we would choose lots of other investments over both of them, like market neutral arbitrage strategies,

private lending strategies, BDCs and MLPs.

Speaking of MLPs, in the yield asset category, 2016 began much as 2015 ended, with REITs outperforming and MLPs getting smashed, but something quietly shifted during Q2 and investors decided that MLPs were an acceptable investment again. We wrote about why the two asset classes might have diverged last year in saying, *“it might seem safe to assume that assets which investors purchased primarily for yield would move together depending on the rate environment (would rise with falling rates and fall with rising rates). The breakdown in that thesis is that the source of the yield may be impacted by different elements within the environment and an asset might not follow the pattern in the event that business fundamentals changed more rapidly than the change in the rate environment.”* The reality is that not all yield assets are created equal. Varying degrees of leverage, different structures and underlying asset quality can combine to produce different return streams in assets that investors may consider to be comparable (like REITs and MLPs). The S&P U.S. REIT Index chalked up “just another” (yawn) big quarter, rising 6.6% in Q2, on top of the 6.3% return in Q1 and now stands up 13.3% for the 1H16 (perhaps even more impressive is the TTM return of 23.7%). The most impressive thing of all about REITs might be what we highlighted last quarter, *“interestingly, REITs have outperformed equities over nearly all trailing periods during the past twenty years, so perhaps there is something to this yield construct after all.”*

Turning back to MLPs, the Alerian MLP Index exploded higher in Q2, soaring 19.7%, more than making up for the negative Q1, and pulled ahead of REITs for the year, up 14.7% for 1H16. We were “early” in saying in Q4 that, *“there are some great assets being thrown out in the oily bathwater, but also some assets that should never have been put into the MLP structure (more cyclical businesses) that will likely fall much further, and it appears that investors are not yet ready to differentiate between the two.”*

We thought MLP prices might continue to fall as long as there was pressure on oil and gas prices, but we truly believed that, *“there will be some generational opportunities in this space in the coming months, but trying to catch falling knives is a dangerous sport and the best strategy is to let the knife hit the ground, bounce around a bit, come to rest and then go pick it up by the handle (lose fewer fingers that way).”* Last quarter we observed that perhaps the knife had indeed hit the floor and stopped moving and highlighted some really impressive moves from the mid-February trough as MLPs like ETE, PAGP and WMB ended April up 172%, 86% and 62% off the low, respectively. Our thesis was that, *“there will be much more opportunity in this area as investors sort out the winners from the losers for the long-term focusing on core mid-stream assets should be a very productive strategy as energy markets stabilize and begin to return to more normal operations.”* It appears that investors have come around to the idea that hydrocarbons will continue to need to be transported in the U.S. and ETE, PAGP and WMB were up 33%, 7% and 24%, respectively, over the past three months and through July have returned an impressive 263%, 100% and 100%, respectively, from their bathwater phase in February.

No one has wanted to talk about commodities for a few years now, since commodity markets had been locked in a brutal bear market since August 2011. Fears of a China hard landing, slowing global growth and a grinding 22% rally in the dollar had been a hurricane force headwind for the GSCI Commodity Index, which had fallen roughly (70%) through the nadir in late January. Commodities of all types had suffered during the cyclical unwind, but given that oil makes up the largest weight within GSCI, the (75%) collapse in crude from peak to trough did the bulk of the damage. Interestingly, the gold bear market has gotten as much (or more) airtime than the “black gold,” despite “only” falling (30%). To put the recent moves in commodities into perspective, it helps to really look at the last throes of the bear market in Q4 of last year and Q1 of this year. We discussed in the

Q4 letter how commodities had been battered despite a relatively small move in the dollar (GSCI plummeted (16.6%) while DXY was only up 2.5%) and we wrote, *“we were somewhat puzzled by the magnitude of the collapse as “a smallish move in the dollar (in theory) shouldn’t have produced double digit losses in commodities.”* We went on to say, *“That type of exaggerated movement felt vaguely like capitulation and we began to think that a bottom in commodities was finally possible.”* In our normal pattern of being early (sometimes too early) we had actually written about the potential for a turn in commodities in the Q3 letter (and gave a presentation at the Investment Institute on 10/1/15 talking about the opportunities this might create as well) saying, *“there could be some continued dollar strength so the commodity headwind would not subside quite yet, but all cycles turn and given the decimation across the commodity complex, some of the moves off the eventual bottom will create tremendous investment opportunities.”* The title from the slides on commodities spoke of generational opportunities to buy extraordinary assets at fire sale prices as babies were being tossed out with oily bathwater everywhere.

As we wrote the Q4 letter in late January, signs were emerging that some significant changes were occurring within the commodity complex. The dollar was confounding the pundits who had predicted a major rise, oil was in the bottoming process (it actually bottomed on 2/11) and gold was firmly locked in recovery mode. In our MCCM Ten Potential Surprises for 2016 presentation, MCCM Surprise #9 focused on, *“the one truism in commodity markets, The Cure for Low (high) Prices is Low (high) Prices. It turns out capitalism works and high prices bring on new capacity that eventually collapses prices and then low prices lead to shuttering of capacity they eventually allows prices to move back up.”* The back half of Q1 saw some extraordinary moves in commodities as capitulation selling (maybe some tax selling too) in the end of 2015 and first few weeks of 2016 set the stage for a magnificent rally. One of the biggest changes over the last few years in the capital

markets is the speed at which moves can occur because of the democratization of trading tools and the globalization of the markets. You used to have to sit inside a big investment bank prop desk to be able to have access to real-time market information and execution capabilities but today, if you are so inclined, you can get real time quotes and execute trades for pennies on just about any security you can imagine from your iPhone on a train in China. Investing used to be all about finding/getting information faster than others and you had some time to get positioned when your research led you to a position where you had some edge. Today, everyone has nearly simultaneous access to the same information and everyone knows what all the “smart money” is doing (thanks to public reporting and the internet), so trades become “crowded” faster than ever before. We wrote about one of the impacts of these trends that applied to commodities last quarter, *“when everyone in the markets is short one particular asset, the short squeeze can be quite extraordinary and that is exactly what played out over the balance of Q1.”* The squeeze continued in Q2 and the GSCI surged 12.7% as oil ripped, surging 26.1%, while gold climbed “only” 7.2%. There were lots of other commodities that soared in Q2 (discussed below), but suffice it to say that lots of investors were caught “offside” when the turn came and big money from sources as diverse as CTAs, Chinese retail investors and sovereign wealth funds piled into commodity futures markets and pushed the moves to extremes. Then, like the locusts in *A Bug’s Life*, they came, they ate and they left. As quickly as the money appeared, suddenly on June 8<sup>th</sup>, it began to vanish and commodities began to correct. GSCI dropped (14%) in the seven weeks to the end of July (down (9.6%) in July), oil plunged (18.8%) with (14.9%) of that coming in July, but curiously gold just kept rising, jumping 6% in the last part of June and another 1% in July. It will be very interesting to see over the next quarter if this recent move was a normal correction in a new commodity bull market or whether the strength in the first half of 2016 was a steroid (read liquidity) induced pause in the ongoing commodity crash that began in 2011.

We talked last quarter about how the Crudecoaster had been the wildest ride of all in 2016. We highlighted the craziness of the price movements saying, *“from the year end price of \$37, crude oil quickly shed (27%) over three weeks, bounced back 23% in just one week, collapsed (21%) in two short weeks and then caught the chain lift for six long weeks and rose 58% before falling (8%) in the last week to finish about back where it started at \$38.”* Roller coasters dip and rise and plunge and surge, but always end up right back where they started, and the Crudecoaster took another lap (albeit a little more boring with just one rise and one fall) over the last four months. After clicking into the chain lift the first week of April, oil prices rose pretty consistently from \$36 to \$51 on June 8<sup>th</sup> and came careening down the hill back to \$40 to begin August. Our view on oil for 2016 was that there would be price weakness early in the year and a recovery in the second half of the year. We articulated that perspective in January in MCCM Surprise #4 saying, *“The resumption of Iran oil trading and short-term storage concerns push the market into steep Contango in Q1 and oil hits a multi-decade low in the 20s, but in the second half of the year the impact of cap-ex cuts and production declines push prices back toward \$50.”* As if on cue, oil hit a low of \$26 in mid-February and then began a fairly stable recovery that actually began to accelerate when Pierre Andurand (our favorite oil trader) raised his oil price forecast in March, calling for \$65 by year-end 2016, \$85 in 2017 and \$100 in 2018. Prices had risen all the way to \$45 by the end of April when we wrote, *“we can’t help but feel that prices have gotten a little ahead of fundamentals and there is some seasonality to this surge that resembles last year when prices went from \$43 to \$61 from March to May before collapsing in the second half down to \$37. We don’t expect a collapse this time, but we will stick with our original year-end target of \$50 for now.”* We are clear-eyed about the dangers of disagreeing with a legendary oil trader on oil prices, and to be clear, we completely agree with Pierre’s directional call, but think the market rebalancing will take modestly

longer based on our conversations with energy fund managers who are running U.S. shale companies. One of the most compelling things we have heard in a while about oil was a respected portfolio manager who told us in May that any money he didn't put in his own fund he would put into buying oil in the ground in the Permian basin. It is always interesting when an expert in the liquid markets confirms the outstanding illiquidity premium being offered in the private markets. After just spending a day in Dallas last week visiting our private energy managers, I came away even more excited about the opportunities in private oil & gas.

While it is true that oil & gold get nearly all the media attention, there actually are other commodities worth talking about (and investing in from time to time) like natural gas, copper and iron ore. Natural gas was not a pretty market in the first part of 2016 as a huge El Niño produced an extremely warm winter in North America reducing demand and causing prices to collapse from \$2.34 to begin the year to a trough of \$1.64 by the first week of March. We wrote last quarter how a, *“small blast of arctic air and some big snowfalls boosted prices from the low of \$1.64 back to \$1.96 to end the quarter “only” down (16.1%).”* Natural gas prices began to rise in April (up 11.2%) and debate began to rage between those concerned that storage was nearly “full” and prices were about to plummet back under \$2 and those who believed that La Niña was going to heat things up and demand would surge taking prices upwards. We actually wrote that the markets were siding with the latter group, saying, *“There seems to be some balance around the \$2 level and the futures curve puts Natural gas above \$3 sometime later in the year.”* Within days of us sending out the Q1 letter prices began to slide back down toward \$2, hitting \$1.98 on 5/24 and \$1.96 on 5/26. Then temperatures in the U.S. rocketed higher and Natural gas prices surged all the way to \$2.92 by the end of June to deliver a 49.5% return to those who went long at the end of Q1. Prices touched \$2.99 on the first day of July (leaving our \$3.00 “sometime this year” for later in the year), but then

took the month off to digest the monster rally and dropped back (4.6%) to settle at \$2.88 at the end of July. With production in the Marcellus and Utica continuing to set records and storage again looking top-heavy, a few of our favorite managers believed we would see one last drop back toward \$2.00 this fall before beginning a steady increase toward \$4.00 in 2017, but the most recent injection data showed that high demand due to scorching summer heat has trumped supply and it looks like the path of least resistance for natural gas is higher.

Dr. Copper, nicknamed thus because of the historical link between copper prices and economic health, has been trapped in one of the most brutal of the commodity bear markets since 2011. The carnage had been so bad that we wrote last time that, *“looking at the extraordinary drop since 2011 from \$464 to \$213 at year-end, Dr. Copper would say that the economy was in the ICU, but that has not been the case and while growth has not been robust, there has not been a Recession.”* We hypothesized that there must be some other explanation and actually found a viable alternative that we described in our MCCM Surprises #5 (*A Black Swan Alights in Europe*). The thesis was that the largest global commodity trading firms were battling to stave off insolvency and were liquidating copper inventories to service debt. Given the activity in the trading company stocks last year (massive losses) there appeared to be some validity to this idea and copper prices were continuing to fall early in 2016. In mid-January, with no warning, Dr. Copper jumped into a roller coaster car and prices surged from \$194 on 1/15 to \$228 on 3/7, collapsed back to \$208 on 4/7, surged back to \$228 on 4/29, plunged to \$203 on 6/10, jumped back to \$226 on 7/19 and slid back to \$222 at the end of July. While the move in copper prices in Q2 was actually 0.0%, the volatility was nausea inducing and some market observers think this is a dramatic bottoming process and that copper prices will head higher with other commodities in coming quarters. We recently met with an interesting manager with a long track record of success in commodity investing who is raising a

dedicated fund from July-September. Because they are so confident that commodity prices (and copper in particular) are headed higher, the fund will have no management fee and a graduated incentive fee. We highlighted an interesting development last quarter that could also be a confirming signal, *“the trading company stocks have soared off the bottom, with some up more than 100%,”* and those most tied to copper, like Glencore and First Quantum are up 160% and 360% respectively since January. We mentioned how this type of reflexive move can happen, saying *“it turns out that when companies come close to bankruptcy, but stay alive, their equity acts like an option and returns can be staggeringly good.”* We have seen these types of moves in a number of areas across the commodity complex from oil & gas, to coal, to steel, to copper and iron ore. Speaking of iron ore, there was a massive recovery in prices in Q1, up 36%, followed by a (7%) drop that triggered rumors that Chinese retail money had propped up commodities (some argued in exchange for a cap on U.S. interest rate increases...the #ShanghaiAccord) and now it would vanish (along with the ephemeral gains in commodities) as that money headed home. Iron ore said not so fast and surged back 9.6% in July and is now up 39% CYTD dragging pure play names like Vale, Fortescue and Cliffs along for the ride, up 164%, 204% and 555% from the January nadir (more examples of optionality).

*“The Last Shall be First”* has been the theme in precious metals in 2016 as poor performance of the past few years has all but been erased in investors’ collective mind as legendary investors like Stan Druckenmiller and sovereigns like the PBOC loaded up on the barbarous relic in late 2015 (when everyone was selling to them at very cheap prices compared to today) and have been handsomely rewarded by runaway metals prices. We wrote last time about the important transition in precious metals, saying, *“metals turned toward their currency role (away from the commodity character) and Q1 was more hospitable for the metals as gold surged 16.2%, silver 11.5% and platinum rose 9.4%.”* The PMs surged

again in Q2 with gold up 7.2%, silver up 21.2%, platinum up 5% and even palladium (more industrial than precious) got out of the doghouse and rose 6.3%. As solid as these returns are, they pale in comparison to the gaudy returns posted by the miners as GDX jumped 39%, GDXJ surged 53%, SIL soared 64% and SILJ screamed upwards 68%. The miner party kept going in July with GDX, GDXJ, SIL and SILJ up 10.5%, 17.5%, 17.5% and 23%, respectively, to bring the CYTD returns to alchemical levels of 123%, 160%, 176% and 255%, respectively. We wrote last time that, *“historically when gold miners and silver are outperforming the gold metal that has been confirmation of a bullish trend,”* and clearly the bull is loose in the precious metals shop. Finally, when it comes to agricultural commodities we wrote last time that, *“extreme volatility due to weather, uncertainty about the dollar and global growth concerns meant it has been best to simply ignore the sector altogether from an investment perspective and we will remain consumers of Ags in restaurants, but not in our investment portfolios.”* Q2 results were more mixed than Q1 when everything plunged. Wheat fell (9.1%), but soybeans surged 24.7% and corn was flattish, up 0.7%. Cotton futures were rumored to have been “manipulated” by Chinese money as enough cotton contracts traded in one day to make a shirt for every person in China and prices surged 11.1% in Q2 and another 13.8% in July (but is only up 12.9% for the CYTD). La Niña also made herself known in the coffee and sugar markets as prices stormed higher, up 11% and 30%, respectively. All that said, we come back to what we wrote two quarters ago, *“the grains might be considered “untradeable” and we have spent very little time in this area as the wild gyrations related to changing weather forecasts and production surprises have not lent themselves to solid fundamental analysis. Perhaps these markets will revert back to a more consistent trend following pattern, but until then, we will leave them to those with higher levels of short-term trading acumen.”* Lots of markets to invest in and we like to focus on those where we can get an edge.

Speaking of edge, we have always found the most talented portfolio managers (those that possess edge) in the hedge fund space. The edge comes from many different places and takes many forms, some have better technology (they get information faster and in a more useable format), some have better analytics (superior models and/or superior computing power), some have better process (more diligent, consistent and repeatable), some have better people (more independent thinkers, great synthesizers) and some have better networks (broader and deeper relationships across industries, sectors and geographies), or some combination thereof. Edge does not come cheap and the genius of the hedge fund model (propagated by A.W. Jones and discussed in our letter titled *A.W. Jones Was Right*) was it provided superior levels of fees which allowed hedge funds to acquire the best talent and resources, develop the best networks and build the best systems. History shows us that over the long term the results have been as you might expect, far superior to traditional long-only strategies (higher returns and lower volatility), but every so often we go through an extended period (as we find ourselves in today, usually inflicted by central bank largesse) where hedge fund strategies don't outperform and a cacophony builds that their edge has disappeared, that they have become “rich and complacent,” that “active management is dead,” that there is “too much money chasing the same ideas” and myriad other negative “explanations” for why the high fee strategies are underperforming the low fee strategies and why everyone should immediately fire all the high fee managers and only buy index funds and ETFs. The logic here seems as twisted as saying you shouldn't hire the best (read highest price) defense attorney to defend you in a murder trial because he lost his last case (despite the fact he is 75-3 over his career). We wrote last time that, *“unfortunately, hedge fund managers gave the media a little more grist for the mill in Q1 as collectively they produced negative returns and in the long/short equity segment there were some truly awful (actually not using this term lightly) performances.”* It is true that many managers

produced disappointing performance in Q1 (some more disappointing than others), and the highest profile managers didn't do themselves (or the industry) any favors by posting the worst performance of the bunch. Performance in Q2 was better, but not up to the standards we expect (we will get in to details below) so we find ourselves in an interesting time that reminds us very much of the second half of 2000 right after Tiger Management was forced to close down. All that said, one thing we have found from nearly three decades of allocating capital to managers is the best way to generate superior long-term results is to find managers who have a great long-term track record (demonstrated edge) who have just suffered a difficult short-term period and invest. Do the opposite of what the media keeps reporting that the big pensions are doing (actually they keep writing the same story about the same three pensions over and over), they hired hedge funds after the global financial crisis (chasing their strong relative returns) and are selling to buy passive strategies (chasing their CB steroid induced strong relative returns). We have seen this movie before and we know how it ends.

So let's dive a little deeper into the performance of the various categories of hedge funds. The HFRX Global Hedge Index was up 1.1% in Q2, a respectable number when compared to the long only MSCI ACWI Index, which was up 1% for the period. Given that the global hedge portfolio is about 50% net long that implies a reasonable alpha during the quarter. We say "reasonable" because it is about half the level we would expect to see over the long-term, but the headwinds on the short side continue to be gale force and our expectations are that these winds will change soon (like the shift from El Niño to La Niña earlier this spring). The U.S. results continue to be worse than the global results (as the craziness on the short side is more acute in the domestic markets) and the HFRX Equity Hedge Index fell (1%), which again looks quite poor relative to the S&P 500 clawing back late in the quarter to gain 2.4%. The real issue for long/short equity fund performance surfaces when looking at the TTM (trailing twelve months) as the

HFRX Global and U.S. Equity Hedge Indices are down (5.6%) and (8.3%), respectively, while the ACWI was down only (3.7%) and the S&P 500 was actually up 4%. Alpha generation by long/short equity managers has troughed at levels we have only seen a few other times, most recently in 2000 and 2008 (just one more sign of the potential for #2000.2.0). We made a point last time that, *"another problem is that in Q1 while the point to point (12/31 to 3/31) return comparison looks bad, it was the comparison at the trough in February that really looks bad, when markets were down nearly (10%) and many long/short managers were down as much (or in some cases more) than the market. So what is going on? Have long/short equity hedge fund managers lost their edge?"* Clearly we have been thinking a lot about edge recently. Is it possible the world has changed so much that the fundamental approach utilized by active long/short managers been rendered obsolete by HFT and central bank manipulations? The answer is the same as we wrote last time in response to the question of whether managers had lost their edge, *"the short answer is no, the longer answer is also no and the good news (or bad news depending on your perspective) is that we have seen this movie before a couple of times in the past and we know how it ends (with the long/short equity managers coming out on top and equity markets down a lot)."* There have been plenty of incidents over the decades when active management has underperformed passive management, where traders beat fundamental analysts and where long only has trumped long/short strategies. In every one of those instances mean reversion has occurred, and to paraphrase Sir John Templeton again, it won't be different this time.

We have been vocal proponents of swapping long only equity exposure for hedged equity exposure over the past few quarters. Last quarter we admitted that, *"with the benefit of hindsight we can see that we were wrong (one quarter is "early," three quarters is wrong), but we do not believe that the group of managers that investors collectively clamor to gain access to and who can charge very high fees*

*(compensation is usually linked to quality and performance in every industry) has suddenly become universally stupid. So then what is going on?"* Our thinking was based on our #2000.2.0 thesis, that the current economic (and market) environment looked eerily similar to the 2000-2002 period and that just like then a portfolio of outstanding long/short equity managers would be the best place to weather the storm. We concluded after a great deal of analysis that we were "early" on that call as well in 2015 and wrote, *"we are changing our view to align more with the timing of the economic, presidential, performance and capital flow cycles. What we missed in the analysis that compared 2015 to 2000 (rather than 2016) was that 2016 is the election year (and a rare 8<sup>th</sup> year of the seated president which amplifies the presidential cycle), the economy, while weak is unlikely to fall into recession until 2017 (right on cue in the first year of the presidential cycle)."* To generate truly outstanding relative performance from long/short strategies versus traditional equity strategies the markets have to function efficiently. Good companies need to rise and bad companies need to fade away, so skilled fundamental analysts can determine which is which and go long the good ones and short the bad ones. In a QE world (where everything goes up regardless of quality), the benefits of long/short management are impaired and in the absence of the business cycle there is no self-correction mechanism to let markets actually be efficient (reward the winners and punish the losers). Lake Wobegon (where everyone is above average) may be a fictional place, but the past few years of central bank intervention have turned global capital markets into a Garrison Keillor-esque version of their formerly efficient self and all companies have looked above average (at least according to GAAP accounting standards), and it has been tough to make money on the short side. However, in the past few quarters, a funny thing has happened beyond the shores of the U.S. The ECB and BOJ have continued to stimulate, but equity markets stopped going up, and in fact have gone down. Perhaps there is an upper bound to the benefits of monetary policy and perhaps the U.S. will

"catch down" to the other markets shortly. We wrote last time how *"Forewarned is Forearmed and Precaution Avoids Perils are likely to be some important words to live by in coming quarters"* and it sounds like sound advice again.

Just like in 2015, the biggest pain (read most media attention) in hedge fund land in 2016 has been felt by the Activist managers (particularly the celebrity funds), which have fallen another (10%) to (20%), thanks to continuing travails in names like Valeant and Herbalife, bringing losses over the past eighteen months to as much as (40%+). Interestingly, the HFRX Event Driven Index (perhaps because it doesn't include brand names since the largest hedge funds don't report to these providers) finally had a solid quarter after a nasty string of losses and rose 4.6% in Q2. Event Driven strategies benefitted from the rally in oil and the crush of money into high yield bonds which collapsed spreads and the index is up in line with equities for the 1H16, up 3.3%, but continues to lag equities over the TTM, falling (5.3%). We have discussed in the past how MCCM has historically avoided Activist managers (primarily because they don't hedge) and to reiterate our view, *"While we believe that there are a few groups (like ValueAct) that have generated outstanding returns over time, we have not seen the level of Alpha we require to warrant paying hedge fund fees."* If one were a cynic (not that we are), one could make the argument that Activist managers are really just a concentrated "pump and dump" strategy and the success (or failure) of the strategy is contingent on the credibility of the portfolio manager to convince others to "buy what he has already bought" by using the media to point the spotlight on what they own. All cynicism aside, the other issue that we see in the Activist space is that the success of the celebrity funds (Icahn, Ackman etc.) has attracted a lot of "me too" managers and the trades seem to get more crowded, more quickly, and have become prone to boom/bust cycles and unattractive volatility. In fact, we noted last time that the phenomenon has gotten so bad that *"an interesting (maybe even a little dodgy) side note was that during a*

*recent trip to London, one of the managers (who was up 13% in Q1) said a meaningful part of their short strategy is to be short the Activist's longs.*" As we said earlier, there are lots of strategies to invest in and this is one where we are happy to be spectators rather than participants.

The one area within the hedge fund family that hasn't struggled in 2016 (or the past year for that matter) was Credit as the HFRX Distressed Index surged 9% in Q2 as credit spreads fell from elevated levels in February (which were the highest since 2009) as fears of a rise in bankruptcies and defaults subsided. The interesting thing about the collapse in spreads is that the fundamentals would seem to indicate the opposite as defaults are at the highest pace since 2009, but the decline in spreads is indeed occurring as a wall of money searching for yield piled into HY bonds at record rates in Q2. For 1H16 the Distressed Index is now up a very healthy 7.4% (double the equity market), but is still down (5.4%) over the trailing year. We wrote last quarter that despite the panic buying in the credit space, *"we still anticipate more tough times ahead for the credit markets over the next few years given the very high level of energy related debt (equivalent to level of telecom debt in 2000) in the indices."* Given what we hear from our private managers in the energy space, we continue to doubt that everything has been fixed in the oil patch and we can't help but harken back to the, *"last gasp rally in 2001 within the Telecom sector before companies like WorldCom and Qwest defaulted (and disappeared, taking huge piles of investors' money with them). There were some tremendous opportunities to make big returns buying the good assets from the bad balance sheets in 2002 and we would expect those opportunities to come again, but not until 2017 or 2018."* Oil prices have stabilized, but at prices with a 4-handle versus a 6-handle a year ago and a 10-handle when much of the debt was incurred by many energy companies. That wall of debt comes due in 2017 and we expect to see many more companies end up in distress and lots of opportunities in the Event Driven

space to buy up the good assets from the bad companies.

Over the past year the least bad hedge fund strategies were the Macro/CTA and Absolute Return sectors, which were able to tread water, or even make a little money in some of the A/R strategies like Merger Arbitrage. The HFRX Absolute Return Index was back in the black in Q2, rising 1.2%, bringing the return for 1H16 back to positive (barely) at 0.6%, which, coincidentally, is also the index's trailing year return. The best performing sub-strategy over the past year has been Merger Arbitrage and the HFRX Merger Arbitrage Index rose again (albeit slightly) in Q2, up 0.8%, bringing 1H16 returns to 2.4% and the strategy is up a very solid 7.2% over the TTM. We talked last time about the challenges facing arbitrage strategies in a world run by Central Bankers, saying *"Absolute Return strategies (Merger Arb, Market Neutral) continue to fight the brisk headwind of Zero Interest Rate Policy (and now Negative, or NIRP) and the generation of Alpha (or simply avoiding negative returns) in such an inhospitable environment is positive outcome (and better than the majority of other strategies)."* Despite the lackluster returns, the reason to overweight these strategies in a portfolio is they are likely to outperform both stocks and bonds over the next decade. They are likely to beat bonds because of the risks of capital loss if rates were to rise is quite high and the very low absolute level of yields caps returns while A/R strategies do better in a rising rate environment since the collateral from the short side sits in cash. They are likely to beat stocks because the expected nominal return for equities is essentially zero today over the coming decade (a loss in real terms) and good arbitrageurs should continue to generate stable mid-single digit returns in the current environment (and higher if rates rise). The HFRX Macro/CTA Index was down fractionally at (0.4%), but has managed to wrestle ZIRP to close to a draw over the 1H16 and TTM posting slight losses of (0.3%) and (0.9%), respectively. We talked last time about the negative press on hedge funds and said that, *"interestingly, if you only read the headlines you*

*might think Macro was down big along with the Activist funds. There is a rising cacophony that these are unacceptable returns given the level of fees paid, but we will continue to make the case that the greatest benefit of paying the high fees comes from the returns during the truly difficult times, which may be closer than we think.*” Irrespective of the returns, the single most important characteristic of Absolute Return and Macro returns is their low (and sometimes negative) correlation to traditional assets (stocks & bonds). This unique characteristic makes A/R, Macro & CTAs an extremely attractive element of a well-diversified portfolio. These strategies have proven their mettle in the most challenging markets like 2000 and 2008 and perhaps we will soon see an environment where they will be called upon again to help us preserve capital and keep the power of compounding working in our favor.

We have written on numerous occasions over the past couple of years that, *“historically, the primary purpose of fixed income in a diversified portfolio has been to counter balance the volatility of equities, which are necessary as the core of the portfolio in order to generate returns in excess of inflation. Given current conditions, traditional bonds are unlikely to deliver adequate returns to warrant their inclusion in portfolios, despite their risk reduction benefits (the opportunity cost is too high).”* We have argued that a superior investment strategy would be to substitute a diversified portfolio of hedge fund strategies to provide the diversification benefits traditionally associated with bonds. The good news is that you get the benefit of lower risk with significantly higher expected returns given current valuations. When valuations are high, uncertainty is pervasive and volatility is above average, alpha will likely outperform beta. We find ourselves in just such an environment at present and, unfortunately, we expect that environment to persist for many years (likely until 2022 when the Demographic tide begins to shift with the aging of the Echo Boomers). Alpha is a precious and scarce commodity and it turns out that it is not found in quiet, safe and stable environments, but

rather in chaotic and unstable environments where it takes courage follow Ben Graham’s advice to, “be greedy when others are fearful and fearful when others are greedy.” We wrote late last year that, *“perhaps a greater challenge is managing through periods when the worst companies will actually outperform the best companies (when central bank liquidity artificially inflates prices like from 1995-2000 and again from 2009-2015) as during these periods, investing in hedge fund appears to be a really bad idea. In fact, toward the end of those periods, it seems like an awful idea.”* After the debacle in the long/short hedge fund space in the first six months of 2016, we understand just how awful that idea sounds. History has repeatedly shown that in the discipline of investing it is at the precise moment when you have the greatest urge to sell, that you have to muster the courage to buy. We are at that precise moment with hedged strategies. Repeating again something we wrote in the *A.W. Jones Was Right* letter, *“we can make a compelling case that long/short investing is a superior strategy to manage equities in all environments, but understanding the reticence of some to have hedge funds as their core investments, investors should increase exposure to hedge “D” strategies when valuations are high and growth prospects are diminishing (like they are today).”* Last quarter, Shakespeare reminded us that in these situations it is always ***“better to be three hours too soon than a minute too late”*** and few truer words have been spoken.

We have endured an awful lot of volatility and have nothing to show for it. I tweeted a pair of charts last week that showed the returns of the S&P 500 over the period from 6/30/99 to 3/31/00 and 6/30/15 to 3/31/16 and they were amazingly similar. Lots of volatility and essentially no return for almost a year is not an ideal outcome for investors, but what could come next (if history rhymes) could be even less palatable.

## MARKET OUTLOOK

In last quarter's letter the theme was *Two Thousand Zero Party Over, Oops Out of Time*. We discussed how all parties must come to an end and that it was time to begin being more cautious and taking a more defensive posture in portfolios. We wrote that *"one of the themes we have talked about for a while is that in the markets, gravity always eventually takes over. Valuations can move to high levels for some period of time, but they always fall back to the average. Corporate profit margins and earnings growth rates can stay high for some period of time, but eventually revert to the mean (capitalism works)."* Said another way (to fit with the Value theme), when there is an absence of bargains to be had in the markets, it is time to look for things to sell and ways to increase cash and add hedges to the portfolio. The challenge for investors in these periods of extremes is that human nature drives us to want to meet every challenge head on. However, to be successful over the long-term in investing requires the wisdom to know when to tilt and when to withdraw. That type of wisdom can only come from the accumulated experience of surviving (and learning from) mistakes and having the self-knowledge of when to take cover until the conditions improve. We believe we are experiencing one of those defining moments in time where the wisest investors (Soros, Robertson, Druckenmiller and Klarman) are voting with their capital and are raising cash (buying gold) and moving to a defensive posture to live to fight another day.

We entered 2016 believing that the investment environment was one that favored Alpha over Beta because, as we wrote last quarter, *"valuations are stretched, growth is slowing and liquidity has evaporated with the banks being over-regulated and the beginnings of a new NPL cycle beginning to appear."* We also believed that hedge funds would outperform long-only strategies. So far that has clearly not been the case as the fundamental approach of buying good companies and shorting bad companies has resulted in losses on both sides of the

ledger for many long/short funds (similar to early 2000). We have written previously that, *"even great skiers fall on occasion, but that doesn't make them less good, it just means they misread the terrain, didn't see a hazard on the slope or simply made a bad turn, caught an edge and ate some snow. The really great ones get up dust themselves off and head back down the hill with great form and great results. That is what we expect to see in the quarters and years ahead as we get through the next storm that is brewing on the horizon."* Many of the great managers did just that and had respectable Q2 results, but the storm didn't materialize as forecast, so the headwinds (on the short side in particular) were still there and the 1H16 was not a great one for relative performance. All that said, the theme for this letter is *The Value of Value*, and there is a subtle difference in how Value managers approach deterioration in the investment climate, they take cover in cash and wait for the storm to pass before they go hunting for bargains. How do they know when to head for shelter? When they can't find investments that meet their margin of safety requirements, they stop buying and begin to look for things to sell. When this type of environment exists there are usually many warning signs that confirm what the Value investors are seeing from the bottom-up.

Last November we created a list of the *Not So Nifty Fifty* reasons why it looked like a good time to get hedged in the U.S. and since most (not all) of the reasons have actually gotten better, we have updated the list below to reflect current data. The point here is that things remain not so nifty and the trail markers continue to point to extreme conditions where we are reminded of Falstaff's wise words in Shakespeare's *Henry IV*, *"discretion is the better part of valor."*

- 1) Welcome to the *New Abnormal*. We coined this phrase a few years ago as we thought there was nothing normal about the equity market environment since the extremes of 2000. From 1983 to 1999 the MSCI World Index almost never went down (2/17 negative

years), compounded at a world beating 14.8% and the intra-year drawdowns were a not so scary (10.5%). From 2000 to mid-year 2016 the World Index has gone down quite often (one third of the years and most recently dropping nearly (12%) in Jan/Feb of this year) and has only compounded at 3.5% while experiencing average intra-year drawdowns of a gut wrenching (17.3%).

- 2) Post-Crisis Deleveragings are measured in decades. There have been four great unwinds in modern economic history, the U.S. from 1873, the U.S. from 1929, Japan from 1989, and the U.S. since 2008 (still going on), and it has taken 14 years on average to reach trough long-term interest rates (which tend to settle between 1.5% to 2%). We are currently in year nine, so 2021 looks like the year for the final trough (the one-handle commeth).
- 3) Global Trade has not grown since 2008 and has recently been declined at an accelerating rate. Low and declining levels of global exports have historically been an early warning signal of pending global Recession.
- 4) Industrial Production turns down ahead of Recessions and has now seen negative growth for ten consecutive months, following a two month respite from seven consecutive declines (although those declines were smaller positives). There have never been six consecutive monthly declines without having a Recession follow within a year (so economy is on the clock).
- 5) Even if the next Recession were a shallow one like 2001 (two slightly negative quarters that weren't even consecutive) the market impact would likely be significant given the level of current valuations and the average correction during a Recession is (38%).
- 6) ISM (Institute for Supply Management) ticked down slightly in July to 52.6, but does remain above the contractionary sub-50 zone. Historically, an ISM of 50 indicates a 65% chance of a Recession within the next year.
- 7) Leading Economic Indicators ticked up slightly in June, but look to have peaked last November. Importantly, the six-month rate of change has collapsed to 0.2% and a reading below zero would indicate a Recession is likely within two to fifteen months (in 2001 it was five).
- 8) Q1 GDP growth (final) came in at a very disappointing 0.8% (nearly one-third of the expected level) due to Inventory problems. Sub-2% levels point to an ISM reading well below 50.
- 9) Regional Fed Surveys have been consistently poor and continue to all point to lower ISM values.
- 10) S&P EPS and Cash Flow growth rates remain negative, which point to a future ISM below 50.
- 11) The Durable Goods Orders growth rate absolutely collapsed in June, down to (6.5%), which is below the (5.2%) rate at beginning of 2001 Recession. If adjust for aircraft orders, decline was still (3.6%), above the trough in 2001, but below the (2.7%) decline right before GFC in 2008.
- 12) When S&P 500 Forward EPS peak (as they did in Q3 last year) and continue to decline (as they have for last five quarters) there has been 100% probability of a Recession within following year.
- 13) Consumer Confidence has rolled over to levels normally associated with Recessions.
- 14) Retail Sales growth has been trending down since 2011 and has been declining at an accelerating pace since 2015. Despite a slight rise in June, current 2.7% level is below both 2001 and 2008 beginning of Recession levels.
- 15) There is no Inflation anywhere as both Headline CPI and PCE are currently well below the Fed target of 2%, at 1% and 0.9% respectively (Core Inflation is 2.3%, but turned down since Feb).
- 16) Headline PPI is at levels (1.9%) only seen in the depths of the Global Financial Crisis in

2008. Core PPI peaked in mid-2015 at 2.3% and has plunged to 1.2% in June.

- 17) U.S. GDP growth continues to be very weak with Q2 (first estimate) coming in at 1.2% (half the level expected). It would now take back to back 3% prints in Q3/Q4 to get back to 2% for 2016.
- 18) Extremely high Inventory levels (as we have been predicting) have become problematic and have historically been a Recession trigger as the inventory cycle turns from restocking to destocking.
- 19) Forward Inflation Expectations (5 yr./5 yr.) have begun falling again, now back to 1.6%, and remain at levels where past QE programs were initiated (in sharp contrast to Fed jawboning about need for raising rates).
- 20) U.S. Long Treasury rates have fallen sharply in past three months from 2.6% to 2.3%, signaling that Deflation is a much larger risk than Inflation.
- 21) The historical relationship between nominal GDP growth and short-term interest rates (equal) actually indicate that the Fed should raise Fed Funds to around 3%. Fed must believe the economy is much weaker than historically, since they are keeping rates at a near zero level.
- 22) Contrary to popular belief, the Fed has not eradicated the Business Cycle and the Citi Economic Surprise Indicator shows we are closer to the end the current cycle than the beginning.
- 23) The Fed tried to leave ZIRP (Zero Interest Rate Policy) too early in 1937 and we had a bad outcome (respectfully called the Great Depression). There is actually a case to be made that the Fed has lost control of the yield curve and there is no way out, just like in the 1930s.
- 24) When the Fed is not expanding the Balance Sheet, U.S. equities have struggled (actually made no return) over the past five years. With no more QE (yet), where will equity returns come from?
- 25) It is looking increasingly likely that faith in the global Central Banks is waning? European and Japanese stocks have actually fallen since the last rounds of QE/QQE by the ECB & BOJ.
- 26) U.S. equities remain at extreme levels of valuation, 87% above the SPX long-term regression.
- 27) U.S. equity TTM P/E and Adjusted P/E ratios are at the third highest they have ever been.
- 28) The Buffett Indicator of the ratio of Market Cap/GDP is second highest ever, only worse in 2000.
- 29) The Q Ratio (valuation vs. replacement cost of corporate assets) is near record levels.
- 30) Margin Debt (the rocket fuel for the rally since 2009) has begun to roll over (down sharply again in recent weeks after expansion in Q1). When margin debt turns down it tends to decline very rapidly, leading stocks lower (also tends to turn down ahead of Recessions by 6-12 months).
- 31) Inflation Expectations levels have historically been highly correlated with forward P/E ratios and the collapse in inflation expectations argues for much lower equity multiples (35% lower).
- 32) GMO Forecasts poor returns for traditional assets over next seven years including a negative (0.5%) nominal compound annual return for U.S. equities (read that again).
- 33) Another longer-term equity model used by a number of asset managers (created by Butler-Philbrick) also predicts a negative real return for U.S. equities over the next decade.
- 34) The December 2014 Barron's cover could be an example of Front Page Syndrome. When comparing the 2009 to 2014 move in equities to the move from 1995 to 2000, the bull market may have ended in April 2015 (U.S. equity markets are roughly at same level today).
- 35) The Strategas Equity Trend Model turned

negative in Q3 2015, just like it did in 2000 and 2008 (right on cue), rallied back to neutral Q4 2015, fell back to negative in Q1 2016, but now bounced back to positive in Q2 (one of a couple of the not so nifty that is better).

- 36) Market Crises tend to occur after Dollar surges like the one we have just experienced in 2015. The question is whether we're more likely to see an environment like 1998, 2000 or 2008?
- 37) Equity market cycle highs usually occur in Q4 of the 4<sup>th</sup> year of the Presidential Cycle (Jeremy at GMO says October) and cycle lows usually occur in Q1 of the 1<sup>st</sup> year (Q1 2017) or the Q2 of the 2<sup>nd</sup> year (Q2 2018) which aligns nicely with the #2000.2.0 playbook of a Recession in 2017 and market trough in 2018 matching up nicely with the 2001 to 2002 period.
- 38) Small-cap weakness (lagged large-caps badly in Q1) has historically been a sign of deteriorating market fundamentals. Small-caps did win by a scant 1% in Q2 (improvement), but TTM is poor.
- 39) There has been huge dispersion in valuation and margins across equity market sectors, which has historically been a target rich environment for long/short investing (but has not been so in 1H16).
- 40) The current equity market advance has become increasingly narrow. Without FANG (FB, AMZN, NFLX and GOOGL) S&P 500 was down (5%) in 2015 (NFLX struggling in 2016).
- 41) Only the largest capitalization companies are rising within many sectors like Tech & Consumer.
- 42) The trend in the Consumer sector has deteriorated dramatically in the past year and without AMZN, sector has struggled for past year.
- 43) Energy sector fundamentals have improved, but there is still risk of rising bankruptcies in

the sector (despite higher oil prices) as overleveraged companies are shut off from additional capital.

- 44) The Healthcare sector remains under attack (easy Election issue to win votes) and is an example of how fragile equity markets have been in the current environment.
- 45) Biotech, in particular, has experienced a meaningful decline as valuation questions have arisen.
- 46) The Four Horsemen of the #Growthpocalypse (Copper, Korea, Oil, 10-Year) are all pointing to slower growth and potentially lower stock prices. Dr. Copper, in particular, remains in ICU, giving back all Q1 gains. Falling copper prices have been a leading indicator of slowing growth.
- 47) The KOSPI Index rallied along with other EM in the second half of Q1, but has declined back below the 2000 level. KOSPI has been a good leading indicator of slowing growth in the U.S. (and lower equity prices) given high tech components weighting.
- 48) The rapid recovery in Oil prices that began in February reversed sharply in June as prices declined (20%) from the peak and prices are still at levels associated with lower growth.
- 49) The 10-year Treasury rate has been stubbornly low, falling from 1.76% last quarter to 1.58% (in stark contrast to predictions of 3%), likely a sign of rising deflation risk and slowing growth.
- 50) Improvement in Unemployment numbers has begun to slow and current absolute levels have historically been associated with ends of economic cycles.

In past letters, at this point in the Letter, we have we have done an Around the World Tour in this section to discuss the most compelling investment opportunities. Last quarter, we took a look at our 10 Potential Surprises and provided some thoughts on where we saw market opportunities within each Surprise theme and we added *"a little Prince and a*

*little Shakespeare just for fun.*” We have kept the Prince Song titles along with the Surprises, but this quarter we will stay in character along the lines of a true Value investor and follow Klarman’s advice to not focus on making predictions, but rather identify pockets of opportunity where we might find Value in a very overvalued world.

### 2016 10 Surprises

A quick reminder on how the Surprises work. Our January ATWWY Webinar was entitled “Channeling Byron: 10 Potential Surprises for 2016” (with a nod to Byron Wien, the former Morgan Stanley Strategist who originated the annual 10 Surprises idea). When talking about Surprises, it is important to clarify that Surprises are intentionally non-consensus ideas and have some reasonable probability of not occurring (they are not necessarily predictions). To this point, the definition of a Surprise is a Variant Perception (an idea that is materially different from the Consensus) that we believe has a better than 50% chance of occurring in the current year. The key point here is that a Variant Perception must be *materially* different than consensus to be valuable. One other important point to be mindful of is a year is a long time, things can change (sometimes dramatically) and we need to remember the wisdom of John Maynard Keynes who famously quipped, “*when the facts change, I change my mind, what do you do, sir?*” We remain vigilant in tracking the progress of each Surprise and are constantly on the lookout for opportunities to capitalize on the themes in the portfolios. That said, we also remain ready to change our minds (and our positioning), should the facts change.

#### **Surprise #1: There Goes the Boom... (*I Would Die 4 U*)**

Despite massive Central Bank stimulus programs around the world, economic growth continues to surprise to the downside as the rising costs of aging populations weighs on the Developed Markets. One (or more) of the U.S., Europe and Japan slip into Recession and global interest rates continue to plumb

new lows.

Global growth has continued to disappoint in 2016 as Japan has slipped into, and out of, Recession, fears of the impact of #Brexit have stirred renewed discussion of Recession in Europe and deterioration in many leading indicators in the U.S. have people buzzing about the actual possibility of the R-word occurring in the first year of the new Administration (some believe it could be a bad one depending on who wins the election). One might think that amidst all the turmoil in growth that equity markets would be in sharp decline and bargains would be emerging, but the story is not that clear. Japan equity markets have clearly weakened, thanks to the massive currency move in the Yen (see Surprise #3), which has caused a reflexive deterioration in profits. European markets have struggled on the back of banking issues (see Surprise #5) and while there appears to be some signs of emerging value, the uncertainty around the banks has made bargain shopping difficult. Finally, in the U.S., despite all the mediocre (and sometimes downright bad) economic and profits data (see Surprise #6), the markets are making new all-time highs, confounding the skeptics (ourselves included) and moving the exact opposite direction from the creation of Values. Overall, the developed markets are replete with significant overvaluation along with small pockets of fair valuation in a few sectors and only an occasional bargain. Taking a focused, bottoms-up approach to individual opportunities is likely the best way to unearth Value in the Developed world.

As confounding as the equity markets have been for pundits, the global bond markets continue to make economists and Fixed Income strategists look downright silly. Global bond yields have indeed continued to plumb new lows and the returns on government bonds has been remarkable. Long duration (30 year) sovereign debt has provided outstanding returns in 2016 (contrary to nearly everyone’s prediction and confounding Value discipline) with JGBs (the original widow maker) up 14.8%, Bunds up 15.9%, Italian BTPs (despite a full-

fledged banking crisis) up 16.3%, U.S. Treasuries up 17.8%, Spanish Bonos (with no government in place) up 22% and UK Gilts (despite #Brexit fallout) up and astounding 33.2% (yes a big chunk of these returns come from the smack down in the Sterling). Many would argue that it is tough to make a compelling Value case for government bonds, but in a world where we have morphed from #Lower4Longer to #FlatForever it may be that any bond with a positive yield (like Treasuries) is a screaming buy because of the wall of money from Japan and Europe that needs to escape NIRP. Klarman would probably not agree with a Value discipline being based on “in the land of the blind the one-eyed man is king” and he would in fact (and he would be right) label these securities as Speculation (you only make money if someone buys them from you at a more ridiculous price). Definitions aside, we are where we are in the sovereign debt cycle and we can make a case (perhaps not a hugely compelling case) that until such time as there is a movement toward a “Debt Jubilee” of some sort, there is still value (with a small v) in high quality government debt in a world devoid of high quality collateral.

**Surprise #2: Two Wrongs Won’t Make it Right.**  
*(When Doves Cry)*

After trying to flex their muscles by raising rates in December, the Fed realizes the (policy) error of their ways, acknowledges that they missed the window to raise rates in 2013 and puts further increases to the Fed Funds rate on hold for 2016. In a total about face, discussions of QE IV begin in the 2H of the year as economic growth continues to disappoint.

Here we are in August and there has still been no rate increase in the U.S.; to the contrary, the Dovish language coming from the Eccles Building has been ramping up this summer. While there still haven’t been any serious discussions about QE IV, persistent weakness in the U.S. GDP growth, very low future inflation expectations and lower than desired actual inflation (CPI, PPI and PCE) all point to an environment where Easing seems a more appropriate

path than Tightening. The problem with continued low interest rates is the perversion of the “Fed Model” where an extremely low Fed Funds rates is used by investors to rationalize higher valuations of equity prices. In this environment, the likelihood that we will find an increase in the number of bargain purchase options is limited. To that end, there will be increasing pressure to raise more and more cash for investors who are truly following a pure Value discipline. If the markets continue to squeeze higher, that cash will continue to create short-term drag on relative performance and push even more investors to redeem from Hedged and Value strategies and chase Passive and Long-biased strategies (which will exacerbate the problem in a reflexive manner). History tells us that as the level of revulsion toward a particular strategy increases, the expected returns increase (and the opposite is true as well, adoration of a strategy signals lower future returns) so the longer this cycle of manipulation of short rates goes on, the greater the opportunity in Hedge Funds and Value strategies will be when the next crisis comes.

**Surprise #3: Save Us Kuroda-san. You’re Our Only Hope.** *(Delirious)*

BOJ Governor Kuroda surprises everyone at the end of the Japan Fiscal Year and pulls out another bazooka to weaken the Yen and stimulate the economy and markets. The Yen falls dramatically, with USDJPY hitting 135. Corporate profits surge to new record highs and Japanese equities rally hard, finishing the year at 21,000.

Japan has become an extremely tricky market in terms of determining where there is/isn’t Value. With the surprise decision to adopt NIRP in January, Kuroda-san caught most global investors off guard and prompted a large volume of foreign sales of Japanese equities (that was mopped up by the BOF and the Government Pension GPIF). In a reflexive manner, the resulting strengthening of the Yen has hurt short-term profits and made Japan Inc. equities less attractive to Speculators (prices stopped going up). The Value investors’ antennae should be tingling as

prices have fallen back to levels where bargains live. The tricky part is that the negative interest rates have actually made banks less profitable and put pressure on areas like insurance companies and other financial services businesses. That said, there are some seemingly crazy low valuations in Japan with the mega-banks (MTU, SMFG, MFG) selling at single digit P/E ratios, Japan Airlines selling at 5X and companies like Panasonic, Japan Tobacco and Japan Post selling around 15X, so it will pay to spend some time digging deeper in Japan to see if there truly are Values to be had (or whether things are about to get a whole lot worse).

The biggest challenge for us right now in Japan is that one of our favorite managers has a view that the Yen is not done strengthening and could run back to the highs of 2012, or around 80 (from 100.6 today). That type of move would be calamitous for Japan Inc. earnings and prices and multiples would suffer more as well. On the flip side, the BOJ has announced plans to step up and buy more ETFs (even though they own more than 50% already) and that could be a near-term tailwind for the markets (we do have to discount the moves of a non-economic buyer as not having much information content). As we discuss in detail above, a good Value manager doesn't try to predict the general markets, but rather looks for individual bargains and the market formerly known as (before this year) the Land of the Rising Stocks seems like a good candidate as a geography that may be (or may become) a target rich environment for unearthing bargains.

**Surprise #4: Saudi Is Not Fracking Around.**  
*(Little Red Corvette)*

Realizing the end of the Hydrocarbon Era is approaching more rapidly than anticipated, Saudi abdicates their role as swing producer within OPEC and recommits to maximizing their production and grabbing market share. The resumption of Iran oil trading and short-term storage concerns push the market into steep Contango in Q1 and oil hits a multi-decade low in the 20s, but in the second half of the year the impact of cap-ex cuts and production

declines push prices back toward \$50.

The rapidity of the recovery in oil prices in Q2 was remarkable as WTI hit our year-end target (and then some, \$51.23) in June, before falling back to \$40 in early August (and now hitting \$45 again in a week). That surprise recovery has taken a huge swath of companies back up along with it including E&Ps, oil services and MLPs. The best opportunities in the energy patch (in keeping with Klarman's comments on buying the dips in low quality) have been those companies that were on the verge of bankruptcy and have rebounded very sharply in the past few months. However, in many cases, even after those bounces, the companies are still selling at deep discounts, while the margin of safety has shrunk from enormous to simply large. Given our view that oil and gas will continue to move higher over the next couple of years, there are likely to be lots more opportunities in this area for Value investors to make some meaningful returns before those assets reach fair value and begin to look like sells again. There should also be a tailwind in these sectors because most managers have been underweight energy/commodities and are trying to play catch up in getting back to neutral weight (or even modestly overweight) given the rapidly improving fundamentals.

**Surprise #5: The Black Swan Alights in Europe.**  
*(Take Me With U)*

The relentless bear market in commodities since 2011 comes to a head with a messy bankruptcy of one (or more) commodity trading companies (Glencore, Trafigura, Vitol, Nobel Group, and Mercuria). The resulting unwind of complex derivatives positions causes huge losses within the European banks, pushing one or more of them to the brink of insolvency.

The sharp commodity recovery (see Surprise #9) has allowed the bulk of the trading companies to avert bankruptcy and Klarman's wisdom that "*bad things happen, really bad things don't*" was true once again, as the markets are able to look past all the

potential bad news and anticipate healing and recovery. Buying these extremely low quality assets when they were on death's door has proved incredibly profitable this year as Glencore (GLEN.LN) has soared 120% (but still down over (60%) since IPO in 2011). Yet even with the crisis averted in commodity trading, European banks have been killed in 2016 as continued fears about NPLs, the impact of #Brexit (and whatever #-exit comes next) and persistent concerns from investors worried about a GFC.2.0 have resulted in relentless waves of selling. The two poster children for the rout, Deutsche Bank (DB) and Credit Suisse (CS), are down (40%) and (45%) CYTD, respectively. There are plenty of smaller banks in Italy that are down significantly more as fears of an ECB bail-out have begun to surface and fear has led to selling, which has led to leverage unwinding, which has led to forced selling. These are the types of words that Value investors love to hear and it may be time to begin looking through to the other side of the chasm (like with the commodity traders). It is entirely possible that the Banks (and perhaps the broader Financials sector) are the "Commodities of 2017." Time will tell, but there are clearly some bargains being created in Europe, and we must now evaluate the margin of safety to see if the time is right to buy. Klarman said in the Process section that normally Commercial Banks are not a preferred investment for Value investors, but in times of crisis they become attractive. We might not be in a full-fledged crisis, but there are emerging signs that there could be some Value in Byron Wien's famous "Open Air Museum" (his description of Europe many years ago).

**Surprise #6: Déjà Vu, Welcome to #2000.2.0. (1999)**

The U.S. economy and equity markets have entered a challenging period resembling the unwinding of the Tech Bubble from April 2000 to April 2003 and 2016 closely resembles 2001 with the S&P 500 down in the low teens. Economic growth falters, corporate profits fall and equities begin a relentless decline that will last through the end of 2017.

Economic growth falters, check, corporate profits fall, check, equities begin a relentless decline, check (in Jan/Feb), that will last through the end of 2017, not so much... Despite near record levels of valuation (and some truly dazzling overvaluation in small-caps), U.S. equity markets rebounded sharply off the lows in mid-February on hopes of a recovery in U.S. growth (that never materialized) and a recovery in oil prices (that actually hurt consumption) and were stumbling along around flat for the year through most of Q2 when the bolt from the blue #Brexit vote shocked markets and the S&P 500 fell (5.4%) in two days and it appeared the decline was back on again. Fear not, however; the global Central Banks are on high alert and CBs all around the world put on their Super Mario masks and spouted "Whatever it takes!" over and over until the markets rebounded and headed higher on the backs of a very low volume (everyone is on vacation) short squeeze. From the low of 2,000 on the nose, the SPX has rallied nearly 10% and has triggered lots of FOMO reactions and lots of dazed and confused looks from Value investors and Hedge Funds that keep desperately looking for something to have fundamentally changed for the better (alas, nothing). The discipline of Value requires that investors sell assets as they become fairly valued and to really sell when they become overvalued. So it is no surprise that all the great Value investors are sitting on big piles of cash (or Gold) and some of them have even begun to get net short as they fear (like Klarman) that the unwind will be bigger because the bubble has been allowed to inflate longer than it should have (thanks to artificially low rates and constant Monetary largesse).

As we said earlier, there are some pockets of value in the overall market in places like energy and commodities (see Surprises #4 and #9) where investors are still not convinced that the Dollar has peaked (see Surprise #8) and the Fed may ruin the party any moment with an interest rate hike (not going to happen, see Surprise #2). Healthcare is another place where there are some real bargains to be found as the wicked combination of the relentless

assault by the political candidates on drug prices (7/10 recommendations require an act of Congress, who are funded by the Pharma industry, so unlikely to pass) and the continued bungling of PR by companies like Valeant, has resulted in some very interesting Values. Specialty pharma companies like HZNP, PGNX and HRTX have shown signs of life lately as investors finally did the work to see that these companies were not the same as VRX and that it is okay to differentiate between companies within a sector. Loathe as I am to say it (because I believe that they have been #DoddFranked), there are some emerging signs of Value in Financials, but we would be more excited about them if there was one last cathartic break down on fears of the 2017 Recession. Investors keep pinning their hopes on Financials to rising interest rates (higher NIMs), further proving their ignorance of history; as the Fed raising rates has historically not been good for the economy, which has not been good for banks and insurance companies.

On the flip side, there are some really egregiously overvalued sectors and companies in the U.S. equity market and we actually see some tremendous opportunities for shorting these highly overvalued companies. Many of our favorite managers have said recently that their idea ledger is full of ideas on the short side, while their cupboard is bare on the buy side mirroring the Klarman view of the world today. When there is nothing to buy, the smart Value investor goes to cash rather than buying things just because they are going up. We contend that the U.S. market is in Speculation territory and sticking to the Value discipline of waiting for the fat pitch before taking a swing will be the optimal strategy for the balance of this year (and probably next year too).

**Surprise #7: Dragons & Tigers Beat Bears, Oh My!**  
*(Let's Go Crazy)*

Emerging Markets divide into two very different groups based on whether they are commodity producers or commodity consumers. Producers (Brazil and Russia) continue to struggle with budget deficits and pervasive currency weakness, while

Consumers (China and India) enjoy the tailwinds of lower inflation and higher growth courtesy of lower commodity prices and the Dragon and Tiger markets beat the Bear and finish up for the year.

Had we followed the Value approach more completely in Emerging Markets this year we would have done much better. While the thesis that Chindia would enjoy a tailwind of lower energy prices was sound, the real play in EM in 2016 was to look to the cheapest markets, Brazil and Russia, and adhere to the discipline of buying the “lowest quality assets” that will turn the sharpest when investors begin to discount the “really bad stuff” is indeed not going to happen. There were (and still are) bargains galore in Brazil (and other parts of Latin America as well) and the catalyst of the Dilma impeachment was all that was needed for capital to begin flowing back into the markets to lift prices. We have been a little (actually more than a little) surprised at the move in the Real this year and we were indeed guilty of staying with the negative perspective (with a little help from a friend in London) on the Brazilian currency too long. In Russia, we knew there were incredibly cheap assets, but we made the error of worrying about political issues rather than focusing on the oil recovery and the ripple effects that would have throughout the Russian equity markets. Even more surprising was the fact that despite the RMB issue being well controlled, investors sold Chinese equities in droves early in the year, despite already trading at bargain prices. The Klarman mantra of “appreciating the interim declines” was the right approach and those that scooped up the cheap assets as they became even cheaper have been amply rewarded in the past couple of months. The most notable winners have been the China internet stocks that have rebounded significantly after being punished in Q1. We expect to see further gains in many sectors of China related to the shift toward consumption. Finally, in India the fading enthusiasm for Modinomics dragged on Indian equities early in the year, but strict Value buyers can find many attractive areas to deploy capital and we have seen the beginnings of nice recoveries in

financials and healthcare.

We were likely too narrow in thinking about Chindia as the best segment of EM and we expect that there will continue to be opportunities for investors to exercise their Value muscles in many Emerging and Frontier markets around the world. One of the great things about EM and FM from a Value investors perspective is they are prone to boom/bust cycles and greed/fear cycles by investors that move prices to extremes and create exciting entry points for patient investors with cash who are ready to pounce when the dislocations occur. With such a large number of very disparate markets there will always be bargains to be found. One challenge is that once you find one it may take a while for others to reach the same conclusion, so it pays to focus on sectors and companies that not only generate cash flow, but have a good record of sharing that cash with minority shareholders.

**Surprise #8: King Dollar Gets Dethroned. (*I Could Never Take the Place of Your Man*)**

Contrary to the powerful narrative that the U.S. Dollar must continue to appreciate in the face of the Fed taking a different monetary policy course (or at least threatening to take a different course) than the ECB & BOJ, the old saw “Buy the Rumor, Sell the News” turns out to be true once again and the USD peaks and actually begins to weaken against other global currencies. The surprising Dollar weakness takes some pressure off of the Chinese to further weaken the RMB and the Yuan continues on a path toward becoming a World Reserve Currency.

We have written for a number of years that getting the Dollar right would be the key to making excess returns in the markets because of the huge impact that the U.S. currency has on global equity markets, credit markets and commodities. So many of the other Surprises are dependent on the direction of the Dollar and the general trend (up or down) has broad implications for the creation of Values in various markets. Our contrarian view on King Dollar has proved correct to this point and (as usual) the Variant

Perception proved very useful in identifying lots of great Value opportunities because fewer people were looking in those places since they had an opposing view. Less competition is always a good thing when bargain shopping (picture the famous brawls at Filenes Basement during wedding dress sales) and we have been fortunate to be able to stroll leisurely through the aisles in commodities and emerging markets as other investors, convinced that the Dollar would rise, were shopping in other stores.

The second part of the Surprise related to the RMB has been valuable for Value investors as well as so many investors wed to the idea that China was going to implode due to a massive devaluation of the Yuan have completely ignored China as an investment opportunity, so the bargains stayed low priced long enough to do some deep digging on the best opportunities. There are many who still think a surprise devaluation could be a Black Swan event and the repercussions of a meaningful move down in the RMB would cause a great deal of pain in global markets. Having very high margins of safety in the assets that you chose to own today is one of the best defenses against that eventuality. That said, the very best defense (other than being short the RMB which is a very expensive hedge) is to retreat to the safety of cash and wait for better bargains in the future. One of the important pearls of Klarman wisdom is that nowhere does it say that the current set of investment opportunities is the complete set of opportunities and you should consider future opportunities in your analysis. For example, how much more attractive would Sberbank be if the RMB devalued 20%? Assume your analysis showed that you could buy Sberbank for \$6 instead of the current price of \$9 and your expected price is \$18 over two years. Holding cash for a few months and then tripling your money is superior to doubling your money. It is never quite this straightforward, but the basic idea is that expanding the opportunity set is a good strategy to employ.

**Surprise #9: Cure For Low Prices Is Low Prices.**

*(U Got The Look)*

The severe Bear Market in Commodities that began in 2011 destroys sufficient industry market capitalization spurring companies to dramatically slash capital spending, cancel large swaths of projects and reduce productive capacity to a point where commodity prices begin to find a floor and some generational investment opportunities arise amidst the bankruptcies and restructurings in places like MLPs, Miners and Exploration & Production companies.

Fear, bankruptcy, excessive debt, leveraged structures unwinding, margin calls, complete revulsion just about sums up the commodity markets in early January (what more could a Value investor ask for?). After a crushing five-year Bear Market that had left many companies down (60%), (80%), (95%) and, in some cases, completely wiped out the equity and forced companies into restructuring, there were suddenly signs that things might be getting ready to turn around. The opportunities were plentiful as there were bargains across multiple sectors and industries and across all parts of the capital structure (depending on the severity of the damage). Investors who wanted catalysts could buy distressed debt and choose between the various strategies of trading distressed (hedge funds and mutual funds), restructuring distress (hedge funds) or distress for control (private investments). Investors who wanted more upside could opt for equity and could select where on the quality scale they wanted to play based on their specific risk tolerances. We began talking about the opportunities that had been created in October of last year and said that coming into 2016 that there were “generational” opportunities in some of the beaten up sectors like steel, iron ore, copper, gold, oil & gas and MLPs.

What a difference a few months makes. There have been tremendous rebounds across the commodity complex and many companies that were on the verge of bankruptcy (but survived) have seen extraordinary rallies (some jumping multiple fold off the bottom in late Jan, early Feb). The bad news is that, as we

discussed in the Process section above, it is tough to buy on the way back up because prices move so quickly, so the best bargains are gone. The good news is that there is still plenty of Value to be found in this sector and while we agree with Klarman when he says that the commodities themselves are not really Value instruments, but more Speculative instruments, the companies that traffic in commodities (producers, transporters, processors, users) can all find themselves in the bargain bin from time to time (with some regularity given the commodity cycle) and can create very compelling returns for investors willing to do the work and understand the fundamentals of the core businesses. The really good news is that this cycle has just started and there could be a fairly long runway of opportunity in these sectors as the failure of a large amount of capacity in certain commodities makes the market more profitable for the surviving players. We continue to see compelling Value investments in precious metals (as miners have secured stable financing and prices have firmed), in industrial metals (where a great deal of capacity has been eliminated) and in oil & gas (where technology has created extremely profitable businesses) in the core basins in the U.S. and service providers like the sand companies (SLCA, HCLP, FMSA, EMES) are benefitting from advances in drilling technology that allows for the use of significantly more proppant to extract more hydrocarbons. MLPs have begun to recover and there are many examples of companies that could still increase multi-fold in the event that energy prices stabilize at these more attractive levels.

We could write many more pages (but this letter is long enough) on the attractive bargains in the commodity space, but suffice it to say that Newton’s Third Law applies here in that the gale force headwind within the industry over the past half-decade has now reversed into an equally strong tailwind for the near term that will help lift a lot of boats back up to full power/speed. Conversely to the broad markets, there will be pockets of overvaluation to be cautious about, but the overall environment is quite attractive for investors with a genetic predisposition to Value.

**Surprise #10: The Bus Stops Here... (Purple Rain)**

Uncle Carl Icahn is right and there is Danger Ahead in the credit markets around the world. Excess Central Bank liquidity has created a bond bubble across myriad sectors and there are abundant opportunities to short credit in emerging markets, high yield (particularly energy) during this new distressed debt cycle.

All systems were go in the early part of the year for a calamity to unfold in the credit markets as fears of contagion from a China hard landing and RMB devaluation, coupled with a rapidly declining global equity market pushed the holders of low quality credit firmly into the sale camp and prices were plunging. Then as if the big party bus hit a Big Black Rock made of rubber, the high yield and distressed credit markets roared back in the last few months as record amounts of capital (desperately chasing yield) moved in Pavlovian unison to buy, buy, buy, when global Central Banks started moving toward negative interest rates in Europe and Japan. We can't see what is high about high yield today and are still very cautious about how this story ends as default rates are beginning to pick up. One thing is certain this is not the place for Value investors to go foraging for bargains. That doesn't mean that prices can't (or won't) go higher (and yields lower), but what that requires is a "greater fool" buying an overpriced asset with a very poor risk/reward ratio and that is the realm of Speculators.

**Bonus Surprise: Unicorns Have Ten Lives. (Kiss)**

Contrary to the drumbeat of negativity that too much money went into venture backed start-ups in 2015, pushing up valuations to levels triggering the mocking moniker "Unicorns," disruptive innovation continues to emanate from Silicon Valley and Route 128 in Boston and late stage venture generates superior returns for investors.

The Silicon Valley is not exactly a happy hunting ground for Value investors and the recent lofty valuations of the Unicorns would say to anyone with a

Value bias, run away, far away. That said, there is a very interesting play developing in this space that has a Value-ish tilt. There are investors who made ill-advised purchases of some of the most famous Unicorns at elevated prices created by endless repackaging of the deals by brokers and I-Banks (fees on top of fees on top of the primary pricing). With the hold period extended courtesy of a less robust IPO market, these investors are seeking liquidity and prices have been significantly below the last round (40% to 50% lower). Even at these prices there is not much Value there, but there could be some interesting returns to be made. We will come back to this in another letter where we talk more about growth and the benefits of investing in disruptive innovation.

So there we have it. We have converted a complete violation of Value discipline (a list of forecasts and predictions) in to a roadmap for finding Value in a very challenging market environment. We would agree wholeheartedly that this is indeed the most difficult investing environment in the thirty years that some of us have been at this business of investing. Yet despite the challenges, there are meaningful opportunities for investors who follow a Value investing approach and embrace the Philosophy, Mindset, Process, Clients, Team and Culture that make up the Value Discipline. If you have stuck with the letter this far you hopefully will have gained a full appreciation for *The Value of Value* and you are now better prepared to not only endure the next few years, but thrive in an environment where if history rhymes, it can earn significant returns while the traditional markets languish (in the GMO.2.0 negative returns for the S&P scenario). We are back to #2000.2.0 and it will take a serious Value Mindset to generate the returns we need to preserve and grow wealth in the decade ahead.

## UPDATE ON MORGAN CREEK

We hope you have been able to join us for our Global Market Outlook Webinar Series entitled “*Around the World with Yusko*.” We have had many interesting discussions in the last few months including: *Soros’ Law, and The Politics of Populism: Brexit, Bregret, and the Potential for Bremain*. If you missed one and would like to receive a recording, please contact a member of our Investor Relations team at [IR@morgancreekcap.com](mailto:IR@morgancreekcap.com). Mark your calendar now for our **September 14th** webinar at **1:00pm EDT**,

We are also a proud sponsor of The Investment Institute, a newly formed Educational Membership Association for Institutional & Private Investors and Managers in the Southeast. The date of the next program will be **November 14th-15th** at **The Salamander Resort & Spa in Middleburg, VA**. For more information on how to become a member and join this elite group please visit [www.theinvestmentinstitute.org](http://www.theinvestmentinstitute.org) or contact Andrea Szigethy at [andrea@annualconnect.com](mailto:andrea@annualconnect.com) or Donna Holly at [donna@annualconnect.com](mailto:donna@annualconnect.com).

As always, It is a great privilege to manage capital on your behalf and we are appreciative of your long-term partnership and confidence.

With warmest regards,



Mark W. Yusko  
Chief Executive Officer & Chief Investment Officer

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Russell 3000 Index (DRI) — this index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. Definition is from the Russell Investment Group.

MSCI EAFE Index — this is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US & Canada. Morgan Stanley Capital International definition is from Morgan Stanley.

MSCI World Index — this is a free float-adjusted market capitalization index that is designed to measure global developed market equity performance. Morgan Stanley Capital International definition is from Morgan Stanley.

91-Day US T-Bill — short-term U.S. Treasury securities with minimum denominations of \$10,000 and a maturity of three months. They are issued at a discount to face value. Definition is from the Department of Treasury.

HFRX Absolute Return Index — provides investors with exposure to hedge funds that seek stable performance regardless of market conditions. Absolute return funds tend to be considerably less volatile and correlate less to major market benchmarks than directional funds. Definition is from Hedge Fund Research, Inc.

JP Morgan Global Bond Index — this is a capitalization-weighted index of the total return of the global government bond markets (including the U.S.) including the effect of currency. Countries and issues are included in the index based on size and liquidity. Definition is from JP Morgan.

Barclays High Yield Bond Index — this index consists of all non-investment grade U.S. and Yankee bonds with a minimum outstanding amount of \$100 million and maturing over one year. Definition is from Barclays.

Barclays Aggregate Bond Index — this is a composite index made up of the Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index and Asset-Backed Securities Index, which includes securities that are of investment-grade quality or better, have at least one year to maturity and have an outstanding par value of at least \$100 million. Definition is from Barclays.

S&P 500 Index — this is an index consisting of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The index is a market-value weighted index — each stock's weight in the index is proportionate to its market value. Definition is from Standard and Poor's.

Barclays Government Credit Bond Index — includes securities in the Government and Corporate Indices. Specifically, the Government Index includes treasuries and agencies. The Corporate Index includes publicly issued U.S. corporate and Yankee debentures and secured notes that meet specific maturity, liquidity and quality requirements.

HFRI Emerging Markets Index — this is an Emerging Markets index with a regional investment focus in the following geographic areas: Asia ex-Japan, Russia/Eastern Europe, Latin America, Africa or the Middle East.

HFRI FOF: Diversified Index — invests in a variety of strategies among multiple managers; historical annual return and/or a standard deviation generally similar to the HFRI Fund of Fund Composite index; demonstrates generally close performance and returns distribution correlation to the HFRI Fund of Fund Composite Index. A fund in the HFRI FOF Diversified Index tends to show minimal loss in down markets while achieving superior returns in up markets. Definition is from Hedge Fund Research, Inc.

MSCI Emerging Markets Index — this is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. The MSCI Emerging Markets Index consisted of the following 23 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.



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