TJIM QUARTERLY INSIGHT

Second Quarter 2019

Tom Johnson Investment Management, LLC

Is risk mispriced? A significant adjustment in either the risk-free rate or risk premiums could have significant implications across markets. Maybe it is time to say the four most dangerous words in finance – "It's different this time", but I do not think so. The following paragraphs lay out a few things in the current market that are abnormal and bear watching.

The way we see it investors essentially have two options - invest according to time tested principles based on valuation, earnings, and cash flow, or to throw caution to the wind and assume this cheap money cycle will last forever and start chasing momentum and the revenue growth that may or may not ever lead to earnings or even a sustainable business model. Investors are beginning to assume things that likely will not prove to be true – the Fed has conquered the business cycle – no more recessions, federal debt/deficits can grow indefinitely with no ill effects, prices for many assets will only go higher, lower rates or more QE can cure all ills, inflation has been eradicated, profits do not matter as long as market share is increasing, and growth investing will always outperform. One thing that constantly reminds us that the market has become highly dependent on Fed stimulus is when we get bad economic numbers and the market reacts favorably because "it is more likely the Fed will do something" or the inverse where we get good economic news and markets sell off because it reduces the odds of Fed intervention.

Central bank intervention around the world has created a surplus of "liquidity" across markets. Since the beginning of 2007 the Fed balance sheet has grown from less than 1 Trillion to roughly 4.5 Trillion in late 2014, but has since declined to around 3.8 Trillion. The European Central Bank (ECB)'s balance sheet has climbed from 1.5 Trillion in 2007 to 5.3 Trillion in June, and the Bank of Japan (BoJ)'s balance sheet has grown from just under 1 Trillion to 5.2 Trillion in June. So, combined their balance sheets have expanded by somewhere in the vicinity of 11 Trillion dollars. Versus a total population of around 800 million people across the US, Europe and Japan, that works out to nearly $14,000 for every man, woman and child. Just to put a trillion dollars into context, a trillion dollars in $100 bills would stack up over 630 miles high or laid end to end would encircle the equator nearly 4,000 times. It is a number essentially unfathomably large to humans, unless you are a central banker (or government treasurer) where it essentially becomes your base unit of measurement.

This significant intervention has led to some surprising and unexpected outcomes. I give you exhibit A, Negative Interest Rates

	Central Bank rate	1 Year rate	5 Year Rate	10 Year rate	30 Year Rate
Japan	-0.1%	-0.20%	-0.253%	-0.155%	0.334%
Sweden	-0.25%	-0.59%	-0.44%	-0.03%	0.60%
Switzerland	-0.75%	-0.86%	-0.88%	-0.62%	-0.047%
Germany	0.0%	-0.73%	-0.70%	-0.38%	0.25%
US	2.5%	1.98%	1.75%	1.95%	2.47%

I have highlighted all of the terms by country that have negative interest rates (note this list is non-exhaustive). This is happening across multiple countries for multiple terms, so, it is not just a technical short-term blip. It is an (intentional?) outcome of stimulative monetary policy that has persisted for over a decade. What exactly does a negative interest rate mean? It means that investors are willing to pay countries and in some instances companies to loan them money. For instance, an investor might buy a 10-year bond with a 1.4% coupon at 120. They would pay the 120 initially, receive 14 dollars in coupons over the 10-year term (1.4 per year) and mature at 100. So, they pay 120 now to eventually get a total of 114, which creates a negative yield (or interest rate). This is roughly equivalent to what investors are doing in Germany right now, and illustrative of what is happening in Japan, Sweden and Switzerland. Irrational? In my mind yes. Why would investors ever pay someone else to take on their credit, interest rate, and liquidity risk? Investors should be getting paid to take that risk, not paying for the "privilege". The central banks in these countries (specifically the BoJ and ECB) want to make holding cash, near cash, or other "risk-free" investments so unattractive that investors either spend their money through consumption (driving economic growth) or investing in riskier investments also potentially driving economic growth. The problem(s) will happen when investors either get burned by riskier investments and flock back to less risky investments or rates normalize and investors move back to their preferred (lower) risk habitats. This will likely have consequences far beyond just interest rates and securities markets. Think about where European and Japanese investors have likely put their investments that would have been invested in securities that now have negative interest rates – just about anywhere that does not have negative rates – longer dated securities, lower rated securities, foreign securities, equities, private equity, venture capital, collectibles (art, wine, cars, etc.), precious metals, commodities, real estate, or even cryptocurrencies. Normally you would have to forego interest payments to invest in many of these asset classes (which makes them less attractive), but with negative rates, you get to avoid paying negative rates by investing in them (which makes them more attractive).

This year there have been seven Initial Public Offerings (IPOs) that have raised more than 1 billion dollars – Uber, Chewy, Slack, Pinterest, TradeWeb, Lyft, and Avantor. Avantor is a chemical company that is over 100 years old and IPO'd due to a merger, so let us ignore it. That leaves us with 6 companies. Of the six companies, only one is currently profitable on an operating basis (TradeWeb), and combined the 6 companies have a market cap of just shy of 150 Billion dollars, revenues of 18.7 Billion, and operating profits of NEGATIVE 4.3 Billion. So, they trade at a price to sales multiple of nearly 8x. For comparison TJIM's Core Equity portfolio has a price to sales ratio just under 1x, and TJIM's Diversified Stock Income portfolio has a Price to Sales ratio of 1.25x. So, these IPOs trade at sales multiples of 6 to 8x more expensive than TJIM's portfolio valuation. Note we had to use sales as only one of these companies had any current earnings or cash flow. The pricing of these IPOs illustrates a very heavy bet "on the come". None of the companies can justify their current valuations with current operating metrics, and will have to sustain substantial revenue growth and eventual margin realization to come anywhere near a fair "fundamental value".

Cryptocurrencies – I am not sure what to write here, but I am sure they have been a beneficiary of abundant central bank liquidity. If there is no interest paid (or if you have to pay in the case of negative rates) on regular bank accounts, there is less incentive to stay in bank accounts and more incentive to seek out yield or appreciation in other asset classes (especially exotic new ones like cryptocurrencies). The scammers have been in full force launching ICOs (Initial Coin Offerings) and taking the money and running. According to Satis Group Crypto Research around 81% of the total number of initial coin offerings (ICOs) launched since 2017 have turned out to be scams. In dollar terms it is only 11% of the 12 billion that had been raised as of mid-2018. That is not to say that there is not some redeeming quality in the blockchain or even cryptocurrencies, but frankly right now it is the wild west out there from a regulatory standpoint and the rampant central bank liquidity has likely made the asset class look more attractive than it would otherwise.

The normalization of capital markets (i.e., less Fed intervention) should have a two-fold benefit to "value" stocks – capital should flow back to them leading to a valuation improvement and the reduction in non-economic competitors (i.e., businesses that do not care if they are profitable as long as they are growing revenue) should lead to revenue and/or margin growth. This double whammy is often what creates the upside for Value stocks – increasing valuation multiples coupled with improving sales/earnings. Not to mention just the benefit of stopping doing dumb things (for instance I saw in an article that Wal-Mart is losing $1 Billion annually on 21 to 22 billion in ecommerce revenue).

When will the adjustment occur? That is the multi-trillion-dollar question. Unfortunately, it is a near impossible one to answer. Markets often "melt up" in the final period before a correction, and these gains can be significant. Any indicators that have shown to be accurate in forecasting a recession or a market correction often have significant variation in lead time, which can mean sitting on the sidelines and missing more upside than the downside you potentially avoid. As always, our plan is to build a portfolio of high-quality securities that are profitable here and now and trading at valuations that provide attractive long-term, risk-adjusted returns without heroic assumptions. It may not outperform in any given period, but we still believe this is the best way to meet long-term goals – ignoring short-term aberrations in markets, avoiding short-term fads, setting and sticking to a prudent long-term plan, and focusing on attractively priced, high-quality securities.

Sincerely
TJIM Investment Team

201 Robert S. Kerr, Suite 510 ✧ Oklahoma City, Oklahoma 73102
Telephone (405) 236-2111 ✧ Fax (405) 236-2008

TJIM