Trump, “perilously high valuations” & "indexing"

The following was sent to us by one of our clients. While we actually know who Seth Klarman is and have previously written about some of his concerns, we thought our response might be worth sharing. As usual, our parenthetical comments are in red.

A Quiet Giant of Investing Weighs In on Trump

Andrew Ross Sorkin

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He is the most successful and influential investor you have probably never heard of. His writings are so coveted and followed by Wall Street that a used copy of a book he wrote several decades ago about investing starts at $795 on Amazon, and a new copy sells for as much as $3,500.

Perhaps that’s why a private letter he wrote to his investors a little over two weeks ago about investing during the age of President Trump — and offering his thoughts on the current state of the hedge fund industry — has quietly become the most sought-after reading material on Wall Street.

He is Seth A. Klarman, the 59-year-old value investor who runs Baupost Group, which manages some $30 billion.

While Mr. Klarman has long kept a low public profile, he is considered a giant within investment circles. He is often compared to Warren Buffett, and The Economist magazine once described him as “The Oracle of Boston,” where Baupost is based. For good measure, he is one of the very few hedge managers Mr. Buffett has publicly praised.

In his letter, Mr. Klarman sets forth a countervailing view to the euphoria that has buoyed the stock market since Mr. Trump took office, describing “perilously high valuations.” (see below)

“Exuberant investors have focused on the potential benefits of stimulative tax cuts, while mostly ignoring the risks from America-first protectionism and the erection of new trade barriers,” he wrote.

“President Trump may be able to temporarily hold off the sweep of automation and globalization by cajoling companies to keep jobs at home, but bolstering inefficient and uncompetitive enterprises is likely to only temporarily stave off market forces,” he continued. “While they might be popular, the reason the U.S. long ago abandoned protectionist trade policies is because they not only don’t work, they actually leave society worse off.” (Mercantilism works economically, particularly for the stronger participant in bilateral trade agreements, which is what Trump is proposing. Historically, Mercantilism ended badly for the world, but it took a long time. After WWII we set the rules of the game to our own economic detriment according to some, but it has brought the world 70 years of relative peace.)

In particular, Mr. Klarman appears to believe that investors have become hypnotized by all the talk of pro-growth policies, without considering the full ramifications. He worries, for example, that Mr. Trump’s stimulus efforts “could prove quite inflationary, which would likely shock investors.” (As we have previously shared, except for less regulation, all of Trump's economic proposals are inflationary, particularly when the economy is

at or near full employment. However, to what extent they are adopted and how long it takes matters a great deal.)

And he appears deeply concerned about a swelling national debt that he suggests could undermine the economy's growth over the long term.

"The Trump tax cuts could drive government deficits considerably higher," Mr. Klarman wrote. "The large 2001 Bush tax cuts, for example, fueled income inequality while triggering huge federal budget deficits. Rising interest rates alone would balloon the federal deficit, because interest payments on the massive outstanding government debt would skyrocket from today's artificially low levels."

Much of Mr. Klarman's anxiety seems to emanate from Mr. Trump's leadership style. He described it this way: "The erratic tendencies and overconfidence in his own wisdom and judgment that Donald Trump has demonstrated to date are inconsistent with strong leadership and sound decision-making." (Agree, but his economic and foreign policy teams are relatively solid.)

He also linked this point — which is a fair one — to what "Trump style" means for Mr. Klarman's constituency and others.

"The big picture for investors is this: Trump is high volatility, and investors generally abhor volatility and shun uncertainty," he wrote. "Not only is Trump shockingly unpredictable, he's apparently deliberately so; he says it's part of his plan." (So investors aren't capable of growing immune to his tweets?)

While Mr. Klarman clearly is hoping for the best, he warned, "If things go wrong, we could find ourselves at the beginning of a lengthy decline in dollar hegemony, a rapid rise in interest rates and inflation, and global angst."

Mr. Klarman is a registered independent and has given money to politicians from both parties. He has donated to Jeb Bush, Chris Christie, Marco Rubio, John McCain and Rudolph W. Giuliani as well as Hillary Clinton, Cory Booker and Mark Warner.

While he has remained largely outside the public eye, Mr. Klarman surprised some of his friends and peers over the summer when he issued a statement after Mr. Trump criticized a judge over his Mexican heritage, saying he planned to support Mrs. Clinton: "His words and actions over the last several days are so shockingly unacceptable in our diverse and democratic society that it is simply unthinkable that Donald Trump could become our president." (So when the "unthinkable" happens, things just have to turn out badly, right? It is called Confirmation Bias and none of us are immune. Just ask Soros.)

In his recent letter, he explained for the first time his decision to say something publicly. "Despite my preference to stay out of the media," he wrote, "I've taken the view that each of us can be bystanders, or we can be upstanders. I choose upstander."

From the letter, it is hard to divine exactly how Mr. Klarman is investing his fund's money. His office declined to comment on the letter, which I obtained from a source. His fund currently has more than 30 percent of its funds in cash. He has lost money in only three of the past 34 years.

What investors say publicly and what they do in the markets can be different things. Mr. Buffett campaigned publicly against Mr. Trump, but he has nevertheless invested in the market since his election — about $12

billion, according to a recent disclosure. George Soros, who also actively campaigned against Mr. Trump, bet — wrongly so far — that the stock market would fall; he lost about $1 billion.

Most hedge funds have found themselves on the losing side of trades over the past several years, a point Mr. Klarman addressed in his letter. Noting that hedge fund returns have underperformed the indexes — he mentioned that hedge funds had returned only 23 percent from 2010 to 2015, compared with 108 percent for the Standard & Poor's index — he blamed the influx of money into the industry. (The standard 2% management fee and 20% of the profits might have contributed.)

"With any asset class, when substantial new money flows in, the returns go down," Mr. Klarman wrote. "No surprise, then, that as money poured into hedge funds, overall returns have soured."

He continued, "To many, hedge funds have come to seem like a failed product."

The lousy performance among hedge funds and the potential for them to go out of business or consolidate, he suggests, may become an opportunity.

Perhaps the most distinctive point he makes — at least that finance geeks will appreciate — is what he says is the irony that investors now "have gotten excited about market-hugging index funds and exchange traded funds (E.T.F.s) that mimic various market or sector indices."

He says he sees big trouble ahead in this area — or at least the potential for investors in individual stocks to profit.

"One of the perverse effects of increased indexing and E.T.F. activity is that it will tend to 'lock in' today's relative valuations between securities," Mr. Klarman wrote.

"When money flows into an index fund or index-related E.T.F., the manager generally buys into the securities in an index in proportion to their current market capitalization (often to the capitalization of only their public float, which interestingly adds a layer of distortion, disfavoring companies with large insider, strategic, or state ownership)," he wrote. "Thus today's high-multiple companies are likely to also be tomorrow's, regardless of merit, with less capital in the hands of active managers to potentially correct any mispricings."

To Mr. Klarman, "stocks outside the indices may be cast adrift, no longer attached to the valuation grid but increasingly off of it."

"This should give long-term value investors a distinct advantage," he wrote. "The inherent irony of the efficient market theory is that the more people believe in it and correspondingly shun active management, the more inefficient the market is likely to become." (We agree.)

How Mr. Klarman wants investors to behave in the age of Trump remains an open question. But here's a hint: At the top of his letter, he included three quotations. One was attributed to Thomas Jefferson: "In matters of style, swim with the current; in matters of principle, stand like a rock."

Our thoughts

Macro investors, like the above referenced billion-dollar-losing Soros, need an especially clear crystal ball. They not only have to forecast how the future is going to unfold, but how other investors are going to react. Two quotes:

“The way you lose money in the stock market is to start off with an economic picture. I also spend fifteen minutes a year on where the stock market is going.” – Peter Lynch

"We've long felt that the only value of stock forecasters is to make fortune tellers look good. - Warren Buffett in the 1992 Berkshire Hathaway Shareholder Letter

Alex Barrow deals with the question of how clear Klarman's crystal ball is and whether the stock market is overvalued below. The unedited version is here: http://www.gurufocus.com/news/480334/why-equities-are-not-overvalued

Why Equities Are Not Overvalued

Seth Klarman excoriates common investors for being 'yield pigs' blindly piling into common stock

February 06, 2017

Some investors, desperate for better yield, have been reaching not for a new Wall Street product but for a very old one – common stocks. Finding the yield on cash unacceptably low, people who have invested conservatively for years are beginning to throw money into stocks, despite the obvious high valuation of the market, its historically low dividend yield and the serious economic downturn currently under way.

How many times have we heard in recent months that stocks have always outperformed bonds in the long run? Funny, but we never hear that argument at market bottoms. In my view, it is only a matter of time before today’s yield pigs are led to the slaughterhouse. The shares of good companies and bad companies alike are vulnerable to sharp declines. Moreover, many junk bonds that have rallied will tumble again, and a number of today’s investment-grade issues will be downgraded to junk status if the economy doesn’t begin to recover soon.

What if you depend on a higher return on your money and can’t live on the income from 4% interest rates? In that case, I would advise people to ignore conventional wisdom and consume some principal for awhile, if necessary, rather than to reach for yield and incur the risk of major capital loss. Stick to short-term U.S. government securities, federally insured bank CDs or money market funds that hold only U.S. government securities. Better to end the year with 98% of your principal intact than to risk your capital roofing around for incremental yield that is simply not attainable.

I would also counsel conservative income-oriented investors to get out of most stocks and bonds now, while the gettin' is good. Caution has not been a profitable investment tactic for a long time now. I strongly believe it is about to make a comeback.

The above is from a Forbes article written by legendary value investor and hedge fund manager Seth Klarman In the article, Klarman excoriates common investors for being “yield pigs” blindly piling into common stock. Low yields having driven them into a frenzy for return as they hoof their way to the slaughterhouse to be ground into some expensive breakfast sausage.

Hopefully some of you more astute readers caught this line, “What if you depend on a higher return on your money and can’t live on the income from 4% interest rates?”

That 4% rate isn’t a typo. This article sounds like it could’ve been written today (it’s actually a lot more applicable now), but Klarman wrote it in '92.

Klarman made some good points. In '92 stocks were overvalued on an historical basis and investors were chasing yield.

What Klarman got wrong was the timing; he was eight years too early.

The “yield pigs” got to enjoy a 269% return in the Standard & Poor's and a not-too-shabby 840%-plus run in the Nasdaq before they were led to the “slaughterhouse.” ...

Back in 1992

Let’s start at the beginning and go back in time to 1992 when Klarman warned readers about the impending “stock market disaster.”

It was a contentious presidential election year between the incumbent George H.W. Bush and his opponent Bill Clinton.

The U.S. military had ended the Gulf War a year earlier, and the economy had just come out of a mild recession in the middle of '91.

U.S. GDP growth was hovering around 4%. Inflation was at just over 3%, and the 10-year was yielding a whopping 7.25%. (Can you imagine getting over 7% on a government bond? Must have been nice.)

If people were to open the New York Times they would see articles such as:

[MARKET WATCH; A Clinton Win: Good for Stocks, Bad for Bonds?]

[Next It May Be Economy Up, Stocks Down]

[Stocks Surge, And Wall Street Is Surprised]

Newspapers were filled with concerns over stock market valuations, debt levels, a coming boost in fiscal stimulus driving up inflation and political risks from a new presidential administration. Just a lot of dour pessimistic views on the economy in general – sounds somewhat familiar, huh?

The S&P had a price-earnings (P/E) ratio of 25.93 (today it’s at 25.56) and a cyclically adjusted price-earnings (CAPE) ratio of 19 (today it’s 28).

Valuations were high (average historical P/E is 15 and CAPE is 16), debt levels were high, we’d just come out

of a war, and like today there were many things to be worried about.

Under these circumstances it was reasonable to be if not bearish, then at least pragmatic about future stock market returns.

Klarman probably sounded pretty smart and responsible admonishing those yield-chasing pigs who were destined to pay for their investing gluttony.

And yet '92 happened to mark the very beginning of the longest economic expansion and greatest equity bull market in U.S. history – one that would last for 3,452 days.

The S&P's CAPE went from 19 to a high of 44, and its P/E climbed from 25 to the nosebleed levels of 34 (and those pale in comparison to the multiples on the Nasdaq which were at 175).

So why did this happen?

How were extremely talented value investors like Klarman ... left sidelined and befuddled by market valuations that seemed to go from stupid to "you gotta be kidding me" levels?

The most common explanation comes from Nobel laureate economist Robert Shiller – the market entered a period of "irrational exuberance." Basically we all lost our marbles and entered a collective hysteria culminating in a massive stock-buying orgy.

Okay, that's kinda like what ol' Keynes said about how the market can stay irrational longer than the investor can stay solvent.

Now it's true our animal spirits may certainly account for some of the '90s bull market, especially the latter part. But it can't account for the first half where market skepticism was prevalent and investors were far from exuberant.

To solve this puzzle, let's unpack valuation multiples real quick. Since the P/E ratio is the most commonly used, we'll deal with that, though what we're going to talk about applies to all valuation multiples.

The P/E ratio has just two variables: price, which is the numerator, and earnings per share, which is the denominator. The valuation multiple is comprised of the ratio of the price paid for an amount of earnings, or price divided by earnings.

So there are two ways to affect the P/E multiple (1) adjust the price paid up or down or (2) grow or shrink the amount of earnings. Higher earnings, all else equal, means a declining P/E multiple and vice versa.

Basic stuff.

Well we know that earnings are driven by the business cycle and the resulting profit margin expansion/contraction. But what really drives the change in valuation multiples is the numerator; the price investors are willing to pay for a certain amount of earnings.

The common misperception is that this "price" is determined solely by investor risk appetite and expectations for future growth. If that were true, then why were stock multiples so high in '92? And why did they continue to scream higher when there were so many logical reasons to be bearish?

The answer is the [Relative Risk-Premium Spread (RRPS)](#).

Here's a quick explanation of RRPS:

The cyclic nature of markets and the economy is transmitted through financial spreads, beginning with the cost of money. The central bank controls the cost of money in which everything is valued. The *r*elative changes over time to the cost of money transmit through these financial spreads, creating large bull and bear markets in different assets. Nothing is valued in a vacuum. Everything is relative and reflexive.

Spreads start with the cost of money. The next spread up is the closest asset in terms of risk/return (i.e., short dated Treasurys). After that comes longer dated treasuries. And then you get investment grade corporates. Then there's high-yield and finally, equities. ...

The difference (spread) between all of these assets is called risk premia. Risk premia is the risk (volatility) and average return function of each asset. The asset classes with lower risk premia (i.e., higher on the capital structure and less volatile) offer a lower average return. While assets like equities, which have much higher volatility and pay out a higher average return over time, have a higher risk premia. ...

Risk premia exists because people need to be compensated for lending their money (exchanging cash for stock) and assuming risk. Or else why the hell would anybody change their fungible safe dollars for a more illiquid and risky asset? They wouldn't. ...

It all starts with the Fed's policy tools. The overnight rate, open market operations and reserve requirements are the tools the Fed uses to set the cost of money.

When they lower the cost of money, it transmits through the yield curve of treasury bonds, bringing down both the short and long end – pulling the premia of cash plus cashlike instruments and bonds lower. As bonds get pulled lower the spread between them and stocks widen. The larger risk premia means that investors get compensated more for assuming risk relative to that of cash and bonds.

As a result, stocks get bid up. The higher their multiples go, the more the premia spread between them and bonds turns around and contracts. As this happens, the future return on stocks actually goes down. This is because future returns have been pulled forward and enjoyed today.

In typical cycles, the spread on risk premia gets pulled closer and closer to that of cash and bonds. This goes on until it can't get any tighter. You can take rates negative, you can make the return on cash negative, and you can eke out a bit more in the return spread between risk-free and risky assets, but eventually that spread gets bid tight ....

Now, here's the thing. When the risk premia spread is pulled as tight as it can go, not only does the future return on those assets drop, but the risk, or volatility distribution, actually widens and becomes increasingly asymmetric with a fat negative tail.

Say what? Sorry; this time in English. When there is little difference in risk premia (expected return) between cash and risk assets (equities), risk assets become drastically riskier. That's because when stocks have high multiples and tight spreads, there's little upside in holding them (future return has been brought forward to today), but there is a lot of downside due to their equity valuations tendency to mean revert.

When there's no difference between the expected return on that of equities over cash, then why would anybody want to hold equities?

That’s a good question.

Now you may be saying, “That’s all very interesting, Alex, but how do you know what the risk-premium spread is on stocks?”

Well, let’s make a generalization and say that an investor can put his cash into either stocks or bonds or some mix of the two.

U.S. Treasurys are the closest thing an investor can get to a free lunch (risk-free return).

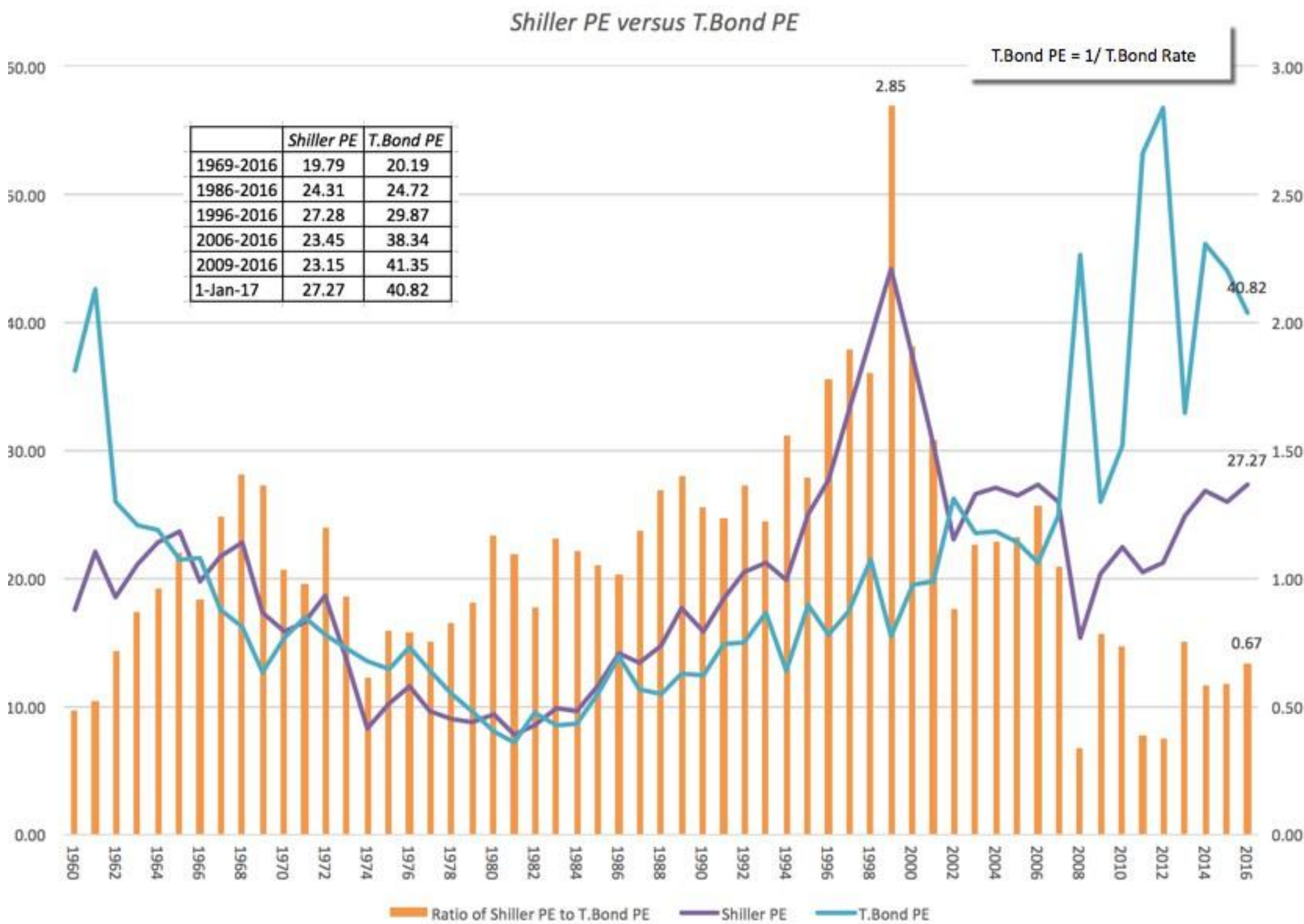
To figure out what the relative risk-premium is on stocks we have to know what the equivalent P/E ratio is for bonds. We can construct a bond P/E ratio by dividing 1 by the 10-year rate.

Bond P/E = 1/10-year U.S. Treasury rate

If you purchased a bond in '92 you would have effectively paid 14 times earnings because 1/.0720 = 13.8

Now that we have our bond P/E ratio of 14, we can compare it to the stock P/E ratio of 25 and get an idea of what the risk premium for equities was.

The following chart is from NYU finance professor Aswath Damodaran. In this, he charts the P/E of bonds (blue line), the Shiller P/E for stocks (purple line) and the ratio or spread between the two (orange bars). The lower the orange bars, the greater the risk-premium spread between bonds and stocks meaning the more



	Shiller PE	T.Bond PE
1969-2016	19.79	20.19
1986-2016	24.31	24.72
1996-2016	27.28	29.87
2006-2016	23.45	38.34
2009-2016	23.15	41.35
1-Jan-17	27.27	40.82

attractive (cheap) stocks are relative to bonds or cash.

In the early '90s we can see that stocks benefited from falling yields (higher bond prices) which drove up the P/E multiple for bonds and made stocks relatively more attractive in comparison.

Secularly falling bond yields acted as a magnet over the '90s, pulling stock multiples higher and higher.

Falling interest rates not only boost the numerator in multiples, but they also increase the denominator (earnings).

Lower yields increase borrowing and lower debt servicing costs, pushing up consumption. This boost in demand widens profit margins and fuels the business cycle.

The driving force behind the extended boom in the '90s was the loose policy of Fed governor Alan Greenspan who kept interest rates too low for too long, leading to the tech bubble.

So it's not enough to say that stocks are overvalued because such and such multiple is at X, like Klarman did at the start of the '90s bull market.

Valuations cannot be looked at in a vacuum. Investors have to put their money somewhere and that somewhere is always based on their considerations of risk/preservation and return/growth across a range of assets.

In its most simple form, this choice is deciding the right mix between stocks and bonds. As a result, it's the relative valuation between the two choices that matter because it's the relative risk-premium spread that drives much of investors' decision making (whether they're conscious of it or not).

A slimming margin of spread

Now that I've explained financial relativity theory we can apply that to where markets are today.

Going back to our premium spread chart we can see that the Shiller P/E to bond P/E ratio is still near record lows despite earnings multiples being near record highs.

Similar to Klarman in '92, we've had many smart financial pundits and market players calling for market chaos over the last four years because of these "high" valuations. And just as in '92, stocks have risen, multiples have expanded, and valuation bears have continued to be wrong.

All this is because real interest rates have been between negative and 50bps for the last seven years (the real 10-year rate is only 46bps, and real rates on the five years are zero).

Low nominal and real interest rates on bonds mean a wider risk-premium spread on stocks and a cheaper relative valuation.

Does that mean we're at a point in time similar to '92, and we're about to go on a large secular bull market expansion?

No. No. No.

The '90s benefited from the tailwinds of a long-term debt cycle where interest rates trended lower from historical highs. And the consumer had a relatively strong balance sheet (reasonable debt to income).

But now we're going through a turning point of the long-term debt cycle and moving into the deleveraging phase. Interest rates can't fall any further and the balance sheets of consumers and companies alike are maxed out with leverage. What were tailwinds in the '80s and '90s will be headwinds over the next 10 years.

With that said, the relative value of U.S. equities is still attractive at the moment. The equity risk premia spread is only at 0.62. This spread has a ways to tighten before equities' relative valuation starts to look less attractive (it's when the stock/bond P/E ratio is closer to 1 that investors should start to worry).

The biggest risk to premia spreads right now are either collapsing earnings or much higher rates.

Barring any politically induced blowups (which both figuratively and literally look more and more possible) we should see sustained earnings growth over the coming year. Earnings growth is continuing to benefit from low hurdle (comparables) relative to the year before. ...

The primary risk is that the rise in interest rates greatly exceeds the growth in earnings. This could happen in an environment in which growth and/or inflation starts picking up and the Fed moves more aggressively to raise rates.

This type of scenario is plausible if the Trump administration is successful in pushing through its tax and regulation reforms and in carrying out its expansionary fiscal policy. ...

And just as lower interest rates can boost earnings and drive the business cycle upward, higher rates can turn the business cycle lower and put the earnings trend in reverse.

When this happens (all business cycles eventually do come to an end) we'll be left with double valuation headwinds: falling earnings forcing high valuation multiples higher and higher stock/bond relative P/E ratios.

It's in market environments like this when conventional valuations of just plain P/E ratios begin to matter. That's because the power of mean-reversion takes effect with higher multiples generally equating to larger falls. ...

About the author:

Alex Barrow

I spent over a decade working for the U.S. military and government as an intelligence professional, including both collection and analysis. I specialized in covering the economic and political spheres of the Asian-Pacific region.

I eventually left the public sector to work as a consultant for a leading Silicon Valley firm that creates advanced data software for intelligence and finance. I then went on to pursue my passion for markets, working at a global-macro hedge fund.

Recently, I co-founded Macro Ops with two other former hedge fund analysts with the goal of helping friends and family navigate these volatile markets.

Our thoughts continued

Fortunately, clairvoyance is unnecessary to be a successful investor. A systematic approach based on the best academic research can help. For HCM that translates into providing each client with a Quantitative, Factor-based portfolio that is properly diversified within the parameters of their objective(s) and Risk Profile. For our clients it requires understanding that their Risk Profile includes their Risk Tolerance and having the discipline to stick with the plan. **"My favorite political philosopher is Mike Tyson. Mike Tyson once said everyone has a plan until you punch them in the face. Then they don't have a plan anymore."** - Obama campaign manager Jim Messina