Blue Ocean Asset Management, LLC
ahead of the current

Investment Perspective
May 2017

"It is not by augmenting the capital of the country, but by rendering a greater part of that capital active and productive than would otherwise be so, that the most judicious operations of banking can increase the industry of the country." Adam Smith

U.S. stock market indices reflect valuations built on foolish credit and hope

If you are involved in trading and financial markets long enough, you will come to accept that the stock market is going to do what it wants to do. Financial ratios and eloquent economic models carry little weight in an environment driven by emotions like hope, greed, and instant gratification. With this perspective in mind, it is important to remain a disciplined investor -- pursuing only those opportunities that have a clear investment thesis, allocating risk capital to only these opportunities, and applying prudent capital budgeting in order to build a well-diversified portfolio.

A speculators market

There is a marked difference between "investing" and "speculating." Investing takes effort. Speaking broadly, this work involves deducing the different sources of value in an asset; developing justifiable projections of the anticipated cash flows of an asset; and determining the net present value of the costs (outflows) and cash flows (inflows) of the asset. Prudent investing then calls for the pursuit of only those opportunities that are expected to generate a positive net present value. An investor needs to recognize that no research or due diligence, no matter how logical and thorough, can account for the risk of the unknown. So prudent investing must also allow for the possibility that one's projections and analyses are wrong and for the inevitable reality that circumstances are ever changing. One can manage this uncertainty by constantly monitoring one's investments to determine if underlying assumptions have changed and by building a portfolio of investments where the correlation of price movement among assets is limited.

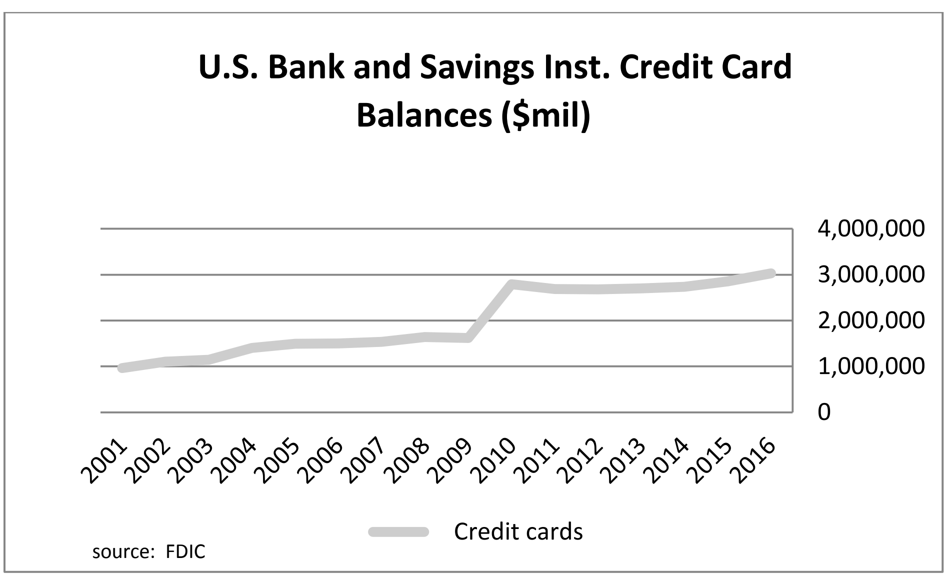
Speculating is more akin to betting on Sunday's game and flipping houses. It is premised on hope (more like optimistic hunches) and the crucial belief that "greater fools" are out there who will eventually "see the light" and show up just in time to pay the speculator a higher price for his or her assets. Thanks to the Federal Reserve and its quantitative easing (QE) policy and the increasing popularity of index "investing," the U.S. equity markets (indices) are now devoid of fundamental support and are more like a pyramid scheme where further price appreciation will require "greater fools" to emerge.

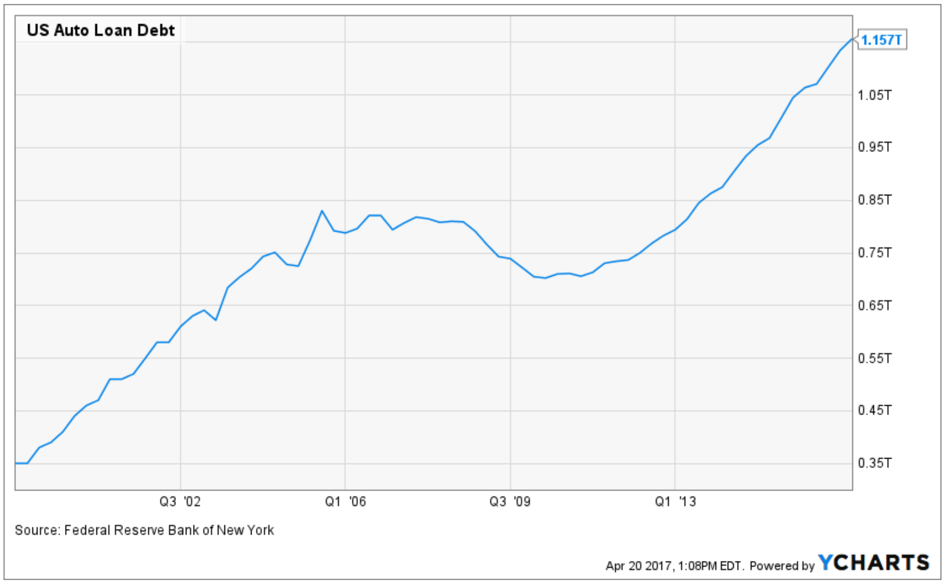
Low rates and the idea that owning a little bit of everything can replace doing the homework

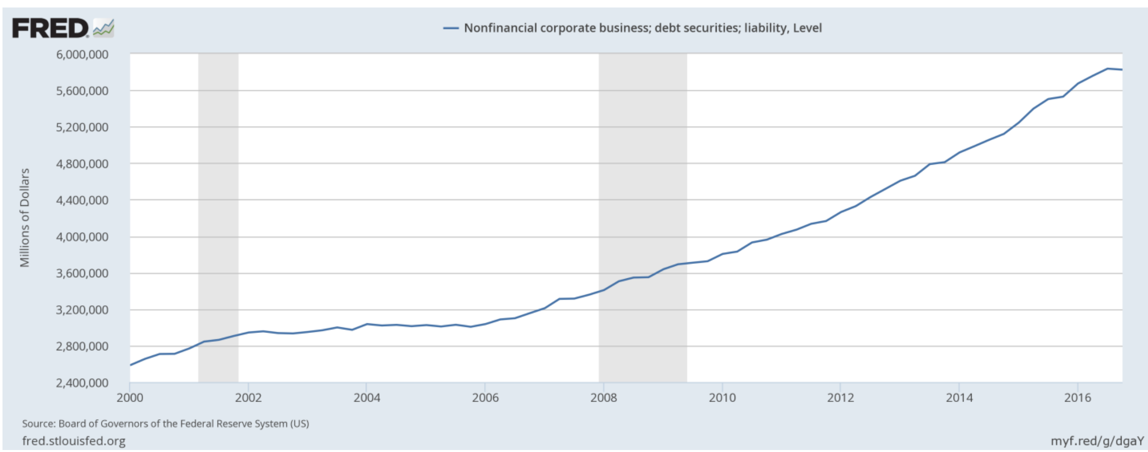
With rates so low, the threshold for a worthwhile investment is now practically non-existent. Wealth is generated when cash inflows exceed costs. What is the cost of money? Interest rates. Thanks to QE the difference between money on hand and money a year or five years down the road is minimal.

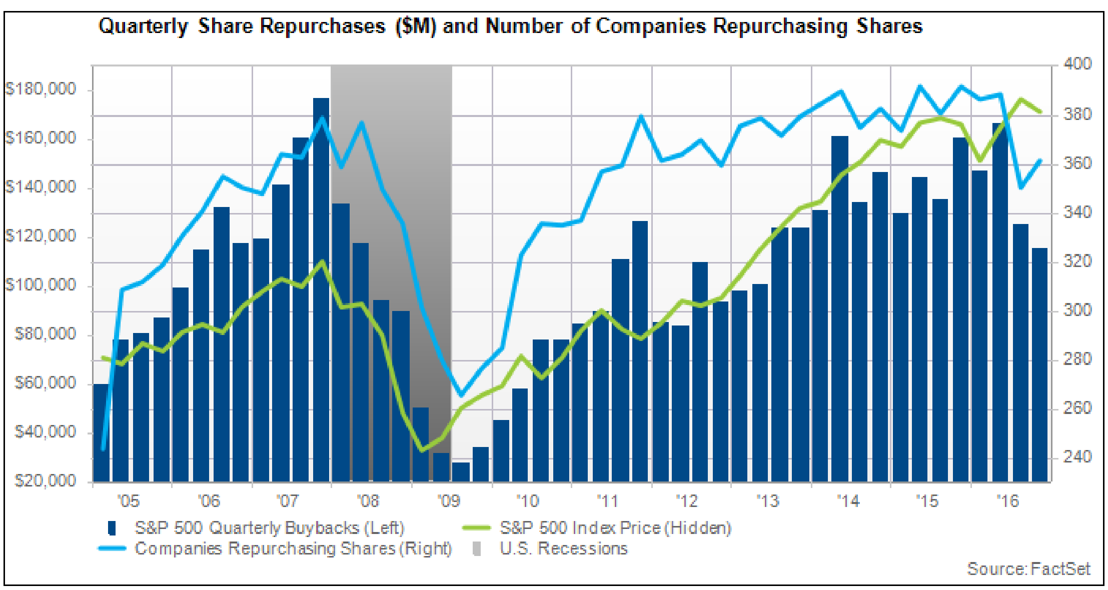
Not too long ago, the minimum threshold of return a 5 year investment needed to achieve to make it worth consideration was around 4% (2000-2008). Thanks to QE, that threshold dropped to roughly 1.5%, if not lower. The next chart shows two more realistic benchmarks of the opportunity cost of money – the prime rate (used to price loans to high quality corporate borrowers) and the 10-year Treasury (a benchmark for mortgages).

With the opportunity cost of money artificially low, we should have seen a golden age in capital investments, new technology, more efficient processes, right? Not really. I am not exaggerating when it seems like the only innovation we are seeing has been along the lines of more entertainment content on our TVs, how to add cute filters to our selfies, and how to turn our car into a taxi… Big businesses and big banks instead chose the path of least resistance. Rather than innovative processes, more of the focus was on the low hanging fruit, like borrowing money (issue bonds) to buy back shares (inflate stock valuations and earnings per share) and increase credit card lending and auto lending.









It does not take an economist to realize that stock buybacks and consumer loans are not the stuff on which strong economic growth is built. Long-term economic growth and sound stock market valuations are not a product of balance sheet manipulation or lowly credit card debt –seriously. Long-term growth and value is accomplished by the pursuit of capital investments that actually create jobs, new technologies, new efficiencies, and increased wealth, not mortgage once future earnings.

Back to the beginning

I opened this perspective with the following chart:

I like this chart because it perfectly illustrates the disconnect between wishful thinking and reality. In just over seven years, stock market valuation (capital gains only) has grown by over 114%. What about people's wages? Only 13% in the same time period. Corporate profits? Only 20% in the same time period. Only consumer credit was competitive, up 49%. Pretty tenuous, it seems.

Regarding the 20% growth in corporate profits, I think we all can agree that cutting costs is a lot easier than growing sales. Sales are the real gauge of activity and demand. Take a look at the next chart and you will see a greater disconnect. In 2008 the S&P 500 began its financial crisis downward spiral. Just strictly looking at capital gains in the S&P 500, relative to the first quarter of 2008, the index has grown by 83%. S&P 500 sales per share? Up a modest 8% in about nine and a half years! …and that is with the benefit of reduced shares outstanding thanks to aggressive buy backs…

Take away

"Only when the tide goes out do you discover who's been swimming naked." Warren Buffet

Now is not the time to blindly buy a little bit of everything, *a la* index funds. Yes, the market can get more irrational before it sobers up to reality. But, with each percentage increase in capital gain you see in indices like the S&P 500, fewer and fewer fools are out there on the sideline. Eventually, blind faith buyers will run out. It is time to go back to basics and actually invest in the company and the idea, not speculate on the tide.

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