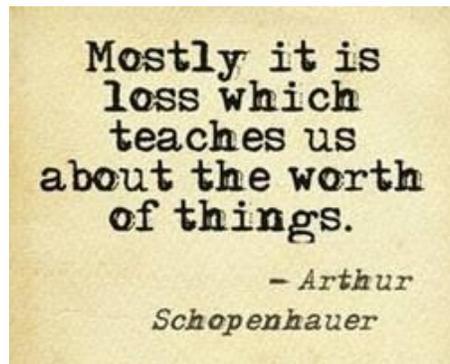


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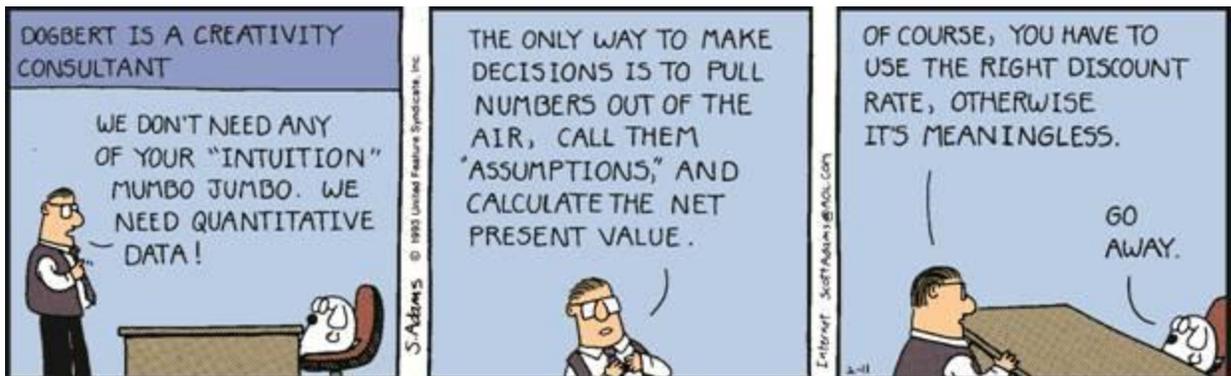
Only Loss Teaches Us the Value of Things

By Alan Snyder



Arthur Schopenhauer, the famous German philosopher, captures the issues confounding investors. Financial assets have been gyrating like cats on a hot tin roof. Bonds, equities, futures and real estate are all participating. This challenge has stimulated Shinnecock to attempt a macro answer to where we stand today on value: Are financial assets relatively high and expensive or low and cheaply attractive? The somber BlackRock return forecast we shared in earlier missives put the pickle on the fork. (See “Zebra Commentary” on our website: www.shinnecock.com/#articles.) Could we independently come to a similar conclusion? And, if yes, then where can we invest for better results with less volatility?

A Dilbert cartoon from Scott Adams raises the stakes further, but with humor.

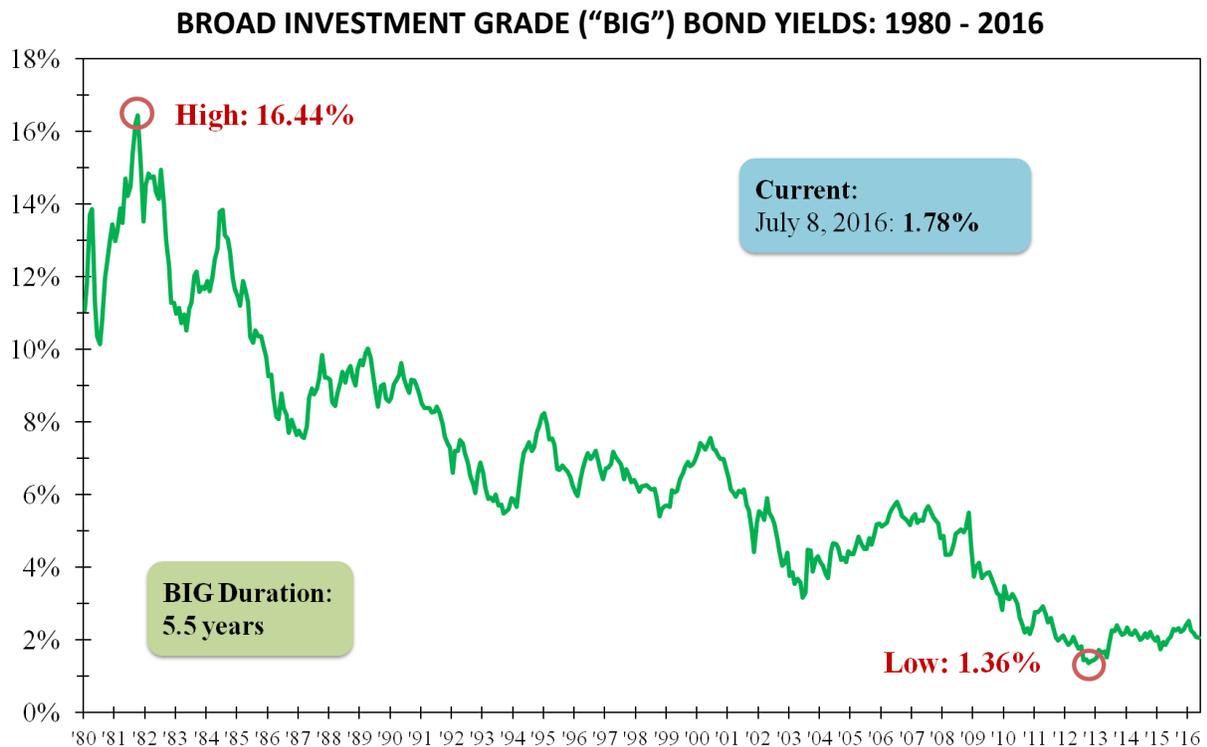


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Quantifying the data drove us back to first principles. All have been trained that the current worth/value/price of an investment should be based on the future sum of money or stream of cash flows that are expected to be generated from that investment. These future sums can be valued using a discount rate to give us their “present value.” We are trying to ascertain what we should pay today to receive these cash flows at determinable times in the future, e.g., what price or level should the S&P 500 be at, based on the discounted value of the projected earnings and dividends of those companies included in the S&P 500?

Companies generate earnings, real estate provides rental income (and possibly a terminal value on sale), options and futures can be assigned a probabilistically weighted fan of future cash flows, bonds deliver interest and usually a future repayment of principal, etc. Present value techniques can value all of them.

For the moment, let’s pull the camera out of the weeds and look at the big picture. What discount rate should we use and what has been its history? ***We know that the lower the discount rate, the higher the valuations and vice versa.*** The following chart shows the interest rate history of investment grade bonds, a possible discount rate for a macro view. Of course, sentiment, volatility and future cash flows all count, but this chart paints the picture in broad strokes. (For the technically inclined, the notes at the end of this article review discount rate considerations in greater detail.)



Over the last 35 years, high grade interest rates have declined to a nadir of 1.36%; the BIG Bond yield is currently at 1.78%. The rate drop has been “YUGE” as Bernie would say. Can rates go lower? Sure, but the balance is asymmetric, more upside risk than downside opportunity; any

discount rate, whatever methodology used, arguably has also dropped sharply. Thus, financial assets on a present value basis are anything but cheap. In fact, most would conclude that they are historically expensive. Not surprisingly, this conclusion seems to validate BlackRock's gloomy forecast. With financial asset values high, further increases must be driven by higher future cash flows. For example, equities would need increased profits yet forecasted growth is not substantial and whatever they may be would need to be discounted back to today as an additional haircut. An even lower discount rate could further increase valuations, but there's not much room remaining for further interest rate declines. However, if rates rise even a modest degree, "Katie bar the door" on valuations. We don't know if it is 9:00 p.m. or 11:30 p.m. before a new day starts, but *caveat emptor*.

Two brilliant minds cement what we believe from different angles.

Seth Klarman, the billionaire founder of the Baupost Group, comments:

"... investing is not a paint-by-numbers exercise. Skepticism and judgment are always required."

Paul Samuelson, the first American to win a Nobel Prize in Economics, goes further:

"Investing should be more like watching paint dry or watching grass grow. If you want excitement, take \$800 and go to Las Vegas."

This valuation backdrop reaffirms our view that niche investing and alternative lending, while not guaranteed, fill the bill in the current environment for the prudent conservative investor.

Alternative lending and other niches can escape from the high valuations noted earlier by virtue of their being a narrow segment of the markets, off the beaten path, and having less uncertainty of cash flows from possibly more modest assumptions. In the case of alternative lending, contractually-promised cash flows and shorter time horizons, lower forecasting error and discount rates used. By their very nature, niche investments, including alternative lending, limit the amount of capital that can be deployed; modest demand versus supply helps to avoid the risks of "tulip mania" distorted valuations. Good news for us, but bad news for those seeking to quickly and easily invest billion-dollar sums. Demand limitations have been real, generally because these investment opportunities must be ferreted out with time-consuming searches and painstaking due diligence. These two areas, by their very nature, capture the advantages of market inefficiencies from the high costs of discovering the manager/participants and/or loan possibilities.

The exception may be consumer marketplace lending. In one of our recent notes, "Poof! Alternative Lending is Gone," we reviewed the valuation methodologies and discount rates for alternative lending. (See post at www.shinnecock.com/#articles.) Recent challenges have cooled the onslaught of capital to create newfound relative attractiveness, particularly as the dust settles.

And yes, we are happy to help you participate in this with us!

Notes

Lengthy treatises have been written on the subject of present value. While tempting to elaborate, we will only treetop some of the considerations. Present value uses a discount rate against future cash flows. Both elements of that formula demand consideration. For cash flows:

1. No crystal ball is perfect, which would drive us to probability weight the cash flow possibilities. Alternatively, some would say uncertainty requires a higher discount rate for more volatile outcomes.
2. Tax effects on cash flows might be considered although two Nobel laureates, Franco Modigliani and Merton Miller, in their Modigliani-Miller theorem, would say not. On the other hand, practitioners would simplify by using pre-tax cash flows and a pre-tax discount rate or an after-tax rate for both.
3. The longer the time horizon, the trickier the issues become because of greater variability, i.e., a higher discount rate.

Selecting the “right” discount rate may be the most difficult decision. Some punt and use a risk-free rate. We believe it should be the rate you would expect to earn on investable cash in the present period that has the same risk profile as the cash flows being present valued. In short, it is the “opportunity cost” of not having the cash today but receiving it in the future.

In our earlier comments, we imply that the pictured bond rate is a good place to start. However, using a blend of bond rates and equity returns (actually achieved) would be another, albeit more complex, approach, in the same way that corporations argue for weighted average cost of capital (“WACC”).

Using the bond yield as a discount rate may not be a perfect solution, but it is a practical one. The go-forward risk is asymmetrical. Our Fed chairwoman has asserted that rates will not go negative and the goal, over time, is that rates should go higher. History would indicate that current rates are artificially low and can be expected to rise at some point. If rates rise, including any discount rates derived, investable assets can be expected to decline, *ceteris paribus*. However, seldom are all other things equal, i.e., investor sentiment or expectations can prolong high valuations.

Nevertheless, in an order of magnitude, it seems logical to conclude that financial assets are relatively expensive **by present value methodology** and that returns from conventional investing will be suppressed. Of course, valuations can go even higher and as recently observed, no one seems to know when “lower for longer” will be rescinded.