

# AVENIR CORPORATION

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## INVESTMENT MANAGERS

August 2018

To Our Friends and Fellow Investors,

The S&P 500 has risen approximately 8.7% year-to-date. Coming on the back of a nearly 22% return in 2017, the index sits at a record level. Since the 2016 elections the market has risen by a third, bringing the total return since the depth of the global financial crisis in early 2009 to 418%, or 18.9% compounded annually, capping what is generally considered the longest bull market in history. It has been an extraordinary run marked by rapid technological change in cloud computing and aided immeasurably by accommodative monetary policies, ultra-low interest rates and, more recently, substantial corporate tax cuts. Historically, seemingly unstoppable markets can condition investors to believe that gains are not only easy, but inevitable. While the economic outlook remains favorable based on measures such as employment and US GDP growth, as well as the wealth effect of market gains, we are concerned that “investor complacency” might be creeping into today’s market.

### **The Global Financial Crisis Revisited**

September 15<sup>th</sup> marks the 10<sup>th</sup> anniversary of the Lehman Brothers collapse, which triggered a near-failure of the global banking system. Over the next six months, equities fell more than 40%. A decade later, it is worth revisiting that frightful period and to place its lessons in the context of the signs of complacency we see today.

In the fall of 2008 amidst the onset of the crisis, we wrote a letter that referenced a comment made by the noted investor and CEO of Berkshire Hathaway, Warren Buffet, in his 2007 shareholder letter about the traits his successor would need to navigate turbulent times:

*Over time, markets will do extraordinary, even bizarre, things. A single, big mistake could wipe out a long string of successes. We therefore need someone genetically programmed to recognize and avoid serious risks including those never before encountered. Certain perils that lurk in investment strategies cannot be spotted by use of the models commonly employed today by financial institutions.*

Buffet’s concern at the time was the growing use of increasingly complex financial derivatives, which he aptly called “Financial Weapons of Mass Destruction”. Without knowing exactly how or when these new financial models would implode, Buffett nonetheless correctly anticipated that their widespread use would end badly. His general concerns turned out prescient when the exotic models supporting credit default swaps and mortgage-backed securities failed, wrecking bank balance sheets and exposing many financial institutions to large and potentially fatal losses. With the strong encouragement of the US Treasury, Bear Stearns was rescued by JP Morgan, Merrill Lynch was sold to Bank America, and the Treasury’s rescue of the functionally bankrupt AIG may have also saved Goldman Sachs, which held a massive amount of securities guaranteed by AIG.

As the financial crisis unfolded and the United States formed its response, which came mostly in the form of unlimited government funding to keep the financial sector solvent and interest rates low, Buffett had this to say in a New York Times op-ed piece, as we noted in our letter of September, 2009:

*The United States economy is now out of the emergency room and appears to be on a slow path to recovery. But enormous dosages of monetary medicine continue to be administered and, before long, we will need to deal with their side effects. For now, most of those effects are invisible and could indeed remain latent for a long time. Still, their threat may be as ominous as that posed by the financial crisis itself.*

The worst of the crisis had passed, and the financial system was on the mend. Equities had rallied furiously, rising 50% in a mere five months, beginning a run that has persisted to this day. Even so, Buffett’s

admonishments regarding the long-term latency of the “side effects” has remained in the forefront of our minds every day since. The *visible* side effects are the continued piling up of federal debt caused by insatiable government spending, which has risen 54% since the year before the crisis, leading to the prospect of trillion-dollar annual deficits. Ordinarily, one would expect a decade of economic growth to reduce deficits, particularly as a percentage of GDP, but the size of the budget deficit has only increased. Our politicians and policymakers have squandered an opportunity.

In the summer of 2016, when writing about our concerns over this phenomenon, we noted that the average cost of federal debt was 2.26% and the interest expense to service that debt totaled \$402 billion. As of July 31<sup>st</sup> of this year, we were paying an average of 2.46% on \$21.4 trillion. Interest expense for the fiscal year-to-date was \$456 billion and will easily exceed a half-trillion dollars when the fiscal year ends on September 30<sup>th</sup>. When placed in the context of anticipated federal receipts of \$3.4 trillion and a nearly \$1 trillion deficit in the next fiscal year, the “invisible” side effects begin to take on contours. In a rising rate environment this continued deficit circumstance is ominous, as the rate of change in the annual interest bill will greatly exceed the rate of change in interest rates. To date, the market has ignored this, but we suspect any impact would come out of the blue. We are reminded of a bit of dialogue from Ernest Hemingway’s *The Sun Also Rises*: “‘How did you go bankrupt?’ Bill asked. ‘Two ways,’ Mike said. ‘Gradually and then suddenly.’” We believe that the United States is by far the best place in the world to invest, so we are far from suggesting that the federal government is going to go broke. We are saying that if and when the markets react to runaway borrowing, the reaction may be swift and severe.

### **The Present**

We mentioned above that markets have compounded at an annual rate of over 18% since the market bottom in March of 2009. That’s almost double the market’s historic average return of 9-10%. That said, if one marks performance from just prior to the crisis-related market decline, equities have only compounded at an annual rate of 8.2%, a little below the historic average. Thus, depending on which starting point one chooses, one can argue that the market has massively outperformed or has slightly underperformed. Regardless, the massive gains achieved during this bull run emerged from a state of investor panic which has matured into a growing sense of complacency. Unsurprisingly, Buffett has spoken about this condition, too. In his 2004 letter to Berkshire Hathaway shareholders, he said “...be fearful when others are greedy and greedy only when others are fearful.”

As long-term investors know, it is performance over several market cycles that counts, and short-term market gyrations are an essential element to long term compounding. Thus, we are focused solely on the intrinsic value of our businesses, a calculation that is independent of the market, and we continuously weigh the discount-to-intrinsic value of our current investments against prospective investments. This leads to investing in businesses that do not require us to make timing judgments about either the markets or the economy per se, an investment process that has served us well over time. Moreover, our commitment to capital preservation means that we do try to “avoid serious risks including those never before encountered” and that means keeping an eye out for the perils such as the unsustainable federal debt and spending structure, including entitlements. We keep a watchful eye on the Federal Reserve, US Treasury interest rates and the hopefully coming debate among policymakers as to how our debt burden is to be managed.

### **Tariffs**

Looking behind the tweets and rhetoric, economic policy since the 2016 election has been decidedly pro-business: huge tax cuts and regulatory relief. However, the use of tariffs and instigating a trade war is an outlier. While domestically punitive, the proposed tariffs are ostensibly designed to level the playing field, particularly with China, where US businesses have long been resigned to intellectual property theft as a cost of doing business. In this context, such trade measures make sense.

Nonetheless, the pro-active use of tariffs signals a departure from the post-World War II international monetary and financial order established at the Bretton Woods Conference and the subsequent General Agreement on Tariffs and Trade, after which global free trade was essentially guaranteed by the US, the only

industrial power left standing at the end of the war. The brilliant move to open markets and the movement of capital throughout the world eventually lifted all nations, especially our own. It worked and has been foundational for nearly 75 years of worldwide economic growth and globalization. While we understand, in limited circumstances, the reasoning behind the tariffs, the fragmenting of international alliances and trade agreements essentially signals the suspension, if not the reversal of the era of globalization. The outcome is not certain. It is certain that the vacuum won't exist for long, and creates opportunities for regionally focused governments in Asia, Britain and Europe.

### **In Conclusion**

The S&P 500 sells for approximately 17 times the next twelve month's earnings. In other words, investors who buy the index pay \$17 for \$1 in earnings. The inverse of the P/E ratio is the earnings yield, which permits an easy but oversimplified means of comparing expected equity returns to other investments, such as bonds or time deposits. In this case, the expected earnings yield is 5.88%. This is on the slightly expensive side, but it is also far from the elevated levels seen prior to massive selloffs. We are students of history, which means we are cognizant of the market's record run. While markets may have become more efficient at the margin due to more and faster delivery of financial information, human nature hasn't changed. The favorable economic conditions and low interest rate environment have created momentum in the equity markets as evidenced by the concentrated leadership of a handful of technology stocks, and some investors have become complacent, clearly forgetting the lessons of 2008. That said, there have been very few times in history when it didn't make sense to own the kind of terrific businesses such as the ones in your portfolio, and we are pleased to hold them today. Come what may, we expect them to compound per-share value for years to come, with the inevitable interruptions from tough markets and recessions.

We remain guided by our commitment to owning businesses that common sense tells us have years or even decades of compounding investors' capital ahead of them. These businesses must be run by top-flight executives who are working to compound per-share value, and we must be able to acquire our interests in these businesses at a discount to our assessment of their true worth. This is simple in concept, but difficult in the execution. If we are successful, we will continue to achieve our objectives of not only preserving your capital but growing it significantly above the rate of inflation.

We are grateful for the privilege of working for you and look forward to your feedback. Best wishes for the remainder of the summer.

Respectfully,

Peter C. Keefe

James H. Rooney

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