CAZ Investments

Quarterly Letter

Borrowed Time or a Pause to Refresh? Part II

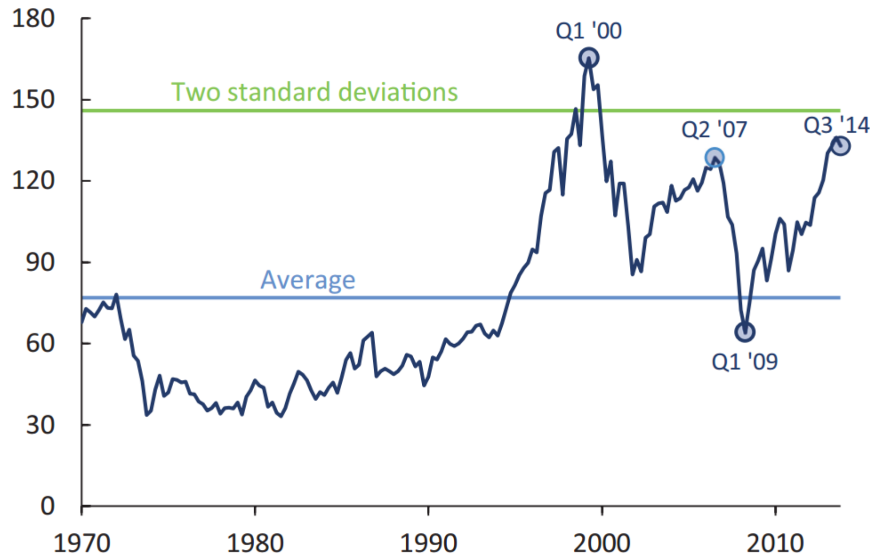
In some ways, we could literally just reprint the letter we wrote in the first quarter. Markets went virtually nowhere in the second quarter, and volatility was exceedingly low in the U.S., but there were some dramatic events around the world: the Greek Drama part 5 (or is it part 6, we lose count...), China's plunging stock market and a nuclear agreement with Iran. In spite of the headlines, for most of our investments, we can chalk the quarter up as uneventful.

As you would expect, the actions of the quarter did not do much to change our general outlook for the world as we remain a cautious "2" on the CAZ Scale. The good news is that the longer the markets go sideways, the more opportunity we have for valuations to improve, IF the profit picture expands and companies can grow. In the first quarter, earnings were up less than 1% over a year prior, and we are concerned about potential negative earnings year over year when the final second quarter results are tallied. What really causes us concern is not profit growth, as companies are doing an outstanding job managing costs, it is revenue growth. No matter what business you have, if you cannot grow revenue, there is a limit as to how much you can grow profits. This is the biggest concern we have, as revenue growth is expected to be NEGATIVE in the second quarter by 4.5%. There is virtually no logical way markets will resume their advance if we do not get meaningful expansion in revenue, and therefore, in profits.

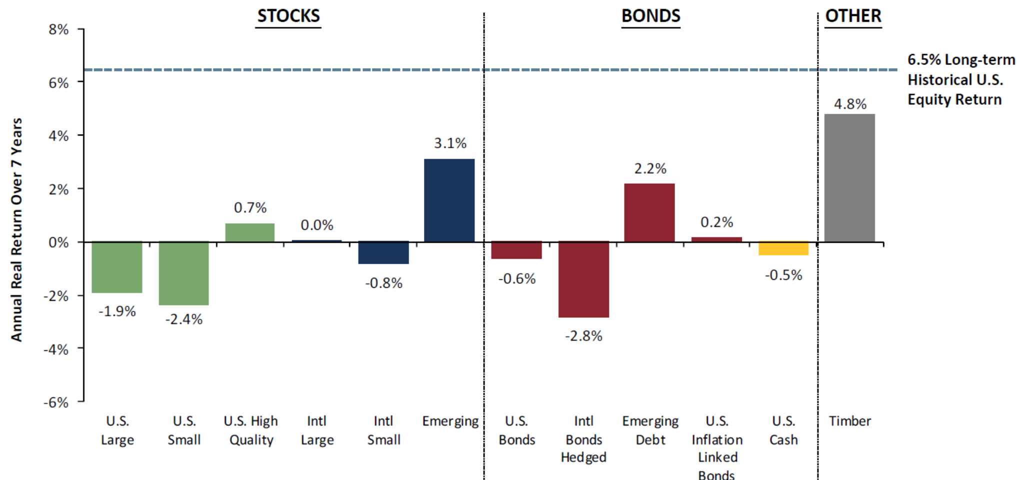
Valuations Matter… Really, Part II

Speaking of valuations, we thought it would be helpful to provide a graphic representation of why we remain concerned. In the two pictures that follow, you will see the "Buffet Valuation Metric" which is the ratio of corporate market value to Gross National Product and the GMO 7 year asset forecast. The first shows how we are now at the second highest level of valuations other than the height of the tech bubble in 1999. The second shows what expensive valuations do to projected return assumptions. For clarity, GMO is a $118 Billion asset manager we have invested with. They have one of the very best records of forecasting asset value returns, and we have tremendous confidence in the quantitative work that they do. For some perspective, their work is one of the reasons we were so cautious in 2007, which is the last time their forward looking asset forecast looked like this chart. It is not hard to put together. If things are expensive they are not as likely to deliver good returns going forward.

Figure 5. Ratio of corporate market value to GNP (percent)



Note: This is the market value of corporate equities (Wilshire 5000 market capitalization) divided by nominal GNP.
Sources: Haver Analytics, Wilshire Associates, OFR analysis



Source: GMO

<u>All eyes on the Fed!</u>

Before you receive your next quarterly letter, the Federal Reserve is expected to raise interest rates for the first time since the beginning of 2006. Let that sink in for a minute. It is likely that we are going to have a Fed policy that is biased toward tightening for the first time in 9 years. What is the impact going to be of that move? Possibly nothing, but the safety net that the Fed has provided is likely to be a bit farther away starting in the fall of 2015. That means companies and consumers are going to have to counteract that action, or the economy will

slow down. While it is always possible that the Fed may postpone their tightening because of Greece, a slowing U.S. economy, China or any other number of reasons, the Fed has postured to the market that the probability is very high that we will see the tightening. Investors should not be surprised when this happens.

So, what should an investor do at this point in history? Be smart, proactive, disciplined and have less correlation to traditional asset classes than is normal for your portfolio. If you subscribe to our “Barbell” method of asset allocation, you have a solid allocation mix that we believe will serve you very well regardless of what the next few years may bring. If you are not familiar with the Barbell, please visit the Insights page on our website, www.cazinvestments.com, to watch a short video where you can learn more. We are happy to answer any questions you may have.

Thank you for your continued confidence in us. We have a lot of interesting things we are working on, and we look forward to sharing more information in the near future. Enjoy the summer!

The CAZ Investments Team