CAZ Investments

Quarterly Letter

The Thunder is Loud and Lightning is Poised to Strike

The 4th quarter was a bit calm compared to the storm experienced in the 3rd quarter, and it proved to be the calm before the real storm hit. We talked last quarter how we heard the rumbling of the thunder in the clouds. Those clouds unleashed a torrential down pour in the first half of January. The U.S. stock markets dropped by roughly 12% in the first 20 days of 2016, one of the worst starts to a year in history. The S&P 500 ended the month down approximately 7%. As we write this letter, the market has tried to selloff but bounced off the critical 1810-1850 level for the S&P 500, which has now held on for four different occasions. If the 1810 level breaks decisively, it is safe to say that the lightning bolt will have struck right at the heart of the market psychology. Is there anything magical about that number? Of course not, but it has held four times so the market is focused on it. If that number breaks, the odds are very high that those that have held onto the notion that this is just a correction in a bull market will don a grizzly suit, and you will hear the bear market discussion incessantly.

Enough analogies and interesting anecdotes. Here is what we know. The market is expensive, and we have just entered a profit recession for the first time since 2008. A profit recession is where there are two quarters in a row of negative profit growth. Expensive stocks and declining profits are a very toxic combination that can lead to combustion in the form of volatility and downside moves that create significant pain for stockholders. We have witnessed this in many sectors. Energy gets most of the attention, but the pain is not limited to that sector as it has permeated thru nearly each and every sector with some stocks down 30 – 50% from their highs. Many investors would call this a stealth bear market, and we cannot disagree with that statement. There is a LOT of pain in portfolios right now, and we may not experience relief for a while. If we do not see a rebound in earnings and/or a significant improvement in the economic outlook, the situation may get much worse before it gets better.

As we have said numerous times through the years, one of our favorite quotes is to "sell when you can, not when you have to." That is so very true today. The market may bounce from here as it appears that the Federal Reserve has no choice but to hold off on their plan to increase interest rates and may have to resort to extreme measures in an attempt to stabilize the economy. Talk has begun about the possibility of NEGATIVE short term interest rates, which is almost impossible to fathom, but it has already happened in Europe. Imagine paying the government for the **privilege** of loaning them money. That is what is happening in Europe, and it is possible we will see this play out in the U.S. As one of our investors, we are urgently telling you to have a plan in place for a continuation of the negative trend that is developing, and confirm you have assets in the portfolio that are capable of generating returns that are uncorrelated to the U.S. stock market. Our long term outlook shows a strong possibility of negative real (after inflation) rates of return in the stock market for the next 3 - 5 years. Therefore we remain a very, very cautious **"2" on the CAZ Scale,** and we will be moving to a **"1"** if the market breaks the February lows.

While the pain in the markets has created anxiety for many investors, it has also created an amazing opportunity that we articulated in our email on January 18, 2016. In case some investors have not seen that correspondence, it is attached at the end of this letter. The dislocation in the energy markets has now reached our classification of a "no brainer," and we plan to take advantage of this opportunity. Please read the details in the email, and be prepared to attend one of our events to discuss our Energy Opportunity Fund which will launch on March 1st. It is time to act! We are very excited about our strategy which will be designed to benefit from a recovery in oil prices, while protecting against the possibility that oil stays "lower for longer." If you cannot attend one of our events, please let us know, and we will get you a recording of the presentation.

Themes for 2016

If you were not able to join us for our "Themes for 16" event in January, you missed an outstanding evening. More than 200 people enjoyed the thoughts, wit and wisdom of our speakers. We were blessed to have three outstanding experts who shared their thoughts on their specific sectors. Carter Neild from OrbiMed, the largest dedicated healthcare investment firm in the world, shared their outlook for the healthcare sector. Sheru Chowdhry from Paulson & Co., the legendary investment firm that made $20 Billion in profits from the unwinding of the housing bubble, shared their outlook for the credit markets. Bob Zorich from EnCap, one of the largest and well respected private equity firms in the energy space, helped us understand the reason for the pain in that market. Each of these men were entertaining and informative, and we greatly appreciate them taking the time to join us. If you have suggestions and/or requests for our 2017 event please pass them along. We hope you will make attending next year a priority as we plan to have an all-star cast again.

Here is a brief summarization of the evening:

Healthcare

- The sector has sold off sharply with the market decline and renewed political saber rattling related to drug pricing. This too shall pass, and the reality is that prescription drug spending is roughly 10% of total healthcare costs and has remained almost the same percentage for the last 50+ years. Stocks in the sector are approaching some of the most attractive valuations we have seen in a very long time, but patience is warranted because of the geo-political environment.
- New blockbuster drugs are expected to enter the market in the next few years as we are revolutionizing the treatment of many diseases. Examples are the virtual elimination of hepatitis C, and the incredible progress that is being made in the area of immuno-oncology, which has the potential to eradicate certain types of cancer… permanently.
- The digital health sector is growing at enormous rates, and the advances in technology are revolutionizing the way services are delivered to patients. There are massive numbers of new opportunities in wearables, telemedicine and devices.
- The opportunities in the healthcare space are best at this time in the private markets, where we can participate most directly in the innovation without the added variable of stock market volatility. Currently our main focus is in Israel where the opportunity is unique and has barriers to entry, along with what we perceive to be a significant information advantage.

Credit

- The outlook for credit is outstanding…..if you are a distressed debt investor. It is not good for mainstream and equity investors. Defaults are on the rise and appear to be headed for an event similar to 2001 and possibly 2008.
- The face value of outstanding high yield bonds has grown by 48% since 2007, and leveraged loans in place have increased by 58% over the same time frame. Large outstanding amounts of debt combined with rising default rates is a dangerous combination.
- Common perception is that the distress is limited to the energy and commodities sectors, but that is just not accurate. We are seeing significant increases in distress in those sectors, along with the media, consumer/retail, telecom and industrials, as well as others. Stated another way, nearly every aspect of our economy where debt is commonly used in the capital structure has some level of distress.
- There is a very strong correlation between earnings declines and defaults. This cycle is not expected to be any different, and unless there is a sharp improvement in earnings, we can expect to see a significant increase in default rates. We believe the opportunity to profit from this cycle is still a few quarters off, but we will be heavily focused on identifying the best way to maximize returns from the cycle.

Energy

- The oil market is roughly less than 2% oversupplied, which is approximately 1 million barrels a day, and is expected to come back in balance via natural forces around the 1st quarter of 2017. Balance can occur faster if OPEC elects to cut production. That is unpredictable so we are not assuming it will occur and so it is likely that the oversupply will be corrected via some combination of three main inputs: depletion rates from existing wells; reduced drilling of new wells; increased demand from lower prices.
- At no time in history have we seen a drop in price of this magnitude, which has been greater than 75%, from such a small supply imbalance. The success of domestic drilling in the U.S. has driven the amount of oversupply as other regions of the world have remained essentially flat. Capex in the U.S. dropped by ~30% in 2015 and is expected to drop by an additional ~30% in 2016. This will have an enormous impact on the amount of new production coming online.
- Natural gas prices have continued to be under immense pressure from the oversupply that has been created by incredible technological improvements. We have been a victim of our own success, and it will take a continued reduction in drilling and/or a significant adaption of natural gas as a fuel source, far and away larger than the current energy plan contains, to see a meaningful improvement in the supply/demand curve for natural gas.
- Breakeven levels for oil production in most basins remain in the $50 - $60 a barrel range, and the longer the price of crude stays below that level, the more stress this will create on the balance sheets of nearly every producer. The industry is relatively unhedged in 2016 and almost entirely unhedged in 2017, which creates great concerns if we have a "lower for longer" scenario for prices.
- See our January 18th email (attached below) to all clients for our view of the dislocation of oil prices and how we perceive it to be the 6th "no-brainer" of the last 25 years.

Expect 2016 to be a very interesting year. We urge caution, while at the same time staying alert for opportunities as we see several on the horizon. In addition to oil, we see other unique places to deploy our capital and will be actively discussing these areas with families over the next few months.

We are very proud of our CAZ team. It is the strongest we have seen in the firm's 15-year history. This is a year where you can expect some additional technological improvements in the way that we communicate with you. We have heard your suggestions, and we are working to put these in place. Thank you for co-investing with us, and we hope that you have an outstanding 2016. Make it a year of positive impact on those in your sphere of influence.

The Team at CAZ Investments

From: Christopher Zook [mailto:caz@cazinvestments.com]
Sent: Monday, January 18, 2016 6:37 PM
Subject: CAZ - Special Market Dislocation Update

CAZ INVESTMENTS
Access to Innovative Investing

Today we are sending special correspondence to all clients, because we believe we are very close to a pivotal point in the markets that must be highlighted. Please read the entirety of this email as it is incredibly important.

We don't send special correspondence like this very often. The last time we sent out a memo of this type was on March 2, 2009, when the S&P 500 was trading below 700 for the first time in nearly a decade. We sent an email to all clients about the extreme buying opportunity we believed existed at that time in the stock market. Here are a few excerpts from that email, and we encourage you to read them as history is known to repeat itself and we believe it may be today in a different asset class. We have underlined a few key sentences for readers to focus on:

"In our 1st Q letter we will expound on our reasons for being bullish, but suffice it to say for this correspondence that this is the time for people to be aggressively allocating money to stocks and risk assets. The returns earned from these levels will be very dramatic. Fortunes will literally be made from these levels.

Many people have heard me say that there have only been a few "no-brainer" situations that I have seen in my career. The first was that the financials were an incredible buying opportunity in 1991. The second was that the tech bubble would burst in 1999. The third was the buying opportunity in stocks in 2002. The

fourth was that the housing bubble would burst. The fifth is undoubtedly today. Stocks will go considerably higher from $700 on the S & P 500 that we closed at today.

<u>The hardest part about "no-brainers" is that they usually fly in the face of everything you hear and, more importantly, what you feel. Great investment returns come from thinking clearly when everyone else is losing their head.</u>

<u>Are things ugly out there? Of course, and that is why the market is at this level. That is what creates opportunity.</u> For those that have less equity exposure than their target allocation, they need to be putting capital to work NOW. <u>Could it go lower? Of course, but one thing we feel is abundantly clear, we are LOT closer to the low than we are to the high.</u> People will look back 10 years from now and ask themselves, "Why didn't I put more capital to work at 700 on the S & P 500?"

To be 100% clear, the purpose of this correspondence is **<u>not</u>** to focus on the stock market. We have been very cautious on the general stock market and we continue to believe there is far more risk on the downside than there is upside potential. Today we are certainly less expensive than we started the year, after an 8% drop in the S&P in two weeks! So, we believe the market may well bounce from here but it would not surprise us if we have begun a serious correction phase for the markets. Our overall market commentary will be more detailed in our quarterly letter, which you will receive in the next few weeks.

This special correspondence is being sent to highlight what we see as the sixth "no-brainer" since 1991. We believe the risk/reward in energy right now is one of the best we have seen in the last twenty years. Everyone is likely aware how much pain has been endured by those exposed to Oil, Natural Gas and the stocks of the same. Oil has dropped from $130 to $29, Natural Gas has fallen from $10 to $2 and some of the very best companies in the E&P space have fallen by more than 75%. It has been amazing to watch this unfold over the last 14 months and

we believe it is going to provide one of the best buying opportunities of our generation!

Please read this next sentence carefully! This does not mean that the risk is gone and people should plow into the energy sector, there is still a massive amount of pain that we expect to be experienced by companies operating in the sector. What it means is that we are at a point where investors should be developing their game plan how to take advantage of the opportunity. It is appropriate to literally paste a few quotes from the March 2, 2009 letter, as they all apply the same today as they did then:

The hardest part about "no-brainers" is that they usually fly in the face of everything you hear and, more importantly, what you feel. Great investment returns come from thinking clearly when everyone else is losing their head.

Are things ugly out there? Of course, and that is why the market is at this level. That is what creates opportunity.

Could it go lower? Of course, but one thing we feel is abundantly clear, we are LOT closer to the low than we are to the high.

And to paraphrase the last sentence above from that letter, people will look back 10 years from now and ask themselves, "Why didn't I put more capital to work at $29 Oil?"

We fully appreciate all the bearish cases regarding technology, Iran, slowing demand etc… If those bear cases were not legitimate, prices would not have broken $30!! Just like in 2009 when people thought we were crazy for taking a stand below 700 on the S&P, we expect people to be similarly surprised by this email. That extreme market psychology is what creates opportunity.

History will judge whether or not this letter was premature or if we acted close to multi-year lows. We don't pretend to be able

to pick the exact bottom but the absolute anarchy and "throwing the baby out with the bath water" that we saw at the end of last week, with massive volume and amazing negative moves within the sector, lead us to believe that we are getting very close. Many great companies in the sector were down 20-35% for the week! Numerous smaller companies were down 30-50% for the week! Extreme moves of this type usually indicate that people have "lost their heads." It is at that time that we want to think clearly.

So, what should our clients do with this information? First, know that we are implementing strategies in our Liquid Growth Fund to maximize our opportunity from this market anomaly. That is the advantage of being an investor in that vehicle, as it has maximum flexibility and can act quickly. The next opportunity to invest in that Fund is at the end of January so please let us know if you would like to discuss. Second, if you have significant holdings in the energy space, be proactive in evaluating the companies you own to be sure they will be a survivor. Don't be an ostrich and pretend this will go away. There is a very, very good chance that more than half the energy companies in the U.S. will endure a restructuring of some type. Third, be on the lookout for correspondence from us as we are preparing for the launch of the CAZ Energy Opportunity Fund. This Fund will be dedicated to taking advantage of this market dislocation. We do not have the final details in place but we wanted to make everyone aware that it is coming soon.

Thank you for taking the time to read this letter and stay tuned for more information as it comes available. All our very best and we look forward to a great evening on Wednesday night, at our Themes for 2016 event. We are at the ballroom's maximum capacity and it will be a wonderful night.

The Team at CAZ Investments