CAZ Special Market Update – 2020.0318

(Charts referenced in the recording are included at the end of this document)

Thank you for joining us for this special update on the March 18th, 2020. A lot has happened since Saturday when I gave the last update. It's amazing how much has changed in our world in literally four or five days. So, two very interesting things are happening.

First, the country's completely shut down. Obviously, we knew it was partially shut down, but now we have effectively all bars, restaurants, and social events of any kind have been locked down in San Francisco. They're effectively under martial law, and they're having everybody shelter in place. New York is potentially talking about *potentially* having military in place in order to effectively enforce the lockdown. And for the first time, certainly in my lifetime and probably even much further than that, there will be no live personnel at the New York Stock Exchange. Everything will be purely electronic.

Secondly, as the virus continues to escalate and get everybody's attention and the economy continues to shut down, the market stopped going down completely. It doesn't feel like that, but I'll get back to that in just a moment. We are consistently testing the lows from last Thursday that happened after the NBA canceled activities, after we had some very high-profile virus-related activity and other cancellations. However, the market obviously rallied dramatically on Friday. We talked about that this weekend. We then saw the market sell off dramatically and today we tested those lows *again*, but we haven't broken them. We broke them a little bit today, but then we rallied back to close above them.

For reference, this afternoon we were taking steps to make this call, and we changed our positioning at about 1:30pm when the S&P 500 was trading at roughly 2,300. We closed today at just under 2,400. But, it's interesting how the indices have kind of stopped going down that much but the individual stocks have continued to get hammered unlike anything we have seen in a very long time. What is interesting as we look at history is how fast this bear market has happened. The speed of the decline and the broad-based nature of it is quite remarkable. This is the fastest bear market that we've ever had in history, and it's by almost 50% compared to anything in the last *two centuries*. July 15th, 1896, we had a bear market that happened only 36 days. Even in the crash of ’29, it only took us 37 days to get to a bear market crash. In the crash of ’87, it took us 38 days to get to a bear market.

And of course, now, March 11th, 2020, we hit a bear market level of 20% decline in 19 days. So, we literally have gone from the peak to a bear market in 19 days. That is remarkable. After 9/11, for example, it took a long time to ever get to a bear market. In 2002 it took 417 days. 19 days is all it's taken for us to endure all this pain in order to go from new highs to bear market territory. And the second thing, of course, is that the selling has been very indiscriminate. Everything has gotten hammered. Last night, there was a statistic that 90% of all stocks in the S&P were negative for the day. That’s only happened eight times in 2008 and it has been true in almost 9 out of the last 20 days. Before, it has happened only eight other times. It's broad based. It goes back to something we talked about Saturday related to the amount of index and activity that's out there to where if everybody's a seller, then all those indexes must sell and there are no buyers. And the same is true if anybody's a buyer, then everybody's buying. The index is the index and managers have no choice. They must be a buyer. And we're seeing these wild swings. We saw last week, and it's continued this week every single day. Basically, it's been a 4% range or greater, which is unheard of, generally speaking.

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Now, the Dow's down 30%. The S&P is down 25%, Russell 2000 is down 40%. Emerging markets are down over 26%. But even bonds have been really, really hit hard. Leverage loan index down 11%. High yields down 13%, even investment grade. Keep in mind what interest rates have done over this period time where they've dropped dramatically. Even corporate investment grade is down 44% year to date. We've seen this massive decline in the market. And that, of course, should help us to feel more comfortable with valuations.

Below you'll see the chart of the price to book ratio of the S&P 500 and the price to sales. Those are the same ones that we showed at our Themes event in January and then sent out to everyone as our follow up. You do see a very sharp decline in the price to book and the price to sales. The first comment is that, of course, is based on what we know at this point. We certainly expect book value to decline, and we know revenue is going to decline because basically the economy is shut down right now, but it's not going to be shut down forever. These numbers are helpful to us, even though we know that they're just guidelines of what we should expect out of the market, but using the exact same charts we showed before, if history repeats itself and if the correlation of returns carries forward, then it means that from this point today for the next 10 years, the price to book ratio would indicate we would have a more than 6%, almost 7% annualized rate of return from the S&P 500 over the next 10 years. Easy to see how we're going to get to that level after this kind of a sell off. But what was a 1% expected return over 10 years is now a 7% expected return over the next 10 years, according to price to book. Price to sales has also improved quite dramatically. It's gone from a -3% expected yield annualized return for the next 10 years to a 2.5% annualized return over the next 10 years. It's certainly not great. It's not something that makes you jump up and down with joy. But at the same time, it's improved a tremendous amount. And it does mean that when we look at the alternatives in the world, that certainly they are also better than they were. And what alternatives we have basically as cash, which is now yielding zero since the Federal Reserve's move. Federal Reserve cut rates to basically zero. We saw the yield on the 10-year treasury and everything else come through dramatically lower. And the S&P 500 sure looks a whole lot better than it did just three to four weeks ago.

So, for that reason, we are changing our rating on the CAZ scale from a 2 to a 3. Again, to remind you, the CAZ scale is simple, overly simple, by design; 1 is the worst risk-reward we can possibly see doesn't mean stocks are going to go down, but we don't see a great risk-reward. 2 means a little better risk-reward. But still not excited about it again. This doesn't mean that stocks don't go up during that period. A 3 simply means the risk-reward is balance. After this enormous sell off 30%, we believe that things are more reasonable. If we look at things from a bottom up perspective, we feel even better about many different positions than we did a couple of weeks ago. And I want to stress here before I move on what was different about today, because it was different, it did feel different: Valuations are reasonable. They're not great. A 3 does not mean we're pounding the table. What it does mean is it's safer to get in the water than it was before. And so, as a result of this, we are increasing our rating to a 3, because at least now we feel like we're getting paid well to take risk. Everyone should look at your rate of return as to what it is compared to the risk-free rate. In real estate, they call it a cap rate and the stock market; we call it a P-E ratio. Bottom line, if a risk-free rate is zero right now, you can't expect to make 15% on a regular basis unless you're willing to take either a significant amount out of illiquidity or significant risk; one or the other thing is going to have to occur. The second thing that we must look at is what is the appropriate spread? To the risk free rate that we are looking to achieve, our rule of thumb has been historically three to five over T-bills for something that's very safe; 4-7% over T-bills for something that's got a modest level of risk, and we want 8-12% over T-bills on something that we consider to be higher risk or that has less liquidity. With that in mind, if T-bills are zero, what we want to know today is do we feel good about getting our target returns based on the spread to T-bills that were just articulated? The answer is yes. We feel it's balanced. And we will be a 5 on the CAZ Scale if and when the market gives us the opportunity like it did in 2009 to say it is a no brainer to achieve our objectives. We'll talk more about your action steps at the end of this, but we want to lay that groundwork for you today.

As the legend goes, history doesn't always repeat itself, but it does tend to sound the same. Today, we saw panic and capitulation, we saw “get me out at almost any price”. In response, we started getting a little more aggressive in our liquid portfolios where we can do that, taking advantage of these price dislocations. They were dramatic and there was not much liquidity. As the saying goes, there just wasn't a bid. We became that bid and we put on some positions to take advantage of these dislocated prices. Because things did feel different today, this gives us a little bit of comfort that we may not be hitting the ultimate bottom. I'm not saying we're fine. We may not hit the ultimate bottom today, but this feels like we might stress we have been put in an intermediate bottom. And it felt like people really threw in the towel. Usually that's when we get a meaningful floor in the marketplace.

Today, there were stocks that literally were trading down that did nothing wrong, had no news, and really aren't even that sensitive to the virus in general. They were trading down in two, three, four percent increments in a matter of minutes, and then only to then reverse higher when liquidity returned. And in one case, we bought a stock at $35.60. It closed at $40. Nothing changed, just liquidity changed. And people realized that it probably didn't need to be down 20% at the time that it was trading at $35. That's one of the reasons why we're changing our rating on top of the improvement in valuations, obviously down from 3400 to 2400.

The other thing that's important to notice is that we're starting to see that panic manifest itself in the volatility measures. You'll see below that the volatility index has literally spiked up all the way to the same level that basically it peaked that when Lehman went bankrupt in 2008. We have not seen this in any of the pullbacks last year, December. It’s good if you believe that we're getting close to a bottom. It is also very good if one can recognize this and keep their head about them when everybody else is losing theirs and can take advantage of that volatility and premiums. We have vehicles specifically set up to benefit from the rising premiums. We have one vehicle we're going to launch, specifically in a couple of weeks, that will take advantage of this heightened volatility to give you the metric that's on the sheet in the handout.

The price of hedging market risk in just one metric has risen by over 16-fold in the last 30 days. Anything can happen with this virus, and we don't know what the bottom will ultimately be. However, we feel really good about our odds.

So, what do you do? Today, here we are. It's the night of the 18th. Tomorrow, what action should one take? The first answer is probably very little. If you already had equity exposure, you should then stay right where you are. If you're in the middle part of your band of allocation, if you want to have 20-40% in stocks, and you're at 30%, your great. Have some money you want to put to work and you've just been kind of sitting on it or you want to change your allocation from a 20-40% to a 30-50%. Increase your exposure gradually, maybe over the next couple of days, maybe over the next week, maybe over the next 30 days, up to 40%. But do it gradually and not in one fell swoop. Take advantage as you have the ability to do so from the enormous amounts of volatility that are out there. Not by becoming a day trader but becoming a seller of that volatility. And again, if you don't know how to do that and you're not an expert at it, please hire us to do that for you. We're really good at it. We've done it for our entire career and we would love to do that for you through one of our vehicles that is designed for that. Both vehicles of which are weekly liquidity.

Keep a long-term view. It's one of our principles on our website to see the forest, not the trees. Today, there are a whole lot of trees, we don't know what the next shoe to drop is going to be from the virus. We don't know what exactly Congress is going to do. They talked about a $1.3 trillion stimulus from the Treasury Department today by sending checks to people. We don't know what the effect of this is going to be. We don't pretend to do that, but we want to take a long-term view. When you look at what's happening inside of the private markets, as well as the public markets, the opportunities are as good as we've seen now and not necessarily as good as what we saw in 2009, and we may get there, but this is the best we've seen in six, seven, eight years. In the private equity space, this is a good time to have conversations about their continuity and how to get past this. Because these managers mostly have dry powder right now, they will be able to dramatically outperform our previous expectations over the next three to five years because they're going to put it to work when there's a lot of need for capital in the marketplace, which translates to higher returns.

What we can tell you is that we are here to calm conversations with you about your overall portfolio. Anything we can do to help, please let us know. We're excited about what we can do in this environment. We're very upset about what's happening from a human cost standpoint for jobs and things of that nature, and we want to help anybody we can in any way we can in that regard. But at the same time, the market is giving us an opportunity, we're in the investment world, and I,t's our job to help you be able to navigate these waters and do so in a very profitable fashion. We're excited about the opportunity ahead of us. We're obviously prepared for what might come. And we want to be there for you in whatever way it is that we can be helpful. So please let us know, and we look forward to talking to each of you very soon.

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This market correction has been remarkably quick:

This Was The Fastest Bear Market Ever

Dow Jones Industrial Average Quickest Bear Markets After A New All-Time High

Date Of Bear Market	Trading Days To Reach New Bear Market
March 11, 2020	19
July 15, 1896	36
October 24, 1929	37
October 19, 1987	38
February 2, 1917	53
October 11, 1990	61
February 5, 1920	67
December 18, 1899	74
May 28, 1962	114
December 12, 1901	128
March 11, 1898	130
August 22, 1966	134
July 2, 2008	184
November 26, 1973	220
March 14, 1907	299
September 17, 2001	417

Source: LPL Research, FactSet 3/11/20

A bear market is when a stock index or security closes 20% or more below a 52-week high.

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

The selling has been swift and indiscriminate:

Risk Asset	YTD Return
Dow Jones Industrial Average	-29.86%
S&P 500	-25.45%
NASDAQ Composite	-21.88%
Russell 2000	-40.42%
MSCI Emerging Markets Index	-25.68%
Bloomberg Barclays US Corporate Investment Grade	-4.44%
Bloomberg Barclays US Corporate High Yield	-12.73%
Credit Suisse Leveraged Loan Index	-11.21%

Source: Bloomberg. As of 3/18/20.

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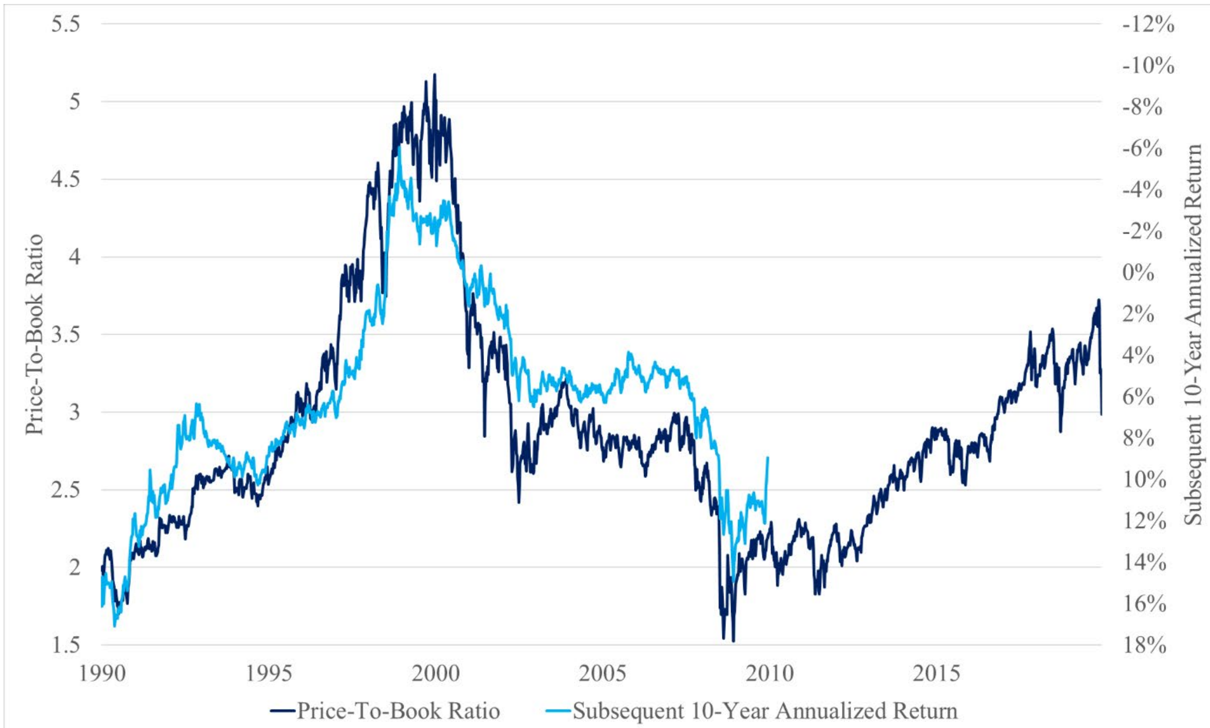
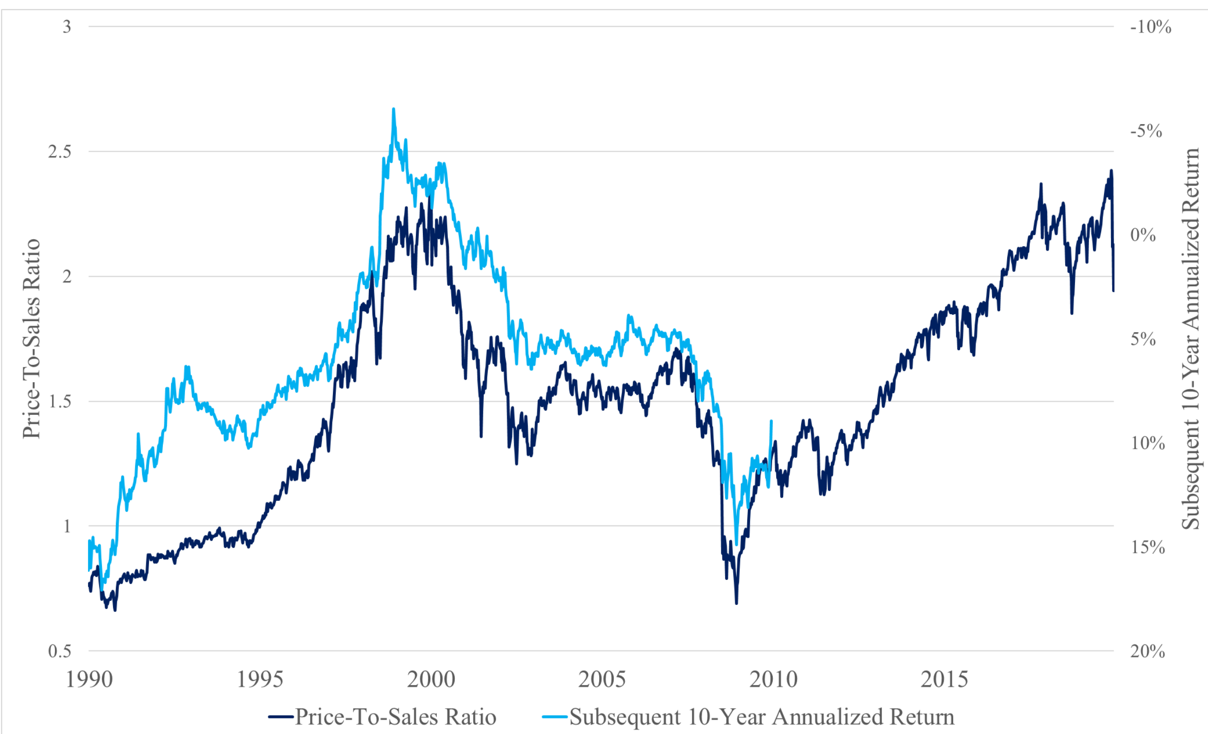
As a result of the selloff, S&P 500 valuations have improved:





Source: Bloomberg. As of 3/13/20.

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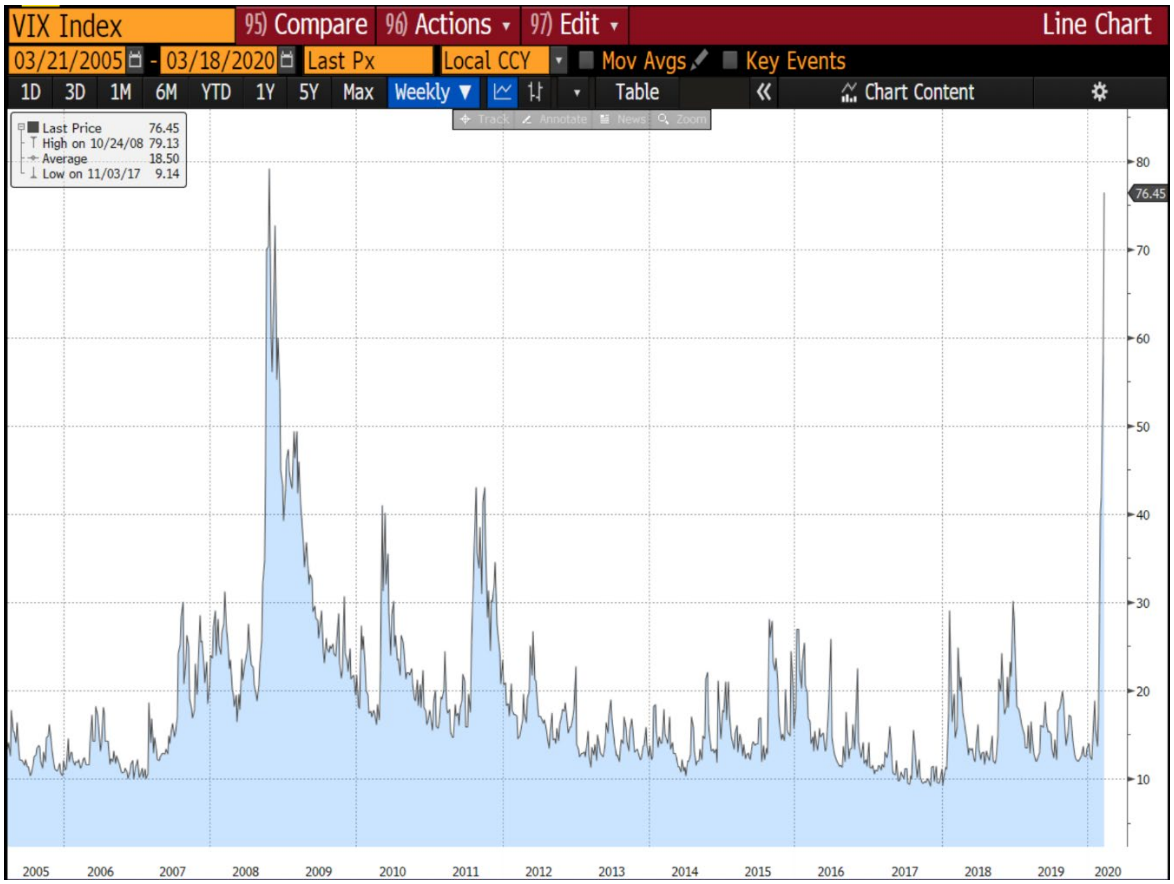
The Volatility Index (VIX) has risen to levels only previously seen during the 2008 Financial Crisis:



Source: Bloomberg. As of 3/18/20.

The price of hedging market risk has risen over 16x in just the last 30 days:

Date	Cost of 30-Day 5% Out of the Money Put on the S&P 500 Index
February 18, 2020	0.38%
March 18, 2020	6.27%

Source: Bloomberg. As of 3/18/20.