

# CAZ Investments

## Quarterly Letter

### The Calm After the Storm

Writing this letter seems somewhat anti-climactic after the extensive dissertation that we delivered in mid-February. We felt it was imperative to provide more background and statistics to explain our view of the world after such a dramatic sell-off. If you have not read that letter, we strongly encourage you to do so. This letter will be short and hit the high points of where things stand as we approach the 2<sup>nd</sup> half of the year.

The markets experienced euphoria, panic and confusion, all in the 1<sup>st</sup> quarter. It never ceases to surprise investors how quickly a market can go from optimistic to pessimistic, and this quarter proved one of our most common adages, which is that “stocks can go down much faster than they go up.” In just a few hours, we wiped out months’ worth of market increases, on virtually no news. This market move was a textbook illustration of what happens when a trade gets “crowded.” When the tide turns, and everyone is in virtually the same position, there is no one there to take the other side of the trade.

After the dramatic sell-off and spike in volatility, the markets became very choppy and entered a trading range that persisted for the balance of the quarter. At this point, all eyes are on the Federal Reserve/Interest Rates, Trade Wars and Earnings reports. Geo-politics are always important, but the market seems to be focused less in that area as North Korea has taken a less aggressive position and has surprisingly begun to appear compliant. (Side note: We are hopeful that the reconciliation on the peninsula is real, but we are very skeptical as to the true intent of North Korea’s leadership.) With that in mind, let’s address each of the key focal points in order.

### Rising Rates vs. Valuations

The Federal Reserve has begun to raise short-term rates and they are not likely finished. The Fed Governors have made it clear that they expect a strong economy on the back of fiscal stimulus, namely tax reform. Market participants are pricing in a very high probability for two additional rate hikes with a modest probability of three increases this year. We fall in the camp that believes there will be three, which should lead to another 75-bps increase in Fed Funds between here and year end. That may not surprise investors, but we think they are going to have to recalibrate their models to account for rates going up faster than expectations.

Intermediate and long-term interest rates have also begun to accelerate their climb with the most watched rate, the 10-year U.S. Treasury yield, rising above the psychologically important 3% level. As the Fed raises short-term rates, long-term interest rates must also climb, barring a severe economic slowdown. As we showed in our last letter, stock valuations are expensive across virtually every metric. As rates rise, they become a competitor to stocks and more importantly, most valuation models utilize some discount rate/cap rate to determine fair value. As that discount rate increases with interest rates, all else being equal, fair value must come down which would imply that stock prices must fall.



### **Trade Talk or Trade War?**

Are the actions taken by the administration going to lead to a full-blown trade war? Or, is this just another negotiating and political tactic that has very little actual impact? We generally believe the latter. Based on what we saw with the tariffs on steel and aluminum, where there was a lot of tough talk but no real bite in the final product, we tend to support the view that this is a lot of show without a lot of substance. It appears to us that the President is doing what he is known for in the business community, which is a very aggressive/over the top initial salvo in the negotiation to shock the opponent. Time will tell if the strategy will work in the political world or if it will backfire, but we tend to believe that cooler heads will prevail. There will not likely be material general economic impact from the actual final product of these trade negotiations.

### **Buy the rumor, sell the news?**

Another common adage that is used at this point in the economic and earnings cycle is that the earnings vs. estimates are not what matters, but actual earnings compared to the “whisper” number will drive stock performance. It is another way of saying that investors will commonly buy the rumor of good earnings, or even a surprise, but once the number is released investors tend to sell the stock, regardless of the amount reported. Why? They do not have another reason to be long the stock for another 90 days. In these circumstances, if the actual earnings report is not even better than the “whisper” estimate, the stock is typically sold very aggressively and can experience a severe decline.

We have seen multiple examples of this phenomena occurring in the last few weeks as companies report good numbers, but not “good enough,” and are then punished with stock declines. Very few companies have been able to outperform expectations enough to receive a markup in their stock price. This is very telling and could be a serious impediment for the market to resume its march higher.

For us, this is the area that we are watching closely. Earnings reports should give us a very good sense of the pulse of the economy and the cash flow growth we should expect from companies over the next few years. We should also learn a lot about the flows of capital as investors weigh rising interest rates against good economic growth. If the market has a “kryptonite,” it is very possible it is the lack of companies that are able to accelerate profit margins in the face of a very tight job market. Keep an eye out for margin compression.

### **Action for Investors**

We continue to believe that the long-term return outlook for stocks and bonds is quite tepid. Unless we see a significant decline in stock prices, it is hard to model out a scenario where investors are going to be able to count on a traditional portfolio to meet their actuarial/return assumptions. Quite frankly, if an allocator of capital simply does what they have always done, they are likely to be severely disappointed with how their returns will fare over the next decade. If someone is a professional allocator, they risk losing their job... We believe that investors are going to need to look where they have not looked before and be open to unique, idiosyncratic, opportunities in order to generate returns of the magnitude they have grown accustomed to. To put it bluntly, the next decade is going to reveal which investors are really capable of creating alpha (similar to the old saying about how, when the tide goes out, we all see who was not wearing a bathing suit!). If an investor is not willing to work for alpha for the next decade, and just wants to count on beta to give them the returns they need, they are in for a rude awakening.



1st Quarter 2018

For this reason, we remain a **“1” on the CAZ Scale**, which is our most cautious position. Valuations are getting better as a result of the selloff, and if company cash flows continue to increase while stock prices stay in this general level, our outlook will improve. We will continue to monitor the long-term outlook for asset prices and will adjust our rating if the risk/reward becomes more favorable.

Therefore, investors should be cautious and reduce their equity weights to the very low end of their target range. Please do not have exposure to long duration fixed income, and be wary of investment areas where valuations are excessive. We continue to favor international stocks over domestic, because they are simply much less expensive, and specifically prefer large companies that provide significant cash flows to investors over small cap companies. Be focused on investments that are creating value and are not just using financial engineering or large levels of debt to generate returns. For the next several years, we need to be extremely diligent to find investors and investments that are actually “wearing a bathing suit.”

The year is moving fast, and we have made a few compelling investments. Every day we are looking at new opportunities for our personal capital, and we will let you know when we make those decisions. As a reminder, we make all investments that we choose for our families available to everyone that co-invests with us. When there is not enough capacity to create a standalone vehicle, we use our fund of Liquid and Illiquid Themes. Every co-investor is able to invest in those vehicles, when they are open. For private investments, that window is open for a short time and then it closes fairly quickly. Once that opportunity has passed, there is no other way for an investor to come alongside us for those investments. Be on the lookout in the next few weeks for more details on the next opening, and please make it a priority to learn more about the very unique investments that comprise that portfolio.

Our team continues to grow, and we are always on the lookout for “superstars” who would be a good fit. If you know of truly unique individuals that we should bring into our family, let us know.

We are always trying to improve the way we report and communicate with our investors. The next phase of this is the launch of an improved website, which will have significant resources for you to access, as well as improvements to our statements. Where we seem to be getting the most positive feedback is with the fund update videos that we rolled out in April. If you have not seen them yet, please take a few minutes to watch them. Each video is 3 – 5 minutes long, with key statistics and commentary on each of our investment vehicles. The objective is to provide, in a very short format, everything that an investor might need to know regarding how an investment is doing. Further, the commentary will include the most current information available as of the date of the recording, even if the information has only been received verbally from the underlying manager. Investors who have watched the videos have enjoyed them and felt they provided a lot of value. If you have any problems accessing the videos, please let us know and we will gladly assist.

Summer is quickly approaching and we hope that everyone will make some time to enjoy themselves. We look forward to seeing you soon.

All our very best,

The team at CAZ Investments

