

CAZ Investments  
Quarterly Letter

**Do Valuations Matter?**

We hope you and your family are doing well and persevering through this legendary time in our world. What was hoped to be a few months of disruption from the pandemic has now become ~6 months, and there is no clear end in sight. The economy is trying to limp along with support from the historical fiscal and monetary stimulus from governmental authorities, but the pain being felt across society is continuing to escalate. We have record unemployment and business failures are occurring at a level not seen since the Great Depression. Nearly all major sporting events are being conducted without fans, there are no significant entertainment events and, just this week, two of the major conferences announced they are not going to have college football, or any other fall sporting events. Earnings for public companies, on average, have plummeted and no one is quite sure when life will begin to return to normal.

And, oh by the way, the S&P 500 is about to make new all-time highs as we type this.... Even while typing the sentence, it is hard to fathom. We will not belabor all the hypotheses as to why the stock market has completely disconnected for the time being with what is happening in the economy. Suffice it to say almost all theories revolve around the all-time lows in interest rates and the historical fiscal and monetary support from the government that was mentioned above. This disconnect can certainly continue, and we are truly hopeful that the world will snap back to normal once a vaccine is proven effective or there is confidence that herd immunity has been achieved. But, as the saying goes, “hope is not a good investment strategy...” Therefore, effective today **we are lowering our rating on the CAZ scale from a “2” to a “1”**, at the current S&P 500 level of approximately 3,380. The 1 rating reflects what we perceive as the least attractive risk/reward environment for stock prices going forward, and one of the absolute worst we have seen in several decades.

To remind everyone, the CAZ scale is not designed to be used for market timing, but it should absolutely be used to make asset allocation decisions. We would strongly encourage everyone to be at the minimum equity allocation that your investment policy design would suggest. To restate one of our most well-known truisms, “sell when you can, not when you have to.”

**Three Primary Questions**

The market may well continue to increase from these levels, but the valuations have now become so extended that the risk of a valuation reset is extreme. The economy could very well improve from here and stock prices perform quite poorly. There are dozens of charts we could post here to support these statements, but at this point it is widely understood that market multiples are at levels practically never seen in history. We also recognize that the next 6-12 months are likely to create binary outcomes in three key areas: the timing of an



effective vaccine for the virus, the U.S. Presidential election, and the resumption of normal hiring practices. We will not go into detail but will provide thoughts on each.

We are not scientists, but we talk to some of the top experts in the field regularly. Those conversations cause us to believe that a vaccine will be available, likely for widespread use, in early 2021. There has been a monumental effort around the world to find a solution for this virus and we have very high confidence in the ability of mankind to overcome tremendous obstacles when there is this much concentrated effort to do so. The science is progressing rapidly and is very promising.

The Presidential election scares us probably more than anything else in the world right now. Not because of who might win and who might lose, while that is likely very important to the pricing of financial assets, but because of the concerns about the legitimacy of the results. What seems clear, at least right now, is that no matter who wins, the other side is likely to believe the results were tainted. In this powder keg of social unrest, it is plausible that we could have significant disturbances that could result from such an outcome. The looming vote in November has us more on edge than any other anticipated event in the 19-year history of the firm.

Hiring is occurring, but at a snail's pace overall and is being driven by a small number of sectors. That must change in short order for the economy to achieve the snap back that financial markets are clearly anticipating. We believe it is very reasonable to expect such a hiring surge to occur in 2021, as long as a viable vaccine can be widely disseminated. The fear we have is that companies will either take a wait and see approach or simply decide they do not need as many people to run their businesses as they thought they did before all this happened. It is impossible to know how this pandemic has either permanently/semi-permanently changed company beliefs and behavior, but it is quite possible that jobs are not created at a rate necessary to facilitate a strong and lasting economic recovery.

We are naturally optimistic as a firm, but we are not going to invest our personal capital without considering the downside scenarios. The next 6-12 months will likely answer each of these three primary questions that we see in the world. During this time, our key focus will remain on preserving capital and investing in themes that have significant tailwinds, where we believe there are very positive asymmetrical return opportunities. Expect to hear from us very soon about two major strategic partnerships we are finalizing, that should give us the ability to execute on that mandate in an extremely preferred way.

Thank you for partnering with us. We appreciate the confidence that you place in our team. Please let us know if there is anything we can do for you. We take your suggestions to heart and continue to try to improve in every area of the organization. As an example, based on feedback from our partners, you will notice two new pages in our quarterly statement design. The information is the same as is presented in the Asset Allocation table, we have just added a new way to look at the information graphically. Now you will see the assets listed by both Liquid and Illiquid, but also where we believe they fit on the Barbell that we use to identify asset type and purpose. We are happy to answer any questions about the approach and how



2<sup>nd</sup> Quarter 2020

we view the investment landscape utilizing that lens. All our very best to you and your family as we enter the home stretch in what has truly been a year to remember!

All our very best!

The CAZ Investments Team

