CAZ Special Market Update – 2020.0314

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

Ladies and gentlemen, thank you for joining us for this special market update from CAZ Investments. As always, past performance is no guarantee of future results, and all funds mentioned are only available to qualified investors via the limited partnership agreement and the private placement memorandum.

Today is Saturday, March 14th, 2020, we are living in truly unprecedented times with the virus scares creating a change in behavior across the globe and certainly impacting the economy in every way. Last week, we saw the canceling of basically every major sporting event around the world; the elimination of all college sports effectively for the remainder of the season, the NBA going on a 30-day hiatus, the Masters being canceled, etc. It really is unprecedented, the disruption that we have seen from this virus. The first thing that is important is to let everybody knows we're fully operational. We are based in Houston and are very used to dealing with natural disasters and putting in place emergency planning. You can reach us at any time, and we can be helpful in any way.

We have never seen markets move with this kind of speed and velocity and veracity. You have to go back to the crash of '87 to find the last time that the market declined 10%, which occurred on Thursday. And then, of course, on Friday, we saw the market rally by 10%. This volatility and this lack of liquidity is something we've been talking about now for several years. As more and more people become passive index investors, it means that basically everyone that's passive is either a buyer or seller at the exact same time. That creates this enormous gap of liquidity which creates air pockets similar to what we saw on Thursday and Friday; where literally stocks were moving 3%, 4%, 5% or even more in a period of seconds, not even minutes.

At our Themes for 2020 event in early January, we indicated that the market was incredibly overvalued and very expensive. While certainly we would have never thought that the catalyst would be a virus, what we did expect was that we were going to see prices come down from where they were. And now that HAS happened, and it's happened with enormous speed, it does create a lot of anxiety, even more so than if it happened slowly. Let's take a step back and let's look at some perspective: we absolutely have seen a pullback that was somewhat expected for an unexpected reason and an unexpected velocity.

But where does that leave us today? What we don't know, of course, is how long the virus is going to persist. We don't know how many people in the US are going to be infected. We don't know when businesses are going to reopen. We don't know when effectively the economy ceases from shut down. We don't know the answer to any of that. The best guesses are those made off educated reasoning and grounded in statistics. We don't want to try to predict when this is going to end, how it's going to end, or what the overall impact will be. Obviously, when it does end, what we want to do is focus on what we know. What we know is that stocks were very expensive coming into this, and now stocks have dropped dramatically. And if you look at where they were Thursday on the close, there were many indices that were down more than 30%, S&P down 27%+, other indices down as much as 40%. Oil and gas totally decimated with indices down over 60% from its peak. What we do know is that stocks have come down a lot, but we also know that they may not actually be cheap yet.

Why is that? Why everybody focuses on price to earnings, but they tend to focus much more on the P and not necessarily the E. What we can say with high confidence is that the economy is likely to go into a recession and that earnings are going to drop dramatically. Yesterday, Apple announced they're closing every single store that they have outside of China for at least two weeks and maybe longer. We know that the cruise business is effectively shut down. The airlines are not completely shut down, but more or less. We know that earnings are going to drop. At our Themes event, we showed a chart that really got everybody's attention. It was price to sales ratio. Company sales are very well-known, somewhat predictable. The chart showed the forecasting of what those levels of price to sales ratios would indicate we should expect. At that point in time, it was forecasting a negative annual return for the S&P 500 for the next 10 years on a cumulative basis. To keep it simple for the purposes of brevity, if the price to sales was too high and the price drops by 20% and sales drops by 20%, we actually didn't get that much cheaper on a valuation basis. We did on price. But on a relative valuation basis, we're not that much less expensive. So, while we have gone from a 1 to a 2 on the CAZ Scale, which means from our least excited on risk/reward to modestly negative on risk/reward perspective, and at some point, we will go to neutral on a risk/reward perspective. Thursday it was getting pretty close, but as we saw after the 10% rally on Friday, things change quickly.

So, price-to-sales have come down, price-to-earnings have come down, and so have sales-to-earnings. We won't know the magnitude of that for at least another couple of quarters. What we do know is that stocks are probably still somewhat expensive on a valuation basis. What we also know is there is an unprecedented amount of stimulus being thrown at the economy and thrown at liquidity in general. Trillions of dollars of stimulus from the Federal Reserve's around the world: fiscal stimulus, monetary stimulus, interest rates that are lower than we've ever seen in the past. What that means is that it is a possibility that we see a slingshot on the other side of this. If the economy shuts down for 60, 90, 120 days, but then we get the "all clear" signal, there is going to be a lot of pent up demand that is going to come back into the marketplace. So right now, it's hard to predict what valuations are going to end up being. That's one of the reasons for the volatility.

Where does that leave us? We have a couple of other things that we know for sure that we know are going to create opportunity for us. The first is that volatility has exploded (no secret there), but the volatility index has gone from 12 to over 80. And obviously, we have vehicles that are designed to specifically benefit from volatility. Our risk overlay has taken us completely out of the market as of three weeks ago, and we're sitting in cash. We will look forward to when the risk overlay that lets us get back into the market where we're going to be able to take advantage of that volatility in a way that has not been available since the opportunity in 1987.

We also know companies, private or public, that have lots of debt have less flexibility, less opportunity to be able to withstand the pain that is being endured right now. So, if you're looking at your portfolio, you must be aware of how much debt is in the companies of which you own or those that are owned by people that you have involved in the management of your assets. Be very careful, because the companies with the most debt will also be the best performers if things start to stabilize or the markets go up, because they have the biggest reason to benefit or be harmed by how long this lasts. So, be aware of where the debt levels inside of your portfolio.

We also know, without any hesitation, that this is creating opportunity. Opportunities in the public markets for sure, but it is also creating ample opportunity in the private markets. The vast majority of private equity managers right now have the largest amount of dry powder that they've ever had in the history of their businesses and certainly as an asset class. They are going to be able to take advantage of opportunities such as acquiring companies with declining valuations and others with too much debt needing to restructure. The opportunities there are enormous.

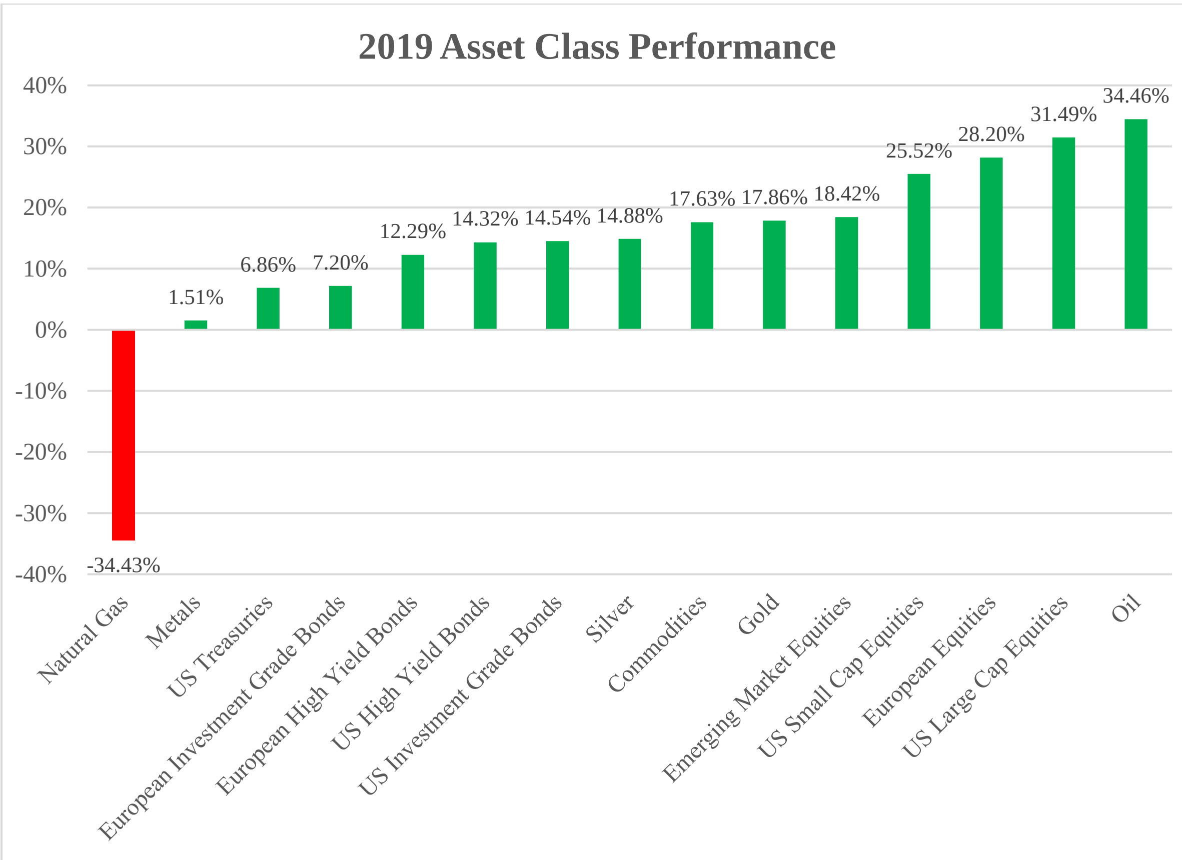
So, what does that mean for you as an investor? The first thing, the most important thing, is you must have a plan. Let your asset allocation decisions that you made in a non-emotional state drive your decisions today. If you were overweight equities at the start of the year, you still likely are, and you need to think about how you incrementally take steps to reduce your equity exposure to a level that's comfortable. If you were underweight equities, you should also be incrementally adding to those positions (not wholesale changes but taking advantage of prices as they improve). As the old saying goes, having a plan is relatively easy and sticking to the plan is tough. Stick with your plan. Don't make emotional decisions. Make small, incremental changes in order to be sure that you are not allowing the emotion of the moment to drive your behavior. Stay focused on themes that you believe are going to persist. Persistence is an important term for us, and we want to find things that are going to persist and benefit well beyond the virus, whether it be enterprise software where we're obviously very heavily involved right now or in the growth of private equity as an asset class. We are focused on themes that are going to be persistent now and in the future. And obviously now, the timing is better from a price perspective to take advantage of all those key themes that we're involved in.

Please know that we're here for you, and please know that we are here to answer any questions you have about any of the investments you have with us. We're here to talk about your overall portfolio. We're happy to give you our opinions. One thing you can count on from CAZ Investments is that we will always have an opinion for you. We are willing to do anything we can to help you and your family from an investment perspective and in any other way that we possibly can. Please take care of yourself, take care of your families and obviously let us know if there's anything that we can do to help you in this time. And obviously, don't hesitate to reach out with any additional questions you may have.

CAZ Investments
Quarterly Letter

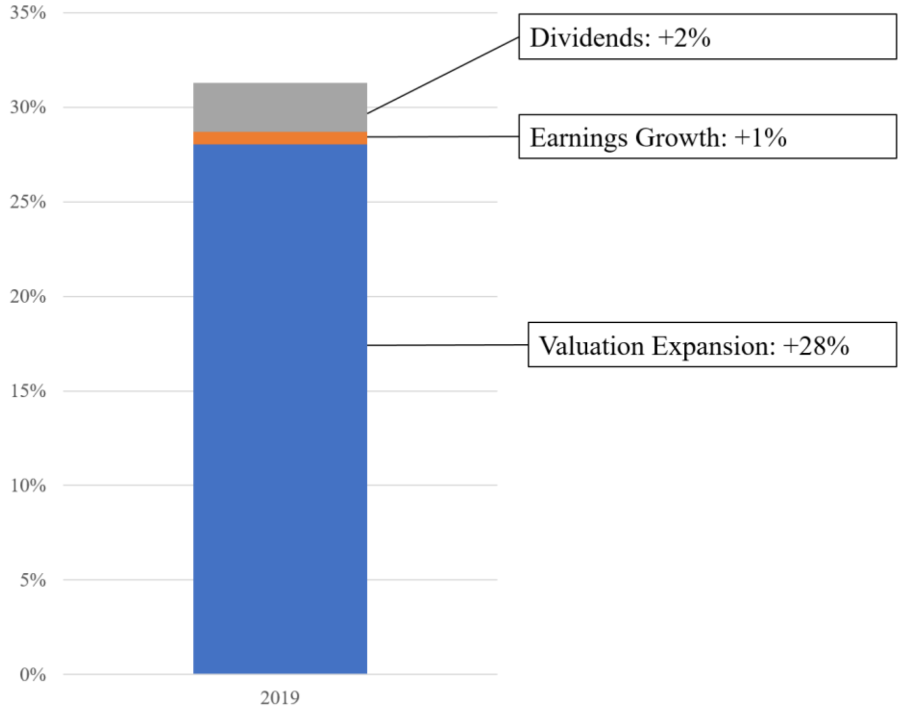
Up, Up and Away

To quote the famous cartoon character, Buzz Lightyear, “To infinity and beyond!” That is certainly what the markets felt like in the 4th quarter of 2019, capping off an outstanding year of performance for nearly every asset class. Risk on was the name of the game as markets began to celebrate the successful completion of the trade negotiations, an accommodating Federal Reserve, and an economy that appeared to be stabilizing.



Just after year-end, we held our Themes for 2020 event, with guest speakers Robert Smith (Vista Equity Partners), Purnima Puri (HPS Investment Partners) and Gabe Cahill (Neuberger Berman) and several of the charts used at that event are powerful enough to reproduce in this document. Below you will find several key points from our Themes recap, and then we will talk about our outlook for the remainder of 2020.

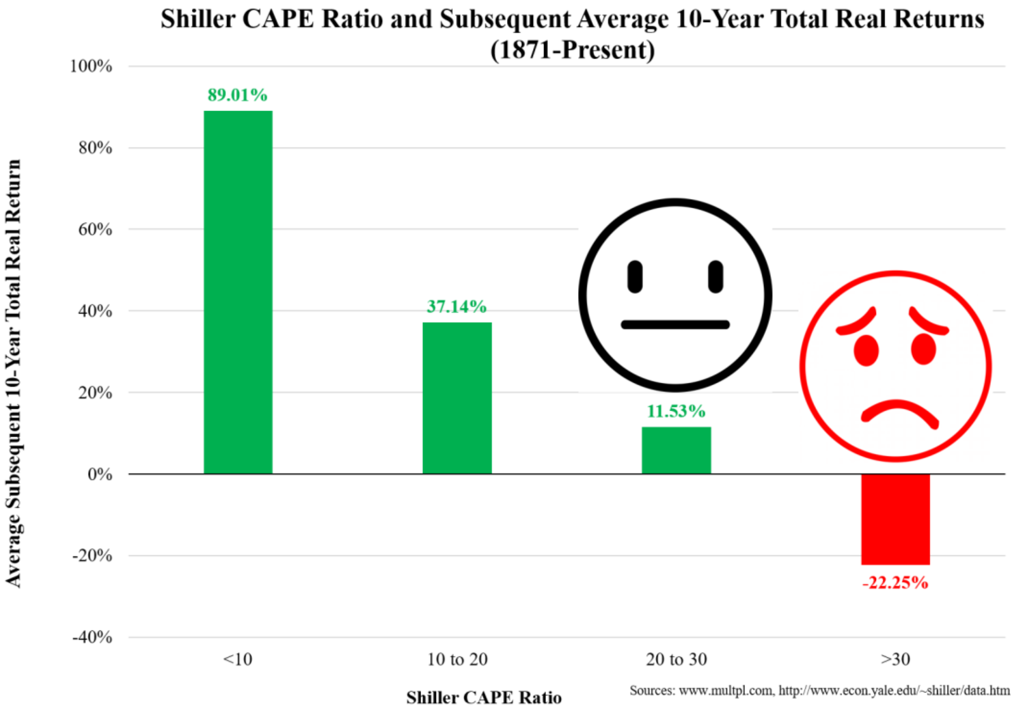
➢ Although it was an excellent year for equities, the S&P 500 return for 2019 was driven nearly entirely by valuation expansion rather than growth in earnings.



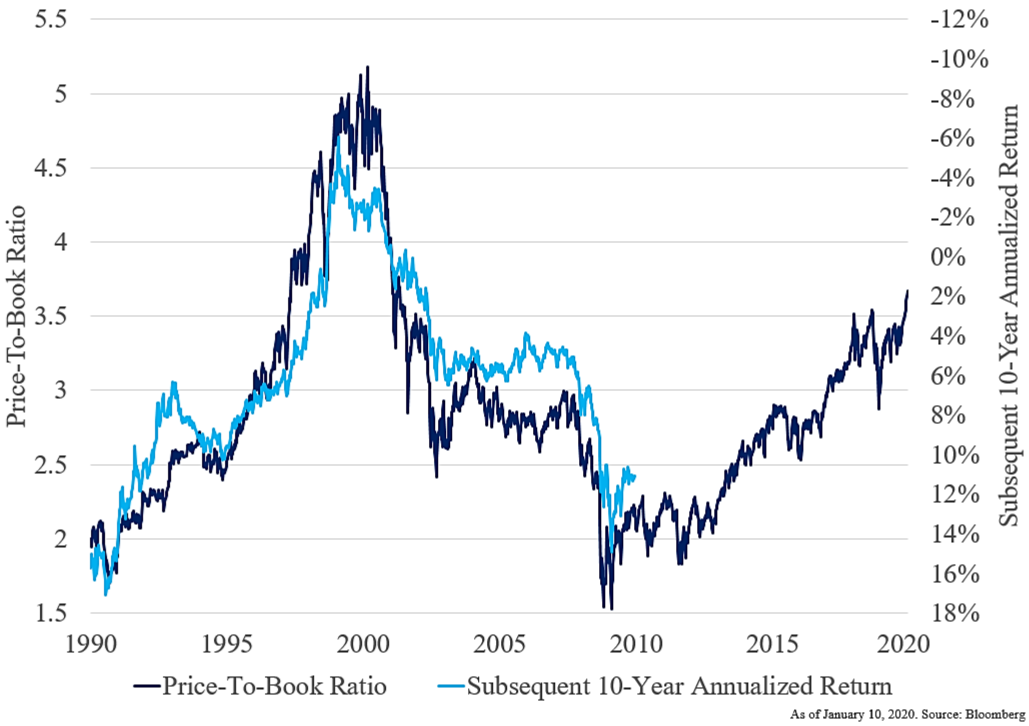
Source: Bloomberg

➢ As discussed at our previous Themes events, the Shiller CAPE Ratio is a valuable indicator of future S&P 500 real returns. As the chart below shows, the ratio has now risen to levels only exceeded by the Tech Bubble of the late 1990's. As a result of the valuation expansion that took place in 2019, the CAPE Ratio is now back above 30. A CAPE Ratio above 30 has historically led to strongly negative 10-year real returns, as shown in the second chart below.

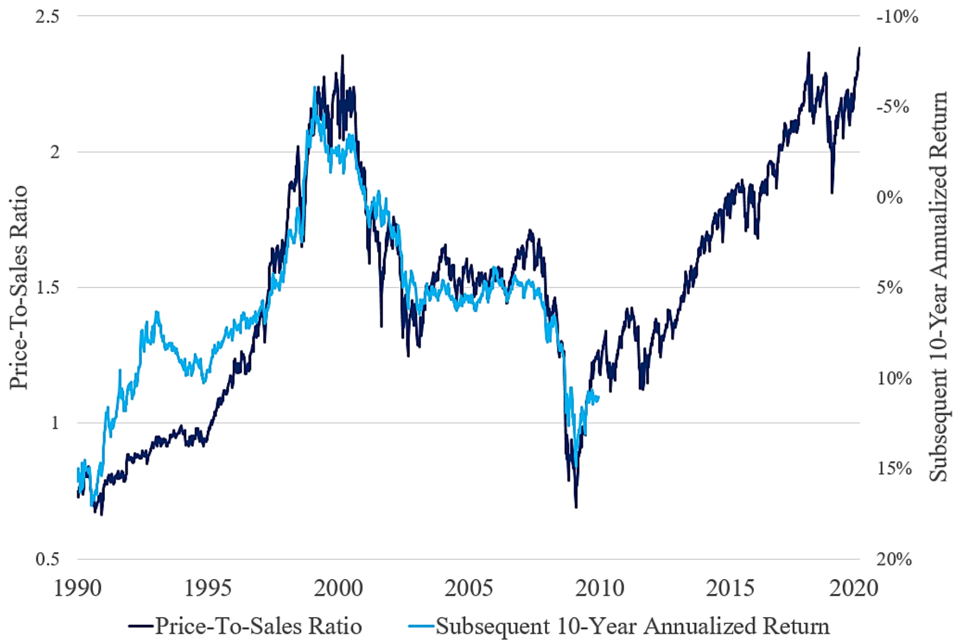
As of January 10, 2020. Source: www.mutlpl.com



➢ Further, the Price-To-Book Value Ratio has been remarkably predictive of subsequent 10-year annualized returns. With the ratio above 3.5, forward returns have historically been very low.



➢ Additionally, the Price-To-Sales Ratio has also been an accurate leading indicator of subsequent 10-year annualized returns. With the ratio above 2, forward returns have historically been significantly negative. We are now in uncharted territory, even surpassing the Tech bubble.



As of January 10, 2020. Source: Bloomberg

2020 has seen a continued march higher in the market despite the Coronavirus, concerns about worldwide economic growth, and relatively mediocre earnings announcements. Now, as we write this, markets are again at all-time highs. So, where does that leave us? It leaves with an outstanding "tape" where stocks seem to shake off any signs of negative news and charge higher, but very expensive valuations when compared to any historical standard. Indeed, as the price-to-sales chart above shows, according to that metric, we are now more expensive than any time in modern history.

We reiterate that expensive valuations don't mean that stocks must fall, however they do make it harder and harder to predict higher prices. And it means that downside risk is significantly higher than it has been, simply because there is farther to fall if valuations begin to revert to any rational mean. Therefore, we will maintain our rating on the **CAZ Scale of a 1**.

There are potentially serious storms that we see brewing on the horizon, including the economic impact of the virus and the increasing possibility of an openly Socialist candidate representing the Democratic party in the November election. How these matters settle out are challenging, at the least, to predict but it is safe to say that the mindset of investors could be influenced significantly by these factors, as well as several others. To reiterate what we stated last quarter, *the hardest part about valuation driven rallies is that they are typically based on psychology, and that can reverse on a dime. One wrong news headline, or tweet, can change the psychology of the markets which makes it very difficult to predict. That said, we are very aware of the adage "don't fight the tape," and the tape is actually acting quite well. Our caution for investors is to be sure that your allocation to stocks has not grown*

to a larger % of your target allocation than it should be. Sell when you can, into strength like this, not when you have to.

We are more than happy to have conversations with you about your asset allocation and be helpful any way we can. Further, we will continue to let you know what we are doing with our personal capital to generate consistent returns with very little correlation to the overall markets. There are several things that we have in final diligence and we will advise if those opportunities become a reality.

Please let us know if there is anything we can provide to make these letters more valuable. Please remember to access the private page on our website with the videos that contain individual vehicle updates. There is a significant amount of valuable information in those videos and they are worth the time to watch them. All our very best to a healthy and prosperous 2020!

All our very best!

The CAZ Investments Team