Eleon Capital Management

- MARKET OUTLOOK -

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In 1999 and 2001 (i.e., before and after the Dot-Com crash of 2000), Warren Buffet wrote two articles which I believe are very pertinent to today's investing environment. In these articles, he described two investing periods: '1964 to 1981' and '1981 to 1999' (each with a duration of 17 years). In the first period, the Dow Index went from 874.12 to 875 despite GDP growing by 370%. In the second period, it went from 875 to 9181.43 (one of the best investment return periods ever), whilst GDP growth was less than half the previous periods at 177%. He went on to explain that there were two fundamental and one psychological factor(s) that drove those returns.

The first factor was interest rates –

the higher they are,
the lower the valuation
of any cash producing asset.

So, for example, in the first period, long-term interest rates went from 4% to 15% as the Fed was tackling the high inflationary period of the 70s. In the second period, however, they went from 15% to 5%.

The second factor was after-tax corporate profits (or free cash flow, to be more precise). In the first period, corporate profits trended from healthy in the begging to sub-par as the effects of inflation took hold but thereafter, in the second period, the trend began to normalize.

The third factor was human/market psychology. Warren Buffet noted that as interest rates continued to rise in the first period and corporate profits were decimated by inflation, investors began to expect these pessimistic conditions to continue to prevail and priced these doom-and-gloom predictions into their valuations. Subsequently, as conditions began to recover in the second period, they reversed their pessimistic outlook, expected the boom times to prevail and pushed valuations to extremes by 1999. He elaborated that in 1971 pension funds (i.e., long-term instruments managed by professionals) in the US were allocating close to 91% of their cash flows to equities vs 13% by 1974. He said: "Consider the circumstances in 1972, when pension fund managers were still loading up on stocks: The Dow ended the year at 1020, had an average book value of 625, and earned 11% on book. Six years later, the Dow was 20% cheaper, its book value had gained nearly 40%, and it had earned 13% on book ... long-term corporate bonds were yielding about 9.5%. So, I asked this seemingly obvious question: Can better results be obtained, over 20 years, from a group of 9.5% bonds of leading American companies maturing in 1999 than from a group of Dow-type equities purchased, in aggregate, around book value and likely to earn, in aggregate, about 13% on that book value? Stocks were demonstrably cheaper in 1978 when pension fund managers wouldn't buy them than they were in 1972 when they bought them at record rates." He further said. "Now, if you had read that article in 1979, you would have suffered--oh, how you would have suffered! --for about three years. I was no good then at forecasting the near-term movements of stock prices, and I'm no good now..."

Mark Twain said: "History does not repeat itself, but it rhymes". We live in a world of high inflation, government, corporate and household debt levels, rising interest rates, and structural risks regarding ETFs. While things are not as they were, there are similarities. The lessons we can learn:

- Fundamentals matter over the long term. Interest rates will affect the value of all assets – as they rise, asset values will fall and vice versa. In addition, they will make companies' debt servicing abilities more challenging. Inflation will hurt corporate profitability.
- Both good and bad times won't last forever, but there will be periods when no matter how rational investment decisions are, there will be periods of pain for investors as fundamentals are not always reflected in asset prices.
- Over the long term, companies with good sustainable (both absolutely and incrementally) returns on invested capital will perform well when bought at fair prices. This is because whilst most companies adhere to economic laws of mean reversion (due to competition), there are some companies (very few, for that matter) that those laws are not applicable.
- While inflection points can be very challenging (and can inflict much short-term pain on investors), they can be very profitable for investors over the long term, especially those who can ride out the short-term volatility. The key is to make sensible, relative fundamental decisions when comparing expected returns between asset classes.

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