May 26th, 2015

"Getting to the top is optional"…

Ed Viesturs is the most decorated American high-altitude mountaineer, having successfully climbed all of the world's 14 mountains eclipsing 8,000 meters (a feat only 12 other people have accomplished) and the sixth person to do so without the aid of an oxygen tank. His credentials entail 29 Himalayan expeditions, trekking 21 mountain summits of over 8,000 meters, and standing atop Mt. Everest on seven different occasions.

Viesturs credits his climbing success to his simple motto that any climb has to be viewed through the prism of a round trip. All of his planning and focus during his climbs maintain this ethic and he is not shy about turning back from a climb if conditions are too severe. In 1987, on his first Everest attempt, Viesturs backed off just 300 feet from the summit because conditions were not right, as he adhered to another one of his principles: "Getting to the top is optional. Getting down is mandatory."

This conservative approach is about risk management as well as being patient enough for conditions to allow an ascent. In his words, "the mountain decides whether you climb or not. The art of mountaineering is knowing when to go, when to stay, and when to retreat." This philosophy has allowed him to procure a track record where he has never lost a team member on a climb, and no one was ever seriously injured.

Viesturs believes most accidents and deaths on the high peaks are due to human error, where ambition and desire overpower common sense. What some people refer to as "summit fever", he calls "groupthink", which is when a majority of the group, desperate to reach the top, disregard variables that suggest the path forward is unsafe (dangerous weather, route conditions, and other important factors). On these occasions, the least experienced climber tags along with the group believing that if everyone else is going, then it should be just fine. Viesturs chronicled such an experience in a 2010 interview he gave to Slate magazine, "Into Thin Error", recounting a 1992 expedition to K2 in Pakistan:

> "About halfway into the day, the clouds below us slowly engulfed us, and it started to snow pretty heavily. I always contemplate going down even as I'm going up, and I was thinking, "You know what? Six, seven, eight, nine hours from now, when we're going down, there's going to be a tremendous amount of new snow, and the avalanche conditions could be huge."
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> I talked to my partners and they were like, "What do you mean? This is fine." So I was kind of alone in my quandary. I knew I was making a mistake; I knew I should just simply go down… I kept saying, "Well, let me go on for another 15 minutes and then I'll decide." And then after 15 minutes I'd say, "Let me go on another 15 minutes and then I'll decide." And I just couldn't make a decision, and I put it off so long that I got to the top.

> Even though we succeeded, I don't ever want to do that again. We just got really, really lucky. There were moments I was convinced we weren't going to make it down, when I said [to myself], "Ed, you've made the last and most stupid mistake of your life." When we got to camp, I was just so angry with myself….
> … It doesn't matter how long you've been there, how much money you've spent, how much energy you've expended. If the situation isn't good, go down. The mountain's always going to be there. You can always go back."

It is not Viesturs success or credentials that stood out to me most, but his approach to risk management and conservative philosophy that I believe are invaluable takeaways for investors today. His accomplishments are a by-product of his preparation, discipline, and awareness of what is truly important, once again as he says it, "Getting to the top is optional. Getting down is mandatory".

That phrase rings loud in my mind each time I read it, as it epitomizes perspective. Today, investors and stewards of other people's capital, like myself, face a similar dilemma when evaluating the terrain that lies ahead for the capital markets. The current equity bull market is now in the throes of its 6th year and is the fourth strongest and longest bull market in history. By a day count this bull market has now surpassed 1900 days and follows one of the most significant bear markets in history. For a gauge of just how rewarding it has been for equity investors the chart below compares this bull market to the recovery in stock prices following three previous significant bear market cycles.

Quoting from Ed Viesturs once again, "When I am climbing, I listen to the mountain. All the information is there, which helps me decide what to do. Arrogance and hubris need to be put aside, and humility and thoughtfulness are essential. I truly believe that is how I survived so many expeditions into a dangerous arena."

Likewise, it is important for investors to objectively analyze the litany of information available in the capital markets to ascertain what to do. Navigating the various stages of a bull market cycle has many parallels to traversing up the terrain of a mountainside. As you click ever higher in elevation you need to constantly reassess the probability of future outcomes before deciding whether to push ahead, chart out an alternative course to reach the summit, or retreat.

Complicating this evaluation is the mental challenge to keep your emotions grounded and in check. It is an extremely difficult task for human beings to look at the recent past and forecast that the future will be any different – it's referred to as Recency Bias. I've never climbed an 8,000 meter mountain, but knowing myself, I believe that if I achieved an elevation of 7,900m on a climb and only had roughly 300 feet to go it would take 'an act of God' for me not to push forward and accomplish my objective. Irrespective of all the warning signals that may be ringing in my head as I set out on this final ascent I would probably fall back on the rationale that I've made it this far, and I can overcome the next 300 feet (no matter how challenging it may be) just like I did the first 7,900m.

Recency Bias in the capital markets refers to investors evaluating their portfolio performance based on recent results or on their perspective of recent results and therefore making incorrect conclusions that ultimately lead to incorrect decisions about how the stock market behaves. While being cognizant of Recency Bias and unwilling to allow investors to succumb to its hypnosis or get caught up in "summit fever" with stocks ascending to new all-time highs, I believe it is appropriate for investors to take a fresh look at the global economic and capital market backdrop today. In my opinion, the elements that drive capital market prices can be simplified to three variables: 1) fundamentals, 2) valuations, and 3) sentiment.

1. Fundamentals: This economic recovery which began in mid-2009 has undeniably been one of the weakest in history; whether you look at real or nominal GDP growth, it doesn't really matter. The reasons supporting such a sluggish recovery are numerous: lingering aftershocks of the post-crisis wave of deleveraging (both domestic and internationally), household balance sheet restructuring and increased savings, global resynchronization, stop and go fiscal policy, individual social stabilizers which dis-incentivized the unemployed to seek out employment, and an incentive system that favors corporate debt issuance to fund stock buybacks and dividends over real capital spending commitments. However, what this economic recovery has lacked in magnitude it has surely made up for in duration as we move past 70 months in length for this expansion – over a year longer than the average post-WWII expansion.

   All in all the fundamental backdrop is rather favorable: corporate balance sheets are flush with cash and not overleveraged, household net worth is at all-time highs, both residential and commercial real estate continue to recover (not to mention picking up steam over the last 6 months), unemployment levels are approaching pre-crisis levels, initial claims for unemployment insurance are back to levels last seen in 2000, growth is gaining momentum in other significant economic regions of the world, namely Europe and Japan, China is tapping the monetary policy spigots to maintain its growth objectives, inflation is low and gradually moving towards the Feds 2% target, and monetary policy remains extremely accommodative even if it is moving in the direction of becoming less accommodative.

   Typically by this point in the economic cycle the Fed is already well into its interest rate hiking cycle, but the economy still operates with a 2% output gap which is one reason why the Fed has been and will continue to be patient even as it begins to normalize rates. With the level of excess capacity that exists today, the Fed can bide its time, waiting for the output gap to close and soak up the prevailing excess capacity before pursuing tight monetary policy.

   Furthermore, as we learned last week from the Conference Board LEI (leading economic indicators), the economic recovery continues to push forward. In the six-month period ending April 2015, the leading economic index increased 2.0% (about a 4% annual rate) with the diffusion index showing seven out of the ten indicators increasing in April. It's not until the year-over-year growth rate of the LEI hits the 0% barrier that investors need to start worrying about a recession. Couple this with a relatively steep yield curve (as measured by the difference between the 10-year Treasury yield of 2.14% and the 2-year Treasury yield of 0.62%) with the 10s-2s spread measuring a healthy 1.52%. Why this metric is worth monitoring is because the last seven recessions were foreshadowed by an inversion in the yield curve (the spread goes negative).

As I have mentioned several times in past commentaries – recessions are the most destructive backdrop to an investor's portfolio, because in a typical run of the mill recession earnings decline on average about 25-30% and stock prices decline 25-30%. This is an environment that is better to be avoided and managed with prudence rather than throwing caution to the wind and winging it. However, at the current time it looks like a recession is a worry for 2016 or 2017, but not today.

Yes, this has been a frustrating, sluggish economic recovery, but it has also been a very long cycle which is perhaps one reason why investors have been willing to pay a premium valuation for stocks. The common fear among investors today is that once the Fed makes its initial volley on its rate hiking cycle then all bets are off. I can understand this line of thinking given the unprecedented monetary policy that has been implemented in this cycle, and it's likely that when that day comes there will be volatility. Hence, why investors should keep some powder dry and not get too far out over their skis on the risk spectrum, but this strategy is different than going to the sidelines and getting out of the game.

Similar arguments were made prior to the start of the last rate hiking cycle that started in 2004 and lasted through 2006 – funny to think that it's been almost a decade since the last Fed rate hike. But over that two year stretch of 17 successive 25 basis point rate hikes the stock market virtually doubled. So, putting all your chips on red may not be the optimal strategy today.

Given this script on the fundamental backdrop, acclaimed mountaineer Ed Viesturs may very well conclude that the coast is clear and that the climb should continue. However, this is only one piece of the mosaic of information that such an accomplished climbing vet would use to make an informed decision before continuing his trek.

2. Valuations: This is a variable that is fraught with subjective thinking depending on what perspective the analyzer is taking when evaluating the data. Many prognosticators today argue that valuations are reasonable given the low interest rate and low inflation environment. And I would agree given those caveats, but I came across the below table from Merrill Lynch's Chief Equity Strategist Savita Subramanian comparing the valuation levels today on the S&P 500 to historical averages and to historical averages excluding the Tech bubble (where evaluations got extremely excessive and skew the historical figures upwards).

Table 2: S&P 500 Valuations (as of 4/30/15) -- borders denote metrics trading above their historical average

	Current	Average	Avg. ex. Tech Bubble	Min	Max	% Above (below) avg	Z-Score	History
Trailing PE	17.6	16.0	15.3	6.7	30.5	10%	0.3	1960-present
Forward Consensus PE	16.8	15.1	14.0	9.7	25.1	11%	0.5	1986-present
Trailing Normalized PE	19.1	19.0	17.4	9.2	33.9	1%	0.0	9/1987-present
Median Forward P/E	17.5	14.6	14.3	9.8	19.6	20%	1.4	1986-present
Shiller PE	27.0	16.6	15.9	4.8	44.2	62%	1.6	1881-present
P/BV	2.92	2.87	2.57	1.65	5.87	2%	0.1	1986-present
EV/EBITDA	10.4	9.9	9.5	6.3	15.1	5%	0.2	1986-present
Trailing PEG	1.66	1.55	1.55	1.07	2.42	7%	0.5	2001-present
Forward PEG	1.59	1.32	1.31	0.98	1.82	20%	1.7	2001-present
P/OCF	12.0	10.5	9.5	5.5	19.6	15%	0.5	1986-present
P/FCF	23.0	28.4	24.8	13.1	65.8	-19%	-0.5	1986-present
EV/Sales	2.11	1.80	1.68	0.86	2.92	18%	0.6	1986-present
ERP (Market-Based)	768	450	464	136	880	71%*	1.9	11/1980-present
Normalized ERP	487	275	322	-96	947	77%*	1.0	1987-present
S&P 500 in WTI terms	38.3	22.5	19.5	2.7	109.0	70%	1.0	1960-present
S&P 500 in Gold terms	1.73	1.52	1.19	0.17	5.53	14%	0.2	1975-present
S&P 500 vs. R2000 Fwd. P/E	0.88	0.93	0.89	0.73	1.35	-5%	-0.4	1986-present

*ERP above average implied equities are attractive relative to bonds. Note: Trailing P/E based on GAAP EPS from 1960-77, Operating EPS from 1978-87, Pro forma EPS 1988-now. Market-baed ERP based on DDM-implied S&P 500 return less AAA corp bond yield. Normalized ERP based on normalized EPS yield less normalized real firks-free rate.

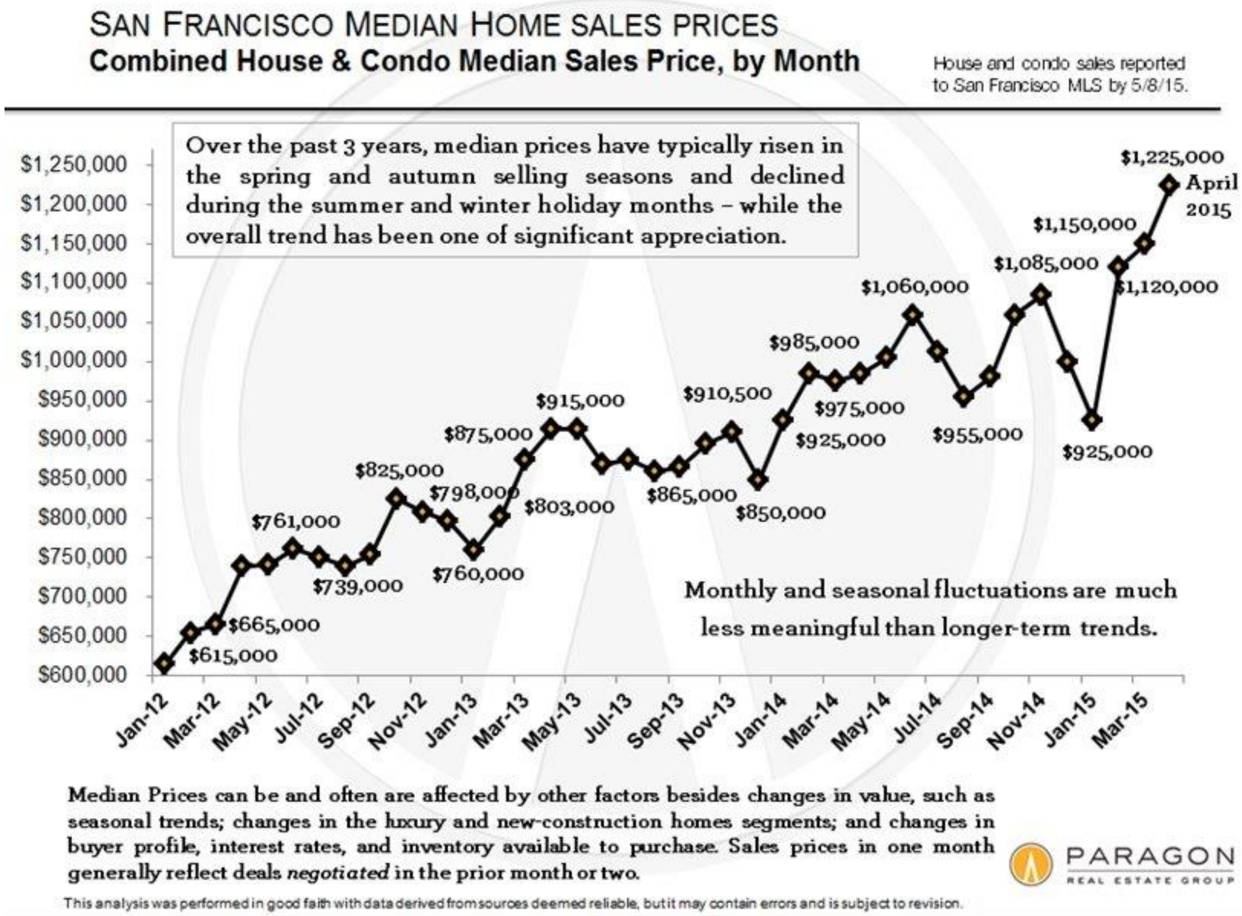
Source: S&P, Compustat, Bloomberg, FactSet/First Call, BofA Merrill Lynch US Equity & US Quant Strategy

On almost every metric, valuations are at or above average, and on a median forward P/E basis the S&P 500 trades at 17.6 – 20% above average and at its highest levels since 2002. The median P/E suggests valuations are much more stretched compared to the aggregate (market-cap weighted) P/E which is 11% above average.

Beyond the absolute valuation levels looking a little stretched, the corporate earnings backdrop remains a little cloudy. Based on the latest data from FactSet, Q1 earnings are largely in the books with 488 S&P 500 companies having already reported with Q1 EPS growth coming in at 0.3% (handily above expectations for a -4.7% decline coming into earnings season). This is the lowest quarterly growth rate since Q3 2012 (-1.0%). More troubling than the flattish EPS growth rate – as it was in large part due to the energy sector with oil prices having been cut in half (excluding the energy sector EPS growth was closer to 8.0%) – was the fact that top line growth declined 2.9% in Q1 (expectations were for -2.6%).

Looking forward, analyst's estimates are for EPS and revenues to decline again in Q2 by -4.4% and -4.5% respectively, with growth in EPS not returning until Q4 and growth in revenue not to resume until Q1 2016. Not exactly the earnings backdrop investors are looking for with valuation levels at cycle highs.

While valuations in the equity market look to be on the high side, other markets – San Francisco home prices for one – are likely more in the frothy echelon. The below chart from Paragon Real Estate Group tracks the median home sales price in San Francisco over the last three years.



The median home price is now 37% above the prior $895,000 peak value in November 2007. This is also having a significant impact on the rental market as the average asking rent in the first quarter hit $3,458/month or $41,500/year (oy vey).

Being six years into this bull market, and I'm not suggesting an imminent end is near, but it is reasonable to conclude that we are closer to the end than to the beginning. Let me remind you that valuation is an extremely poor timing metric for short-term market returns, but a very important factor in determining long-term returns. So what the prevailing valuation levels are suggesting to me today is that future returns are likely to be much more muted relative to the last couple of years. Case in point would be the market action that has transpired so far this year: the range on the S&P 500 over the last four trading weeks has been 11 points, 6 points, 7 points, and 5 points – an average range of 0.3%.

The trouble with coming to an investment conclusion on valuation alone is that it also needs to be conducted with an eye on what other investment opportunities are available. Asset allocation is a zero sum game where when you take capital from one asset class, you are left with the choice of what other asset class to redeploy those proceeds. And while S&P 500 valuations on a standalone basis are high, potential returns from other asset classes do not look particularly compelling. Perhaps this environment warrants a little more reflection on comments from Viesturs: "the mountain's always going to be there. You can always go back."

Like the mountain, the capital markets are always going to be there for investors. I am not suggesting that investors attempt to time the market throughout the duration of this cycle – my philosophy has always leaned towards "time in" the market not "timing the market". But this doesn't imply that you shouldn't make adjustments, adapt, and change your return expectations as the business cycle evolves.

3. Sentiment: This is another variable that can have various interpretations depending on the perspective with which you are interpreting the data. In my opinion, this variable, like the valuations variable, is flashing amber yellow lights. The latest Federal Reserve Flow of Funds data shows equity ownership as a percent of household net worth above the levels prior to the '07 credit crisis and only bested by the levels prevailing at the peak of the Tech bubble. Even at the institutional level of investment management we are witnessing atypical behavior as Reuters published a story last week, "Active stock fund managers load up on ETFs, scrimp on cash" where money managers are redeploying cash coming into their funds in ETF's so that they can keep up with the performance of their benchmark index.

   Merrill Lynch published a report last week indicating that the average dispersion of EPS estimates for stocks within almost every sector is near record lows. In the past this type of "groupthink" was thought to be a sign of certainty, transparency, and predictability of earnings, but today this type of activity may be accurately interpreted as complacency setting in or even a reluctance to deviate from guidance.

   Either way, in both instances – active managers buying ETF's or sell side analysts estimates flocking together – it is an indication that career risk in the financial services industry is on the rise. Meaning that individuals in the financial services industry are becoming more fearful of stepping outside the crowd and making an out-of-consensus call for fear that if they are wrong they may get the axe.

In summary, the investment environment continues to get more complex as this business cycle evolves. Investing and risking one's capital is an individual endeavor which does not have to be done with the crowd. For example, we as stewards of other peoples' capital have our models, our process, and conduct our own analysis, however we still believe that it is of paramount importance to report back to our clients on our views and opinions. Furthermore, it is our communication with them that helps us collectively come to a conclusion about what approach is best for them in the current environment to meet their objectives.

With that being said I would be remiss if I didn't share with them my apprehensions about the prevailing capital market backdrop. Like Viesturs, we are evaluating the pros and cons of trekking forward on our climb given the information at hand. At this point we have not concluded that we want to retreat, but we are climbing with ever greater skepticism and caution. Being aware that any future elevation we achieve is optional, but getting down is mandatory. Investing is unique to the individual, but for most of our clients it is striking an ever delicate balance between capital preservation and return generation.

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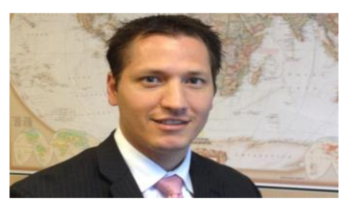

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