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"Anyone who isn't confused really doesn't understand the situation." *-Edward R. Murrow*

The Prudent Man Rule

Dear Investor,

The long bull market may not be over, but the wild swings of the past few weeks illustrate the inherent fragility of investor psychology and the state of global markets.

The on-again / off-again threat of trade wars has been a major contributor to the ups and downs, but there has been no shortage of other issues contributing to the large daily moves.

The recent tariffs on Chinese goods announced by the U.S., and China's potential retaliation, pose a threat to the global economy. American businesses are aggressively lobbying against any trade action by the Trump administration because such moves will negatively impact consumer spending and corporate profits. Protectionist trade policies may be attractive to specific industries, but history suggests that trade wars have a negative impact on most stakeholders.

Trade issues aside, there is no shortage of potential black swans. **Rising interest rates will eventually impact consumers and investors**, while geopolitical issues, such as Brexit, Russia, Syria, North Korea, Venezuela and the splintering of the electorate across much of Europe, each present considerable risk. Any one of these could erupt and lead to a market sell-off.

Finally, valuations across asset classes are not cheap. That alone should make investors wary.

Then, why don't we sell everything and wait?

Despite the aforementioned risks, there are a number of positives which may continue to support markets. First, the global economy is in great shape. The unemployment rate has been declining in most of the world, with the U.S. and Canada close to full employment. The U.S. income tax cuts will provide some offset to rising interest rates for consumers, while giving corporations a significant earnings boost. Many companies responded quickly to the legislation by announcing increased dividends and share buybacks.

Also, the "Bernanke put[1]" mentality is alive and well, as investors are assuming the Fed will continue to raise rates at a measured pace so as not to upset investor confidence. However, even with 2% inflation, the Fed governors are projecting another 5-6 rate hikes over the next two years, which suggests that the

[1] The "Bernanke put" is a reference to retired Fed chairman Ben Bernanke, who was perceived as using monetary policy at least partially to boost investor confidence.

10-year bond yield will rise to at least 4%, up from the current 2.9%, which will probably result in at least some repricing of asset values.

As we witnessed during the dot-com era and the 2005-2007 period, market values can continue to rise well above “fair value” metrics for years; therefore, rising asset prices can certainly persist, especially **if** the best-case scenario plays out.

If...

- Inflation remains relatively benign
- There is no major geopolitical upheaval
- The present economic recovery (already one of the longest on record) continues
- Investors continue to be comfortable buying “risky assets” at rather full valuations with little margin of safety

...then this bull market may continue to run.

Despite the present volatility, our approach remains as it always has. If an investment offers excellent upside and a good margin of safety with a five-year time horizon, we keep it. If not, we sell.

We own a portfolio of quality businesses trading at attractive valuations, but cheap stocks that meet our criteria are not easy to find today, and the result is that we are maintaining our cash position.

Activist investors - buyer beware

Up until about twenty years ago, businesses that had little or no debt were admired by investors for their financial strength and prudence. Their dividends were easily covered by cash flow, share buybacks were a rarity, and they were always prepared for calamity.

However, as hedge funds and private equity firms began attracting large pools of capital, they (and their institutional investors) have driven many public companies to focus on short-term goals at the expense of long-term shareholders. So-called “activist investors” pressure management to spend all of their cash and increase debt to buy back shares and raise dividends, in order to boost share prices and make a quick profit. Their goal is to get an attractive exit as fast as possible, and then move on, often leaving these companies in far worse shape. However, increased leverage means higher risk, and those companies with increased debt levels, have less flexibility when times are tough.

There are countless examples, but GE is a recent one – a once-great company that shifted its focus to short-term results. GE started using too much debt to financially engineer earnings and destroyed tens of billions of dollars of shareholder value in the process. If GE had not bought back its shares over the past five years (at prices significantly higher than the current price!), it would not be forced to sell assets to survive.

For myself, companies that have little debt and a healthy cash position are never the ones that keep me up at night. Yes, earnings may be below expectations for a quarter or two, and the share price can fall, but a strong capital structure gives management the freedom to ignore short-term issues and focus on winning the long game. That is part of the attraction to holding companies such as Cisco, Microsoft and many of our Japanese companies.

On my desk at the office, I keep a list of the five biggest investment mistakes I have made in my career. The shares of each of these companies appeared extremely cheap and offered significant potential upside. However, despite the fact they were in different industries, they all shared one attribute in common – they each had too much debt – and that was their downfall.

High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: **High Yield Quarterly**.

Final Thoughts

In 1830, Judge Samuel Putman of Massachusetts, issued a ruling that is now known as the Prudent Man Rule, when he stated that "[...] a trustee [...] shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, considering the probable income, as well as the probable safety of the capital to be invested."

Investors spend too much time focused on potential returns, without enough attention paid to evaluating risk. The era of zero interest rates is over, and as the risk-free rate rises, it is rational to expect that valuations will revert to a level closer to the mean.

Sincerely,

Lorne Steinberg
President

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