PRICE**VALUE**PARTNERS

What lies beneath

"Briefly stated, the Gell-Mann Amnesia effect is as follows. You open the newspaper to an article on some subject you know well. In Murray's case, physics. In mine, show business. You read the article and see the journalist has absolutely no understanding of either the facts or the issues. Often, the article is so wrong it actually presents the story backward—reversing cause and effect. I call these the "wet streets cause rain" stories. Paper's full of them.

"In any case, you read with exasperation or amusement the multiple errors in a story, and then turn the page to national or international affairs, and read as if the rest of the newspaper was somehow more accurate about Palestine than the baloney you just read. You turn the page, and forget what you know."

- Michael Crichton (1942-2008), quoted by Ben Hunt in 'Gell-Mann Amnesia'.

Surveying the wreckage of markets in 2018, it is human and therefore tempting to put the more optimistic (contrarian ?) case for the year ahead. But our job for the medium term is to protect and grow our investors' capital, not to be optimistic simply for optimism's sake. 2018 was an *annus horribilis* not just on account of the severity of certain market declines, but on account of the universality of those declines. No major market was spared. Apparently, and seemingly uniquely, the Qatari stock index managed to put in a positive return for the year as a whole. Perhaps we should all seek to be embargoed by Saudi Arabia. The extent of the pain is clearly visible in the table below, more extraordinary since it was unaccompanied by the sort of explicit narratives that bombarded investors during a year like 2008:

Asset Class Performance YTD 2018, Q4, and December - Total Return (%)

US Related

ETF	Description	December	Q4	YTD 2018
SPY	S&P 500	-8.79	-13.52	-4.56
DIA	Dow 30	-8.48	-11.29	-3.74
QQQ	Nasdaq 100	-8.65	-16.73	-0.12
IJH	S&P Midcap 400	-11.33	-17.28	-11.18
IJR	S&P Smallcap 600	-12.19	-20.18	-8.49
IWB	Russell 1000	-8.91	-13.74	-4.88
IWM	Russell 2000	-11.97	-20.29	-11.11
IWV	Russell 3000	-9.14	-14.25	-5.41
IVW	S&P 500 Growth	-8.46	-14.68	-0.19
IJK	Midcap 400 Growth	-11.29	-17.69	-10.52
IJT	Smallcap 600 Growth	-12.06	-19.77	-4.39
IVE	S&P 500 Value	-9.38	-12.06	-9.19
IJJ	Midcap 400 Value	-11.39	-16.89	-12.04
IJS	Smallcap 600 Value	-12.38	-20.64	-12.84
DVY	DJ Dividend	-7.98	-9.74	-6.32
RSP	S&P 500 Equalweight	-9.54	-13.90	-7.82
FXB	British Pound	0.06	-2.19	-5.75
FXE	Euro	1.12	-1.51	-5.30
FXY	Yen	3.43	3.52	2.31
XLY	Cons Disc	-7.95	-15.20	1.59
XLP	Cons Stap	-8.91	-4.97	-8.07
XLE	Energy	-12.43	-23.57	-18.21
XLF	Financials	-11.12	-13.08	-13.04
XLV	Health Care	-9.35	-8.66	6.28
XLI	Industrials	-10.65	-17.33	-13.24
XLB	Materials	-6.88	-12.22	-14.87
XLK	Technology	-8.36	-17.35	-1.66
XLC	Comm Services	-7.98	-15.47	--
XLU	Utilities	-3.99	1.37	3.92

Global

ETF	Description	December	Q4	YTD 2018
EWA	Australia	-3.88	-9.62	-12.02
EWZ	Brazil	-2.56	14.98	-2.57
EWC	Canada	-8.55	-15.35	-17.16
ASHR	China	-5.19	-12.40	-28.44
EWQ	France	-5.12	-15.13	-12.88
EWG	Germany	-5.55	-14.76	-21.37
EWH	Hong Kong	-1.05	-4.53	-8.73
PIN	India	0.82	1.91	-7.55
EWI	Italy	-3.43	-11.35	-17.19
EWJ	Japan	-7.69	-15.19	-14.09
EWW	Mexico	3.06	-18.87	-14.59
EWP	Spain	-4.10	-7.69	-15.32
RSX	Russia	-3.64	-8.60	-7.10
EWU	UK	-4.58	-12.10	-14.28
EFA	EAFE	-5.35	-12.62	-13.81
EEM	Emerging Mkts	-3.50	-7.64	-15.31
IOO	Global 100	-7.43	-12.26	-6.22
EEB	BRIC	-5.65	-6.48	-11.34
DBC	Commodities	-3.99	-18.31	-11.62
USO	Oil	-9.97	-37.76	-19.57
UNG	Nat. Gas	-33.79	-0.48	5.96
GLD	Gold	4.94	7.53	-1.94
SLV	Silver	9.01	5.75	-9.19
SHY	1-3 Yr Treasuries	0.76	1.30	1.46
IEF	7-10 Yr Treasuries	2.80	3.86	0.99
TLT	20+ Yr Treasuries	5.85	4.59	-1.61
AGG	Aggregate Bond	1.98	1.85	0.10
BND	Total Bond Market	1.87	1.64	-0.11
TIP	T.I.P.S.	0.53	-0.52	-1.42

Source: Bespoke Investment Group

As we have written before, historians tend to break their sources down into two types. There is the primary source – the eye-witness account, say, of a major incident, from someone physically present at the time. And there is the secondary source – a journalist, say, phoning it in. Which is why we cite the Gell-Mann amnesia effect, just in case anybody still takes financial journalists seriously any more.

In markets, there is only one primary source: the non-negotiable history of the price, as determined in a free exchange between willing participants. Everything else is a secondary source, and certainly market commentary from the financial media, which is always and for all time a long way from any objective reality.

Fundamentally, however, there is another primary source, and in the world of listed equities it is one that trumps even the price. That source is the company itself, reporting on the health of its underlying operations (honestly, one trusts – which is one reason why our portfolios have no or negligible exposure to the emerging markets of China and India, where corporate governance is *literally* another country).

The slow waltz between these primary sources can be seen nicely in the chart below.

The history of Seaboard Corp, 1995-2019

Source: Bloomberg LLP

The chart shows three lines. Let's account for the pink line first. It's the S&P 500 stock index. Over the last 23 years, the US market has returned 446%.

The admittedly more volatile white line denotes the share price of Seaboard Corporation itself. Seaboard is a diversified agribusiness which, in the interests of full disclosure, is a stock we own and love. Over the last 23 years, Seaboard has generated returns for its shareholders of 1447% - albeit hardly in a straight line.

Which is where the third line comes in. (The third line being our super-primary source, as discussed above.) The third, green, line denotes the book value per share (or intrinsic value, if you prefer) of Seaboard Corp. Note that whereas the share price is wildly erratic over the shorter term, the growth in book value is a sedate festival of sweet rationality by comparison. It's certainly a far smoother upwards ascent.

Our takeaways from this slide ?

One: there are clearly companies out there capable of beating the market. Not that this is our primary objective. Our primary objective is to protect our clients' capital. But if we can secure outsized returns in the process, so much the better.

Two: over the longer term, the share price – at least in the case of Seaboard – tends to track growth in the company's intrinsic value.

Three: but in the shorter term, the share price can trade at both a sizeable premium to intrinsic value, and also (more rarely, in this case) at a discount to intrinsic value.

Four: provided the company in question is sound, and is run by highly competent, shareholder-friendly management, being presented with an occasion to buy the shares at a discount to the company's intrinsic value can be a hugely attractive opportunity for longer term profit.

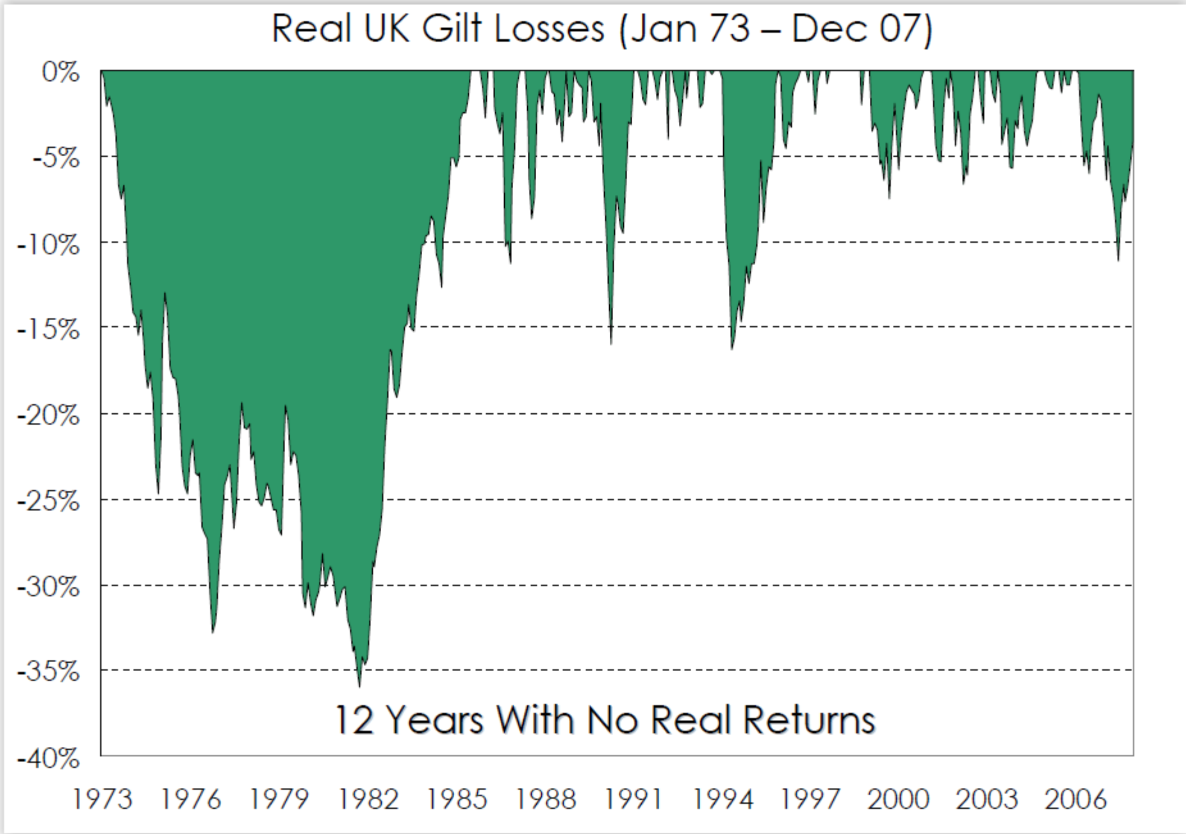
Five: there are only four takeaways. And there only need to be.

Too many investors are distracted by the noise of the stock market to focus on the underlying numbers that matter – those provided by the companies themselves. But even more helpfully for active investors, there is now a giant cohort of investors who have essentially abandoned the search for value and are content to own everything in the market, provided the vehicle they can do so within charges only a modest fee. The phrase 'penny wise and pound foolish' springs to mind.

Speaking of 'penny wise and pound foolish', an IFA correspondent writes:

> A small firm I am involved with overseas advises a few clients on portfolios, but as that is regulated advice within the EU we have to use a 'prescribed process' to satisfy the regulator (I am sure you know how that works), Otherwise we would not have a MiFID licence. We are encouraged to only use highly liquid UCITS type funds. They are obsessed with, amongst other things, liquidity.
>
> So we use [Financial Planning Service Name Redacted] – problem is it's all based on historic price patterns for various asset classes and considers bonds being 'the safe part' of the portfolio. There are apparently 6500 advisers (mainly UK based) following that system now, so all of their clients are being placed into portfolios that are guaranteed to suffer heavy losses if interest rates rise as equities fall. The vast majority of UK IFAs (those that do not delegate everything to Discretionary Fund Managers) are now using this methodology as it keeps them on the right side of the UK regulator and keeps their Professional Indemnity Insurance renewals sensible. I think there are many advisers now placing folks into portfolios that they don't believe in, but their hands are tied. Something is not right within our regulatory system here, what a mess..

The investment policy of the rear view mirror is clearly alive and well in adviser-land. Whether it will survive a looming bear market for bonds is another question. Since we raise the issue of the rear view mirror, here is a snapshot of how UK government bonds performed in a previous bear market:



Source: Frontier Capital Management LLP

This is what a burst of inflation can do to a bond portfolio. Investors who owned Gilts in 1973 had to wait until 1985 before they made any of their money back in real terms. Any Gilt investors flirting with the idea of a Corbyn / McDonnell government, you have been warned. If you thought Brexit was bad..

Of course, from the vantage point of 2019, it's not different this time. It's just that interest rates are slowly starting to normalise after reaching their lowest levels for 5,000 years. Any correction will surely be painless for bond "investors".

So 2018 was a bust. What matters most to us in the months to come is not so much how stock markets perform (we don't own stock markets) but rather how our underlying companies perform. And if their underlying performance deteriorates markedly, we will sell them, and replace them with companies operating well, provided we can buy shares in them cheaply enough. And since the mood music of the market appears to have turned markedly atonal, we will continue to supplement our value stock investments with uncorrelated funds, and real assets, as dual forms of portfolio (and inflation) protection for the long run. We can't control the outcome, at least not in the short term, but we can at least control the investment and diversification process.

A happy new year to all readers !

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Tim Price is co-manager of the VT Price Value Portfolio and author of 'Investing through the Looking Glass: a rational guide to irrational financial markets'. You can access a full archive of these weekly investment commentaries here. You can access the archive of our regular 'State of the Markets' podcasts, with Paul Rodriguez of ThinkTrading.com here.

Price Value Partners manage investment portfolios for private clients. We also manage the VT Price Value Portfolio, an unconstrained global fund investing in Benjamin Graham-style value stocks and specialist managed funds.