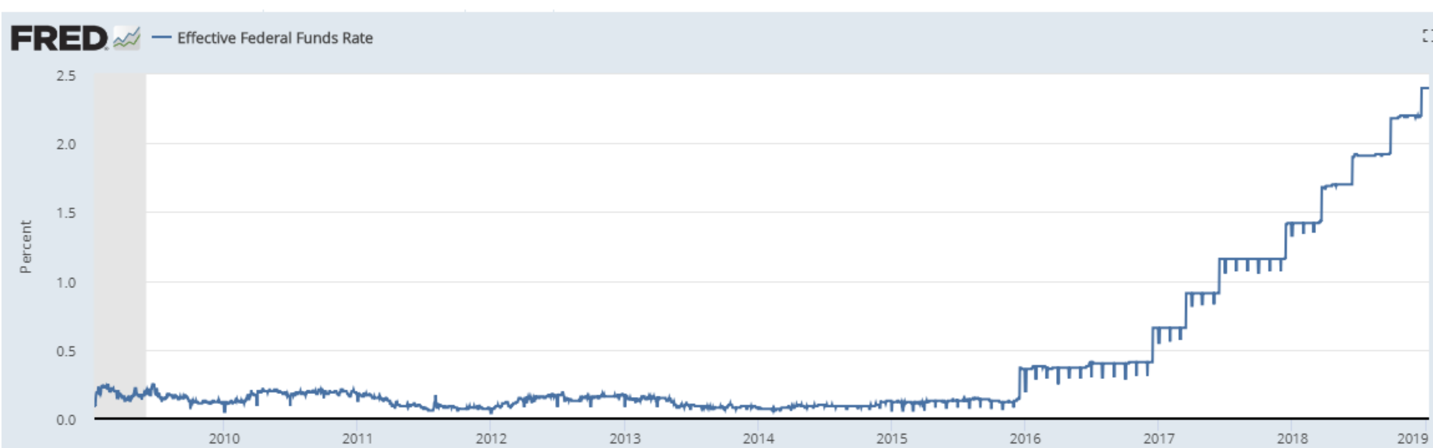
January 2019

INVESTMENT PERSPECTIVES

Psychology and Cycles

> *"When the same or closely similar circumstances occur again, sometimes in only a few years, they are held by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery in the financial and larger economic world. There can be few fields of human endeavor in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present period."*[1]

In this Investment Perspectives, we will explore the way various cycles influence investing and financial planning. We contend with many different types of cycles, and it's fascinating how often they are interrelated and reflexive. Economic cycles weigh on financial market cycles, and market cycles influence the psychology of us all. When the economy is strong, markets rise; in steadily rising markets, investors grow confident and spend more of their income. Rising consumer spending boosts the economy, giving us a pleasant, self-reinforcing cycle. The longer a cycle persists, the deeper it grows ingrained in investors' minds. But nothing lasts forever, and we chose to discuss the relationship between cycles and psychology because we believe we are in the midst of a transition between legs of a cycle that has been so long-lived that it has had a meaningful effect on investor psychology. Investor uncertainty is evident in the rising stock market volatility. After nine years of complacency, investors are now waking up to the hazards of easy money government policy. Since the end of the easing cycle (Quantitative Easing), the US Federal Reserve has increased short-term interest rates nine times. These rate increases garner much press, but the Fed is also removing $50 billion per month of excess liquidity out of the financial system (Quantitative Tightening). The chart below tells the story. It shows the long period of near-zero interest rates preceding the stair-step rise in Fed Funds to 2.5%.



There is some debate among market participants as to whether the Fed is actually employing restrictive monetary policy. Even after nine rate increases over three years, they are only just now approaching a neutral policy stance[2].

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[1] Galbraith, J.K.; *"A Short History of Financial Euphoria"*; Whittle Direct Books; June 27, 1905.

[2] A neutral rate of interest is one that is neither stimulative (too low), nor restrictive (too high); the assumed range of neutral rates is 2.5% to 3.5%

Even if investors haven't made up their minds about this cycle, the stock market senses change is in the air. After 3,492 days of rising prices for the S&P 500, an increase of 333%, the fourth quarter of 2018 was a genuine sign of change. The recent sell-off we experienced took the S&P 500 down 19.6% over 85 days, a 61% annualized rate of decline.

- The performance of the S&P in the fourth quarter of 2018 was the worst in seven years
- It was the worst month of December since the Great Depression

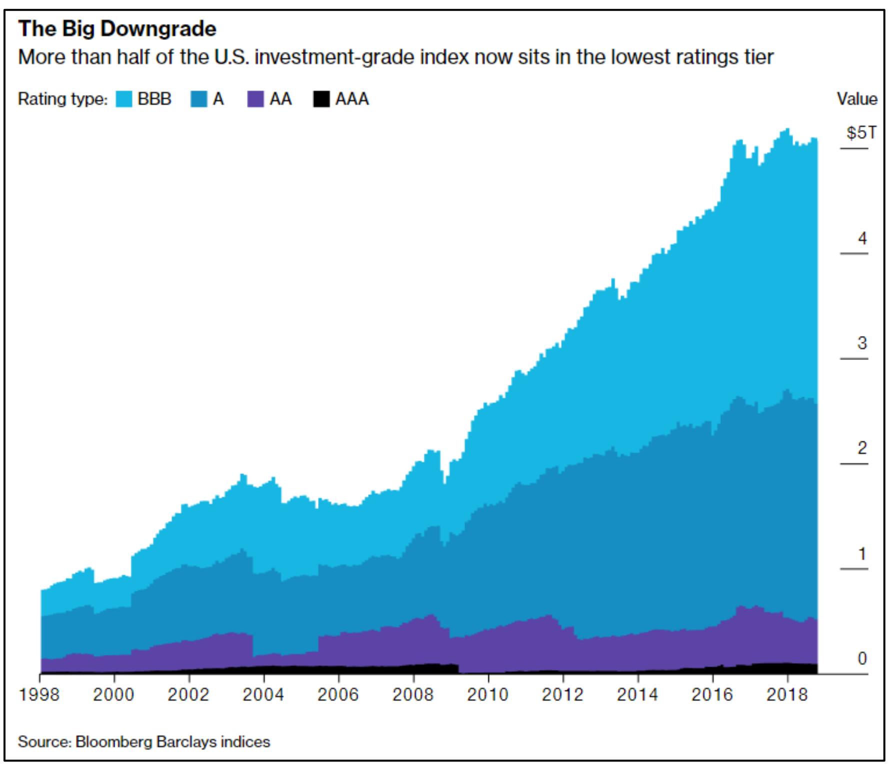
Investors dislike uncertainty, and the renewed volatility we are experiencing in financial markets is a reflection of investor uncertainty about future economic growth, interest rates, and inflation. There's an additional factor that may be compounding the market's short-term price fluctuations; we think you'll be hearing more about the lack of trading liquidity in both stock and bond markets and how this makes short-term sell-offs more pronounced than we're used to. Fear is a powerful market behavior and very effective at creating temporary gaps between market prices and intrinsic value. This can be stressful but also a source of opportunity for fundamental value investors like us.

<u>We've Seen This Before</u>

The good news is that we've seen this all before. Much of what it takes to get through rough markets is the experience to maintain the right frame of mind. In the midst of a market downturn it's common for investors to become overwhelmed, and fearful. Moreover, the change in the depth of market liquidity will demand greater investor fortitude during downturns. But it helps to remember that cycles are natural and inevitable. They are always self-correcting and act as a cleansing mechanism for market prices. Cycles can offer opportunity for us because they create price inefficiencies. We opened this piece with the quote from Mr. Galbraith to reinforce the importance of experience and the value of learning from the past in the pursuit of success in the future.

<u>The Role of Credit</u>

"*The worst loans are made at the best of times*."[3] Easy credit has been at the root of most market cycles that have pushed asset prices above intrinsic value. At the same time, nothing creates bargain valuations faster than tight credit conditions. In our previous *Investment Perspectives* (September 2018), we discussed the potential market risks that might accompany a normalization of interest rates. Much of the fuel igniting speculation and high asset valuations in this cycle can be traced back to the credit markets. The chart below demonstrates the change in the size and credit quality of US corporate debt as the cycle lengthened.



[3] Economist Magazine; *"Destructive Creation: What Happens When the Good Times Come to an End?"* January 25, 2001.

What this chart depicts is the dollar value of investment grade corporate debt, segmented by quality. Higher quality bonds are represented by the darkest colored segments, while the lower quality bonds are lighter colored. When this cycle began, the composition of the US investment-grade corporate debt index was heavily skewed toward higher quality companies ($1.5 trillion out of the total $2.0 trillion of investment grade debt was at least ‘A’ rated). Most recently, the index has ballooned to over $5.0 trillion with much of that growth fueled by the lowest-quality ‘BBB’ credit (half of the index is now comprised of debt with the lowest investment grade rating). Bonds rated ‘BBB’ are riskier and, ordinarily, it would be difficult for companies to find so many investors willing to buy so much of this marginal paper. But the length of this cycle, coupled with investors’ need to find yield, has proved fertile ground for companies needing credit. We can’t foresee all the ways that this credit complacency will unfold in the future, but you can take comfort in the knowledge that HCM is not among the buyers of BBB rated bonds.

Macro to Micro

Different types of companies are affected by the growth rate of the overall economy in different ways. GDP growth is generally stable around an average rate of 2% to 3% per year. Certain companies demonstrate high variation in corporate profits and stock prices in response to changes in GDP growth. We refer to these companies as “Cyclicals” or “Pro-Cyclical,” meaning that small changes in growth for the overall economy (i.e. GDP) have a significant influence on their fundamentals. Much of the value in individual stocks that we have found during this long and shallow economic recovery has been in companies that are pro-cyclical, and depend upon strength in the broad economy.

One element of our portfolio construction process is understanding the current investment climate and how we are positioned for it. Within that context, we must evaluate whether the state of the cycle suggests aggressiveness or defensiveness in our asset allocation and stock selection. And, since cycles are fluid and dynamic, our investment process must also be adaptive. We do not attempt to predict changes in the cycle, but crucial evidence comes through our analysis of individual company fundamentals.

There’s Value in Understanding Cycles

The world and the investment landscape is a complex adaptive system with reflexive properties. For example, when asset prices are rising, lenders often relax their lending standards because the value of collateral is rising. This is how we ended up with the 2008-2009 credit crisis; lenders dissociated the extension of credit from the individual borrower and focused on the property itself. The rationale being that if the borrower can’t make the payments, the lender can just sell the property at what is sure to be a higher price. When the music stopped, and asset prices began to fall, it had a cascading effect across multiple asset classes. Typically, the vagaries of real estate prices are uncorrelated with stock prices. But the reflexive nature of home equity, consumer confidence, and the stock market, <u>unique</u> to that cycle, turned out not to be a trend at all, but just a cycle. Moreover, the characteristics of that cycle had a profound effect on the cycle out of which we are now transitioning. The efforts of central banks to stabilize asset prices (namely home prices in the US), led to the quantitative easing experiment that has so severely distorted markets. As we transition back to a normalized, free-market economy, we must brace for a potential asset repricing cycle. But no matter how uncertain this transition might feel, we understand that this process is natural. After several frustrating years for value investors, the silver lining on the other side of this credit-tightening cycle is the likelihood that it will eventually create terrific opportunities for us to buy high-quality assets at prices we’re willing to pay.

Conclusion

Within financial markets, boom and bust cycles are more like balloons than elevators. Elevators rise and fall at about the same rate but markets are more like balloons; they take much longer to inflate than to deflate. Cycles are natural. We may not be able to predict them, but we can analyze them and adapt to them. Through our long investment experience, we have earned an appreciation for the power of cycles and the knowledge to adjust our risk exposures in the face of uncertain cycle transitions. Part of maintaining a disciplined investment policy is remaining focused on factors that we consider knowable: the fundamentals of industries, companies, and securities. Most episodes that look like trends end up being just plain old cycles. Time is an integral part of this, as longer-term legs of cycles can be mistaken for permanent trends. So the longer this goes on, the more violent can be the reversion. Like an elastic rubber-band, the further it is stretched, the more violent the snap-back once released. The length of this current cycle caused some value investors to believe it was different this time, and that valuations would never revert toward the mean. The jury is still out on this transition, but we are cautiously optimistic and prepared to adapt to whatever conditions the market presents.

For a complete list of holdings, please see our most recent 13F filing on the following SEC website: http://www.sec.gov/edgar/searchedgar/companysearch.html

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

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