

## 2<sup>nd</sup> Quarter Commentary

July 2018

This commentary will, in its way, be client-directed. While preparing for this review, a few consistent questions or concerns were forwarded to me. I thought I'd lean on those.

Here were the issues that were raised.

Inflation. A number of clients have heard of the recent inflation data, which is pretty close to the 2% target rate the government has set. To many, this seems benign, while they note the emphasis in our portfolios on classic inflation beneficiary securities.

Another reaction to the inflation figures is a positive one, with the thought that if there is inflation, that also signals growth in the economy and company earnings.

Cash balances in portfolios – and our treatment of them. Why, for instance, hold so much cash in a rising market?

And a third was about the shipping sector weighting in our portfolios and whether it might suffer from the possibility of a global trade war initiated by President Trump. One such question was worded this way, "I don't mean to pick on a scab but a refresh on AP Moller-Maersk would be interesting. Thanks."

### *Inflation and the Fundamental Problem of the Fixed Income Asset Class*

The Federal Reserve has a 2% inflation target, although it recently indicated that it might tolerate 2.5%. In 2017 the Consumer Price Index rose by 2.1%; in June, it was 2.9% higher than a year ago. Whether these figures are good or bad from an investment perspective is relatively meaningless without reference to the interest rate you can receive on your capital or savings. Let's accept for the moment that a 2% inflation figure is both attainable and actually true. That means you need 2% more money every year to purchase pretty much anything generally necessary to life as you experience it, from food and electricity to housing and transportation and medical services, all of which are detailed in the CPI. In 15 years, you'd require 35% more money to pay for the goods and services you use now. So what can your safety capital earn?

Those of you residing in New York City may very well be in the 50% tax bracket, if you round up just a touch, once state and local taxes are added. Therefore, on a pre-tax basis, you would need to achieve at least a 4% return on your savings to avoid losing purchasing power every year, if inflation is 2%. So what does the fixed income asset class offer you? Here's a survey.

The largest bond fund in existence is the **iShares Core U.S. Aggregate Bond ETF (AGG)**, which seeks to represent the entire U.S. bond market. It has \$56 billion in assets under management. The distribution yield is **2.63%**. Obviously, after taxes, this fund could not possibly provide return more than the 2% rate of inflation. It has an 8.2-year weighted average maturity, so it has meaningful price risk if rates rise. And the five-year, pre-tax, annualized return as of June 30<sup>th</sup> is 2.23%.

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Therefore, the question becomes: How can one improve on this?

The nearly 40% of AGG that is invested in Treasuries depresses the yield. An alternative is the **iShares iBoxx \$ Investment Grade Corporate Bond ETF (LQD)**, which doesn't have much credit risk. The yield is **3.68%** so, after taxes, one might be close to the inflation break-even mark, if one accepts that inflation will be confined to 2% per year. But the average maturity is even higher, at 12.7 years, which means that it has quite a lot more price risk in response to changes in interest rates. If you want a taste of what that would look like, pay attention to these couple of figures. At December 31<sup>st</sup>, the 10-year Treasury yielded 2.40%; at June 30<sup>th</sup> it was 2.83%. Not much of an increase, really. This fund's return through June 30<sup>th</sup> was -4.3%.

One could take a different tack: no credit risk, but buy an inflation hedge with the **iShares TIPS Bond ETF (TIP)**: every bond in it includes an inflation-indexed increment to the return. But, the actual rate of return for the five years ended June 30<sup>th</sup> is **1.6%**. After taxes, the real return (meaning after inflation) is quite negative, even if you already decided not to live in New York. This fund is quite popular, if you measure it by its size: it has \$24 billion of AUM. I don't know if you think that's a lot. I do – Horizon Kinetics, with all of our 70-plus employees and diligent efforts, has somewhat over \$5 billion – a drop in the ocean; you might think it could evaporate on a really hot day.

You could go in an entirely different direction and deliberately decide to accept credit risk for a sufficiently high yield with the **iShares iBoxx \$ High Yield Corporate Bond ETF (HYG)**. Now you've got a distribution yield of **5.48%**, and the weighted average maturity is only 4.9 years, so there is not much interest rate price risk. But you really do have to accept the credit risk; they're not kidding around. This has yet to manifest itself since the last credit crisis – remember that one? The fund's highest-rated debt is BBB, but that's only 1% of the fund; the rest is BB and below. In fact, 10% is CCC rated. Which pretty much means that 10% of this ETF is going to default but just hasn't yet, and in the meantime, the really high interest rates on those bonds are being counted in the fund's overall yield. So you're not really getting the full stated yield.

With this ETF, you must think about this: we are in the best credit cycle we have ever been in, the most beneficent market one could possibly imagine for high yield credit, yet the five-year annualized return through June 30<sup>th</sup> is **4.24%**. Which means that even under these record setting conditions, a New York City resident would have earned a real, after-tax return of about one-quarter of 1%, even accepting the 2% CPI figure as an accurate measure of inflation.

Like rats in a maze, let's turn in a different direction, more esoteric. There is the **iShares MBS ETF (MBB)**. It holds mortgage-backed securities issued by Fannie Mae, Freddie Mac, and Ginnie Mae. The distribution yield is **2.72%**. All AAA. One might imagine the longer term returns for this fund would be higher, but the 5-year rate of return is only 2.02%. A significant negative real rate of return after taxes. It hasn't even produced a positive real rate of return on an untaxed basis. It's not really so esoteric, though, to judge by its size; the fund has \$12 billion in AUM.

Last, we'll go further afield. A popular asset allocator choice has been the \$12 billion **iShares J.P. Morgan USD Emerging Markets Bond ETF (EMB)**. Being emerging markets bonds, 90% of the holdings are rated BBB and below. Among the top weightings are Turkey, Russia, Ukraine, Dominican Republic and *Lebanon*. Let me say that again: *Lebanon*. The fund's five-year rate of return is **4.26%**. The after-tax real rate of return is about as close as one can reasonably come to positive. The distribution yield is **5.12%**. The weighted

average maturity, as far as price sensitivity to interest rates goes, is over 12 years. One should be aware that as interest rates rise, investor anxiety about credit loss increases also, so that the rates demanded from riskier credits rise even faster, which means greater price declines. You might recall that the Investment Grade Corp. Bond ETF just discussed, with about the same average maturity, lost 4.3% through June 30<sup>th</sup>; this fund lost 6.2% this year, which is 50% more.

### **A Word About Politics, Statistics and the Consumer Price Index**

The Bureau of Labor Statistics calculates the annual inflation for the five years through 2017 at 1.32%. A large portion of the bill paying public might say that in their experience inflation is a lot higher than that. Yet a large portion of academics and policy makers would say that those are merely subjective judgments, and not derived from rigorous statistical sampling that is then subjected to rigorous analysis and formulaic treatment, as at the BLS. Nevertheless, the publicly traded financial market – which *is* accepted by economists to be among the most effective discounters of pending events – might also be said to question the CPI figures, since over the same 5 years, the iShares TIPS Bond ETF returned only 0.02% per year<sup>1</sup>, which is zero. In other words, a fund composed entirely of securities designed to keep pace with inflation lost 1.3% per year relative to the CPI, and that's before taxes are taken out.

For the sake of argument, let's temporarily accept the average person's belief, in good faith, that their cost of living is rising by noticeably more than 2%. Why might that be? The history of the CPI, in a serious, comprehensive form, began during World War I as a necessity to adjust wages for industrial war-effort jobs to accommodate the rapid inflation in the prices of food and other consumer goods. The index has been subject to ongoing refinements ever since, so that aspect of the index is not new. Few people would be surprised that such changes reflect the social and political pressures of the moment; that's why the CPI was established in the first place – who could argue with that? Yet...

Preceding many of the major recent methodological changes, one might have read an article like the following one from the New York Times in September 1995. A massive set of adjustments to the CPI were planned, squarely as a major budget battle was shaping up between the White House and Congress, and budget negotiators looked to changes in the CPI figures to be a decisive element in reducing outlays (such as through reduced Social Security payments) and increasing tax revenues. An example of the latter is through the income brackets in the IRS tax tables. If the rate at which those income brackets are indexed upward to reflect inflation is reduced through an altered CPI methodology, but wage inflation continues, then workers are 'inflated' into higher tax brackets even though their purchasing power hasn't increased, even though they're not actually better off. Which is, effectively, a hidden tax increase that is more likely to escape public scrutiny.

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<sup>1</sup> As of December 2017

NEW YORK TIMES NATIONAL FRIDAY, SEPTEMBER 15, 1995

## Panel Sees a Corrected Price Index as Deficit-Cutter

By ROBERT D. HERSHEY Jr.

WASHINGTON, Sept. 14 — Opening an arcane but politically painless door to budget balancing, a bipartisan Congressional panel has calculated that the Consumer Price Index overstates inflation and that a correction of that bias could reduce the Federal deficit by \$634 billion over the next 10 years.

The five economists appointed to study the index said in an interim report made public today that their best estimate of the overstatement was one percentage point for coming years. If this is not corrected, the report said, in 2005 the total amount of the overstatement will exceed all but the top three items in the Federal budget.

The index, which is calculated by the Bureau of Labor Statistics, is the basis for the cost-of-living adjustments that increase the benefits for tens of millions of Social Security recipients and veterans. It is also used for purposes like adjusting individual income tax brackets so the Government does not benefit from inflation at the expense of taxpayers.

*Findings that are bound to be interjected into the budget debate.*

Although the panel has had little time so far for original research, its findings underscored the seriousness of the overstatement problem and are likely to be quickly injected into this autumn's budget debate.

Speaker Newt Gingrich, Republican of Georgia, suggested this week that fixing the index, with its implications for lower spending and higher revenue, would provide significant maneuvering room for budget negotiators. The plan that has passed the Republican-controlled Congress assumes a modest downward C.P.I. adjustment of two-tenths of a point, with conferees rejecting a six-tenths of a point House adjustment in favor of the smaller one endorsed by the Senate.

The stakes involved in such a correction are tremendous, and the commission's report comes just as Congress and President Clinton are preparing for a budget battle that many hope could be eased by a change in the inflation index.

Here are just a couple of the significant methodological changes that have been made in the recent era. There are others, and they all share the goal of reducing the inflation measurements and, in the words of those involved, making it more accurate.

In 1999, the BLS began using a geometric mean formula instead of the standard averaging figure most of us are familiar with. There is plenty of highly academic reasoning by extremely qualified people who say that it is more accurate. But it does reduce the result. Here's an example, with our own made-up 5-year data set that represent percentage changes in inflation:

Year 1: +8.0%, Year 2: +5%, Year 3: +3%, Year 4: -1%, Year 5: +9%. The simple average adds each of the 5 figures, then divides by the number of samples, for  $(24 \div 5) = 4.8\%$ .

The geometric mean, in contrast, multiplies each of the figures together and then reduces them by the  $n^{\text{th}}$  root of the number of samples, in this case 5. So that would be  $(1.08 \times 1.05 \times 1.03 \times 0.99 \times 1.09)^{1/5}$ , which simplifies to  $1.26^{1/5}$ , which = 4.7%. Which is less than 4.8%.

A similar sort of choice was made by the QQQ Nasdaq 100 Index providers to reduce the P/E from what would have been an average figure of roughly  $60x^2$  to  $23x^3$ , which is less than the S&P 500 valuation, despite the dominating presence in the QQQ of companies like Google, Amazon.com and Netflix. In that case, they used the weighted harmonic average rather than geometric average.

<sup>2</sup> Weighted average of the trailing twelve-month P/E ratio for the ETF positions. Source: Bloomberg.

<sup>3</sup> Source: Invesco

The major difference between the government calculation and the average person’s experience, though, has to do with the chain-link method, which was initiated in 2002. It presumes that when the price of one good rises, consumers will substitute with cheaper goods. For example, if the price of gasoline rises, you can replace super-grade with regular, and the degree of inflation is presumed to be mitigated. If the price of beef rises, people are presumed to substitute more chicken. These changes were factored into the CPI, and the academic expertise behind those changes is easily observed in the accompanying set of formulas from the BLS. How is one to argue with this?

But we know that such ready substitution is not what happens, that empirical reality is different. That reality likewise has academic backing, through the well-known economic concept known as the Duesenberry Effect.<sup>4</sup> The CPI, as it’s currently constructed, goes against the Duesenberry Effect. The empirical evidence suggests consumers don’t behave in the manner presumed by the Bureau of Labor Statistics.

<https://www.bls.gov/cpi/additional-resources/chained-cpi-methodology.pdf>

4. Estimation of Price Change in the Chained Consumer Price Index (C-CPI-U)

LOWER-LEVEL AGGREGATION:

$${}_{i,a}IX_{[0;t]}^L = \sum_{k \in i,a} k S_0 \left( \frac{k P_t}{k P_0} \right) \quad \text{or} \quad IX_{[0;t]}^G = \prod_{k \in i,a} \left( \frac{k P_t}{k P_0} \right)^{k S_0}$$

UPPER-LEVEL AGGREGATION:

	Long-term Price Change	Month-to-Month Price Change
Initial C-CPI-U	${}_{I,A}IX_{[z;y,t]}^{G_i} = {}_{I,A}IX_{[z;y-1,12]}^{G_r} \times \prod_{n=1}^t {}_{I,A}IX_{[n-1;n]}^{G_a}$	${}_{I,A}IX_{[t-1;t]}^{G_i} = \lambda_y \prod_{i,a \in I,A} \left( \frac{{}_{i,a}IX_{[0;t]}^{L_{orG}}}{{}_{i,a}IX_{[0;t-1]}^{L_{orG}}} \right)^{{}_{i,a}S_{b_1}}$
Interim C-CPI-U	${}_{I,A}IX_{[z;y,t]}^{G_r} = {}_{I,A}IX_{[z;y-1,12]}^T \times \prod_{n=1}^t {}_{I,A}IX_{[n-1;n]}^{G_r}$	${}_{I,A}IX_{[t-1;t]}^{G_r} = \lambda_y \prod_{i,a \in I,A} \left( \frac{{}_{i,a}IX_{[0;t]}^{L_{orG}}}{{}_{i,a}IX_{[0;t-1]}^{L_{orG}}} \right)^{{}_{i,a}S_{b_2}}$
Final C-CPI-U	${}_{I,A}IX_{[z;y,t]}^T = {}_{I,A}IX_{[z;t-1]}^T \times {}_{I,A}IX_{[t-1;t]}^T$	${}_{I,A}IX_{[t-1;t]}^T = \prod_{i,a \in I,A} \left( \frac{{}_{i,a}IX_{[0;t]}^{L_{orG}}}{{}_{i,a}IX_{[0;t-1]}^{L_{orG}}} \right)^{\frac{{}_{i,a}S_{b_1} + {}_{i,a}S_{b_2}}{2}}$

KEY:

k = unique good or service	IX <sup>L</sup> = Laspeyres elementary index
A = CPI aggregate area	IX <sup>G</sup> = Geometric Mean elementary index
a = CPI elementary area	IX <sup>IA</sup> = Initial C-CPI-U index
I = CPI aggregate item	IX <sup>IR</sup> = Interim C-CPI-U index
i = CPI elementary item	IX <sup>T</sup> = Final C-CPI-U index
0 = elementary index base period	${}_{i,a}S_b$ = expenditure for elementary item (i) in area (a) in expenditure period (b), divided by expenditure for all elementary items in aggregate item (I) in aggregate area (A) in expenditure period (b)
t = month	${}_{i,a}S_a$ = expenditure for elementary item (i) in area (a) in month (t), divided by expenditure for all elementary items in aggregate item (I) in aggregate area (A) in month (t)
y = year	${}_{i,a}S_{y,t}$ = expenditure for elementary item (i) in area (a) in month (t-1), divided by expenditure for all elementary items in aggregate item (I) in aggregate area (A) in month (t-1)
$p_t$ = price of good (k) in month (t)	$\lambda_y$ = Adjustment factor used in year (y) to calculate Initial (y) and Interim (y-1) C-CPI-U indexes published in year (y); NOTE: $\lambda_y=1$ for C-CPI-U indexes published in 2002.
$p_0$ = price of good (k) in base-period (0)	
${}_{i,a}S_0$ = expenditure for good (k) in base period (0), divided by expenditure for all (k) goods in elementary item (i), area (a) in base period (0)	
z = December 1999 index base period	
b <sub>1</sub> = expenditure reference period of CPI-U index of year (y); NOTE: b <sub>1</sub> = 1999-2000 for y=2002 and y=2003.	
b <sub>2</sub> = expenditure reference period of CPI-U index of year (y+1); NOTE: b <sub>2</sub> =b <sub>1</sub> for y=2002 and b <sub>2</sub> =2001-2002 for y=2003.	

<sup>4</sup> James Duesenberry developed the relative income hypothesis, which states individuals’ attitude to consumption and saving is dictated more by their income in relation to others than by an abstract standard of living, and that the present consumption is not influenced merely by present levels of absolute and relative income, but also by levels of consumption attained in a previous period. It is difficult for a family to reduce a level of consumption once attained. The aggregate ratio of consumption to income is assumed to depend on the level of present income relative to past peak income.



Another of the changes is what is known as hedonic adjustment. Meaning, if you pay more for a new car than you did for the last one, but the quality is deemed to be higher, such as through the introduction of a better braking system or superior sound system, the BLS make an adjustment to reduce the price increase within the CPI. Nevertheless, the statistical adjustment doesn't reduce the amount you have to pay for the car.

The point is that the CPI does not exist in a dispassionate scientific vacuum; it is an extraordinarily valuable political bone. You can even put a price on that bone: \$634 billion worth, according to the Congressional panel from the New York Times article cited earlier, and that was in 1995 dollars. There is a website known as Shadow Government Statistics ([shadowstats.com](http://shadowstats.com)), which is subject to much criticism by many economists. It uses the 1990 U.S. Bureau of Labor Statistics methodology, before the recent changes, to assert that the current rate of inflation is roughly 6%. Why would there be so much effort, assuming that [shadowstats.com](http://shadowstats.com) has any validity, devoted exclusively to moderating the reported inflation numbers, as opposed to making it a stable benchmark against which changes in people's cost of living can be measured – which is what it used to be?

From the point of view of policymakers, if the inflation rate were really 6%, it is reasonable to believe the 10-year Treasury would yield 7%. And if the 10-year Treasury yielded 7%, mortgage rates would be higher than that. In which case the average interest rate for all debt could easily be 8%. But since the total amount of debt in the U.S., for everything from a car loan to a Treasury bond is over \$70 trillion, an 8% cost of debt would bring the total interest expense to \$5.6 trillion. That's well over a quarter of the GDP. It would destroy the entire economy. We would be in the worst depression we've ever seen. By the most direct logic, from the government's point of view, the interest rate can't be allowed to rise, and the only way of mitigating the problem is to enact policies that make the debt burden more manageable. That seems to mean favoring the debtor (with artificially low interest rates) over the saver (who cannot live on those interest rates).

From the point of view of savers – which are all of you listening – if you believe that the true inflation rate is 6%, that's a calamity. In the course of one working career or one extended retirement, if we use 35 years, inflation would destroy virtually all of one's purchasing power, if you consider over 85% to be virtually all. It used to be that bonds yielded more than inflation. But bonds are a guaranteed loss, so the answer is not to be found in the mainstream fixed income asset class. One has to go elsewhere or even devise alternative methods or even new asset classes. We do a little of that (though much of it can't or shouldn't be done within a Core Value or Strategic Value account), and every once in a while, when we can, we do more.

### ***Can Passive Save Us? Is it a Superior Method of Investing? History Has Already Spoken***

Let's not take the Wall Street investment formulas and computer modelled asset allocation software so seriously that we forget the most basic lesson of all. Investment returns are more about price (or valuation) than anything else – it's a lot better to pay too little for a poor business than to pay too much for a good business. And price is strictly, 100%, about human behavior and demand or absence of demand. After all, is there any other factor that exists in the universe that would impact the price of a stock, that would care about buying or selling shares? Any independently operating computer with its own capital? Anything in the non-human primate world? Extra-terrestrial beings? It seems silly to write this, but we seem to forget that when we see a well-performing stock or sector that there is nothing intrinsic about it – it simply reflects

the impact of other people’s demand. Is a certain baseball card or Beanie Baby doll intrinsically worth some given amount of money? Some websites advertise a particular Beanie Baby for sale at \$16,000; others say that they don’t really change hands there, that the real price – the transaction price – is more like \$7 dollars.

With every passing day, more and more of the supply of financial assets is allocated to the same global asset classes and, in turn, to the various asset class sub-sectors and, finally, channeled to the same relatively small number of sufficiently liquid securities within those sub-sectors. That is because these choices are determined by the index classification system, and access to them is via the ETFs linked to those indexes. On an average day, the equity ETFs receive an additional \$1.4 billion of inflow<sup>5</sup>, which translates immediately into buy orders, and bond ETFs receive about \$0.5 billion.

By the laws of human nature and markets, that persistent and undifferentiated demand has created excessive valuations and will ultimately place a limit on the future returns. In fact, that limit might already be measurable. Some ETFs now have a 20-year track record, and a whole bunch more are

closing in on it. Their records speak for themselves. First the 20-year club, all of them individual international markets. There are 17 of them, and all began on March 12, 1996. Not a single one produced as much as a 10% annual return, and only 4 of them beat a long-term Treasury.

Next are some of the major equity allocation building blocks, the S&P 500, the Russell 2000 index of smaller companies, the Nasdaq 100 rocket ships, some early factor based efforts in the form of the S&P 500 Growth and S&P 500 Value sub-sets, the major international stock index known as EAFE, which

<i>Inception date 3/12/1996 – 22 years ago</i>	AUM (\$ bill.)	Annualized Return Since Inception (%)
iShares MSCI Japan ETF	\$17.8	0.96%
iShares MSCI Germany ETF	3.4	6.19
iShares MSCI Canada ETF	2.9	8.03
iShares MSCI Hong Kong ETF	2.8	5.99
iShares MSCI United Kingdom ETF	2.0	5.45
iShares MSCI Australia ETF	1.5	7.87
iShares MSCI Mexico ETF	1.2	9.25
iShares MSCI France ETF	0.9	6.73
iShares MSCI Spain ETF	0.9	7.58
iShares MSCI Switzerland ETF	0.9	6.65
iShares MSCI Singapore ETF	0.6	3.02
iShares MSCI Italy ETF	0.5	4.14
iShares MSCI Malaysia ETF	0.4	2.01
iShares MSCI Sweden ETF	0.2	8.09
iShares MSCI Austria ETF	0.2	5.60
iShares MSCI Netherlands ETF	0.2	5.97
iShares MSCI Belgium ETF	0.1	5.82

Source: iShares

	AUM (\$ bill.)	Annualized Return Since Inception	Inception Date	Years from Inception to June 30, 2018
iShares Core S&P 500 ETF	\$152.9	5.49%	5/15/00	18.14
iShares Russell 2000 ETF	47.5	8.51	5/22/00	18.12
Invesco QQQ (Nasdaq-100)	69.2	7.13	3/10/99	19.32
iShares S&P 500 Growth ETF	22.0	5.27	5/22/00	18.12
iShares S&P 500 Value ETF	14.8	5.70	5/22/00	18.12
iShares MSCI EAFE ETF	72.0	5.41	8/14/01	16.89
iShares MSCI Emerging Mkts ETF	31.1	11.18*	4/7/03	15.24

\*Lest a reader think they’ve found the Holy Grail, the 10-year rate of return for this Emerging Markets ETF is 1.58%. Source: iShares

<sup>5</sup> Source: Investment Company Institute for 2017



covers Europe, Asia and the Far East, and finally the major emerging markets index as well. Most of these are in the 18-year club.

Here, too, no 10% annual stock market returns that have long been presumed to be a form of manifest destiny, a virtual right owed to investors. Some of this has to do with the weighting tactics and rebalancing rules that these indexes devise. In fact, if, 20 years ago, you decided to buy a 30-year U.S. Treasury Bond, the yield to maturity, according to the St. Louis Fed, was 5.62%. That’s pretty much the same as these major stock index returns. Moreover, that Treasury would still have 10 years remaining. And since the yield on 10-year Treasuries today is only 2.86%, that Treasury could be sold today for 123.8. That would add 1.07% to your annual return, for an all-in rate of return over 6.6%. That beats the majority of these stock indexes.

Let’s not forget that these roughly 6% stock returns were achieved with the support of the greatest fiscal and monetary stimulus in the history of civilization, including one of the longest stock market recoveries and one of the longest post-recession economic recoveries. What will happen without a further stimulus?

Just to be thorough, maybe you could have done better with some of the narrow growth industries like Technology

	AUM (\$ bill.)	Annualized Return Since Inception	Inception Date	Years from Inception to June 30, 2018
iShares U.S. Technology ETF	\$4.3	3.01%	5/15/00	18.14
iShares North American Tech Software	2.0	8.22	7/10/01	16.98
iShares Nasdaq Biotechnology ETF	9.6	7.25	2/5/01	17.41

Source: iShares

or Tech Software or Biotech, where higher returns can presumably be cherry picked (alongside all the other people who put billions of dollars into the same instruments).

You see how mutually consistent all of these different equity class returns are, with very little variability. They don’t reflect the underlying economic attributes of the countries, industries and companies. Rather, they reflect to some great degree the common, undifferentiated inflows of cash they all receive. That might not be the only reason. This is a unique period in history, because the central banks of the world basically brought interest rates to zero; we have not had an interest rate cycle in decades. Historically, the Federal Reserve would periodically raise rates and that would affect particular companies and industries and, certainly, the high yield bond index, but we haven’t had such an interest cycle in a long while. The companies today that are dangerously leveraged have not created the problems that would have previously developed, and they’ve actually performed exceedingly well relative to the historical experience. In any case, both possible reasons are systemic and one wants to be away from those risks.

**Inflation Beneficiaries in a 2% Inflation Environment**

In this distorted system it becomes essentially impossible to remain functionally diversified. And by those same human behavior laws, to wherever the bulk of the money *has* flowed, so too will that be the direction *from* which it will ultimately flow. But usually with a lot more urgency than when it entered.

Another law of human nature and markets is that one can’t know what the precipitating event will be – interest rates, international trade disputes, credit market deterioration, or inflation. If history is a guide, the catalyst might be none of the above, but something entirely unconsidered. Neither can one know when.

Nor must a market disaster be in the form of a collapse. From a bondholder’s perspective, a long period of gradually rising interest rates would not be a positive; it would mean a repetitive series of bond price declines as investors continually move more of their funds from short-maturity to longer-term higher-yielding securities. That’s happened before.

For equity investors, it would be no less damaging if the record high valuations were to subside to normal in the most gradual, unobtrusive manner over, say, 10 or 15 years. In that scenario, the major asset classes would fall woefully short of the returns necessary to sustain the needs of retirees, state pension plans, insurance companies, or endowments and charities. Here’s what state pension plans still assume they’ll be earning on their blended bond and stock assets. In the interest of space, I’ve just copied the top third of the table, but the balance looks the same. They’re not likely to get that 7 or 8%<sup>6</sup> they’re officially planning on.

This is a reason for trying to identify securities or methods or even devising new asset classes that operate outside of that system of exposures – to add some elements

of independent return creation and pattern to a portfolio. This is the preparation phase. One of those elements is our capital deployment strategy, reflected in our cash balances, which I’ll discuss separately. But even within our equity portfolios, we want securities whose prices do not reflect their ultimate worth, that are not exposed to indiscriminate buying interest, and whose businesses might operate somewhat independently from the general business cycle.

Many of these holdings, as we detailed in the past couple of quarterly reviews, happen to be inflation beneficiaries, as classically viewed. To address the first client question posed earlier, why now, when inflation statistics and expectations are so low?

## INVESTMENT RETURN ASSUMPTION BY PLAN

AS OF JUNE 2018

Plan	Rate (%)	Plan	Rate (%)
Alabama ERS	7.75	Missouri State Employees	7.35
Alabama Teachers	7.75	Missouri Teachers	7.60
Alaska PERS	8.0	Montana PERS	7.65
Alaska Teachers	8.0	Montana Teachers	7.75
Arizona Public Safety Personnel	7.30	Nebraska Schools	7.50
Arizona SRS	7.50	Nevada Police Officer and Firefighter	7.50
Arkansas PERS	7.15	Nevada Regular Employees	7.50
Arkansas State Highway ERS	8.0	New Hampshire Retirement System	7.25
Arkansas Teachers	7.50	New Jersey PERS <sup>8</sup>	7.50
California PERF <sup>1</sup>	7.25	New Jersey Police & Fire <sup>8</sup>	7.50
California Teachers <sup>2</sup>	7.0	New Jersey Teachers <sup>8</sup>	7.50
Chicago Teachers	7.75	New Mexico PERA <sup>9</sup>	7.51
City of Austin ERS	7.50	New Mexico Teachers	7.25
Colorado Affiliated Local	7.50	New York City ERS	7.0
Colorado Fire & Police Statewide	7.50	New York City Teachers	7.0
Colorado Municipal	7.25	New York State Teachers	7.25
Colorado School	7.25	North Carolina Local Government	7.0

<sup>6</sup> From the National Association of State Retirement Administrators. <https://www.nasra.org/latestreturnassumptions>

First, once inflation appears or is anticipated, inflation beneficiaries will have already been bid to high valuations. So for latecomers, those securities won't provide any protection; they'll just be ordinary securities. For the same reasons, it is precisely when there is no inflation fear that they trade at sufficiently low prices as to provide real optionality. That is when they should be accumulated, in preparation for the future. Murray and I did just this at Bankers Trust Company quite some time ago, and established an inflation beneficiary fund as part of a bond substitute strategy – at that time you could buy a broad range of the preferreds, convertibles and common stocks of classic inflation beneficiaries at, more or less, bond yields – which was your starting return level – because inflation was not a worry.

It is because gold and silver prices are so low that the precious metals royalty companies in the portfolios, like **Silver Wheaton** and **Franco Nevada** and **Sandstorm Gold**, have a great deal of earnings and valuation optionality whenever those metals prices recover. The iShares Global Gold Miners ETF (RING) trades at only 1.2x book value. Most of the companies in that index are profitable. The five-year rate of return through June is negative. Gold has almost no weight in the S&P 500. For example, one of the largest holdings in the Gold Miners ETF is Newmont Mining. It's a 9 basis point weight in the S&P 500, which is 9 one-hundredths of 1%.

It is because Texas Pacific Land Trust has not a single Wall Street earnings estimate and is not in a single ETF that it is priced – in our considered opinion – much too low relative to its future earnings from oil royalties, land leases and water rights. All of which are asset classes with no or meaninglessly little presence in the major indexes. There's nothing magic about TPL – it's just that not enough investors are aware of it or care about it.

Which brings us to the original question about the AP Moller-Maersk position, which was really a way of asking about trade sanctions and the potentially deleterious impact on shipping companies.

### *Sanctions and Shipping*

Ocean shipping has its own business cycle, which is not coincident with the U.S. business cycle. In a depression since 2008, it is the only industry in the world that has yet to emerge from the economic crisis of ten years ago. Some of the difficulty merely illustrates the extent of the oversupply of shipping capacity. Once a ship is constructed, it can operate for a quarter of a century. Even well-maintained ships ultimately become technologically obsolete, although this process takes much longer than in other industries. One could argue that all of these factors are known and reflected in the price of publicly traded shipping companies.

Apart from their fundamental investment merit, if any, many of these companies lack sufficient market capitalization or trading liquidity to qualify for inclusion in equity indexes, so they have no utility to mainstream investors. Even as the world's largest shipping company, with a \$25 billion market value (though over half the shares are family controlled), AP Moller-Maersk is held in just one ETF, the iShares MSCI Denmark ETF. Before you say, "Ahah!", that ETF has a grand total of \$43 million in it. If that ETF only held AP Moller-Maersk, if it were a 100% weighting, that would amount to less than 1/10<sup>th</sup> of 1% of the company's shares. The company is not even in the top 10 of this ETF. AP Moller-Maersk trades at 0.8x book value. The price-to-book-value ratios of some other shipping companies are shown in the accompanying

table. They pretty much all trade at one-half of book value. From within that list, **Stolt-Nielsen** is a holding in the Small Cap, the Research and the Spin-Off strategies, and **Navigator** is in Core Value.

As to geopolitical risks, there are two recent changes. The first was the reimposition of sanctions on Iran. In early May, the U.S. announced it would no longer participate in the international plan of sanctions relief for Iran. Among the actions triggered by the U.S. withdrawal, the shipping insurance industry is banned from providing insurance to ships involved in transport to and from Iran. This ban will go into effect on August 6<sup>th</sup>. This will create idle tanker capacity.

*Price/Book Value Ratios of Select Shipping Companies*

<u>Ticker</u>	<u>Company</u>	<u>Price/Book</u>
FRO	Frontline Ltd	0.5x
SNI NO	Stolt-Nielsen Ltd.	0.6x
BON NO	Bonheur ASA	0.5x
NVGS	Navigator Holdings Ltd.	0.7x
TRMDA DC	TORM PLC	0.6x
ODF NO	Odfjell SE	0.4x
TEAM NO	Team Tankers Int'l Ltd.	0.6x
CCORB SS	Concordia Maritime AB	0.5x
OCN LN	Ocean Wilsons Holdings	1.0x*
AMKBY	AP Moller-Maersk	0.8x

\* The Ocean Wilsons price/book value is not actually 1.0x, because it controls another publicly traded company; if one subtracts the value of the other company that of Ocean Wilsons, its shares would be as discounted as the other companies.

Source: Bloomberg

Among holdings in our portfolios, many shipping related companies have dropped considerably in price since this news, such as AP Moller-Maersk and Clarkson’s, the shipping broker. Others, such as Navigator Holdings, Stolt-Nielsen and Braemar Shipping Services, another shipping broker, have not.

Second, investors have become concerned about the impact changes to U.S. trade policy will have on shipping. Prior administrations of both political parties have promulgated trade policies that increased the volume of cross-border trade and were relatively unconcerned about the consistent growth of U.S. trade deficits. The current administration pursues an entirely different approach. Once the consensus investment view reflects the belief that the world trading and tariff regimes are being compromised, the shipping company shares can decline further, although AP Moller-Maersk is already down over 25% from early May. The concern is that trade disputes will further delay the recovery in this industry.

Yet, recalling the valuations we just saw, these firms already reflect the conditions of a trade war. The unifying theme is that they have been operating in a depression for about a decade. Most have adapted to an environment of low shipping rates. Costs have been dramatically reduced, and many operate at levels that are more or less breakeven. Their valuations reflect that there appears to be little possibility of improvement in the foreseeable future.

The attractive aspect of this, if one may use that term here, is that these companies trade well below their book or, really, salvage value. If some diversification away from systemic equity risk was desired, this would be a good choice, since no other sector in the realm of equities has comparable upside optionality. Obviously, if these companies were to trade at even a modest premium to book value, all else equal, they could easily double. But all else would not be equal, because for that to happen, shipping lease rates would first have to rise, and when that happens rates can double and triple in a matter of weeks. That would translate into higher earnings and then into higher book value. That circumstance can unfold very fast.

The point is that one should evaluate the bad news, but you can't stop there. The price has to be evaluated, too. Because price and bad news on global trade brings us back to the topics of broad stock market risk and systemic risk.

### *Sanctions and the S&P 500 et al*

There's a bit of unwitting self-deception that investors commit when they immediately relate the possibility of a global trade tariff war with the ocean shipping industry. It's not that the conclusion is wrong, for indeed it will have its impact. But they don't seem as concerned about the impact on most of the important companies in the stock market. All the indexes are based on trading liquidity; given that, the major indexes are top-heavy with the large global multinational firms, which are the most liquid and have the greatest market capitalizations.

It is not merely that, for instance, Coca-Cola gets over 60% of its revenues from outside of North America. Global multinational companies have pursued cost efficiencies in labor and materials on a worldwide basis, based on the open trade policies that exist. The commonly used stock indexes are almost entirely comprised of companies that derive profits from this arbitrage of producing in low cost economies and selling in more affluent ones. The parts and raw materials that go into almost every conceivable consumer product, even those 100% made in the U.S.A., are sourced from around the world, thousands and thousands of components, including ones you would never know exist and might be critical to a major manufacturer, like a special spring or flange made from a very specific grade of steel that has to go into a jetliner or car or lawnmower and for which there is zero manufacturing capability in the U.S..

If the U.S. were to adopt policies that would ultimately eliminate the U.S. trade deficit, the impact upon the modern index investment posture would be profound. It is no exaggeration to suggest that by investing in indexation products, one is actually exposed to the prior U.S. trade policy, not the current one. The change in U.S. trade policy is without precedent.

But even that is not the problem, exactly. The problem is – getting back to the earlier point of discussion – price. The shipping industry already trades at all-time lows. Nobody owns those companies. Someday they might really want to. The S&P 500 trades at all-time highs. Everybody owns those companies. Someday they might really *not* want to.

So, yes, in answer to the question: global trade tariff disputes will no doubt affect the ocean shipping sector.<sup>7</sup>

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<sup>7</sup> This was, by the way, my shorter answer to the original e-mailed client question about AP Moller-Maersk:

Not a scab, we're not emotionally invested in our holdings, though we appreciate his sensitivity to our possible sensitivity. The AP Moller-Maersk investment, like most of our holdings, was not only intended as a long-term work-out, but the pricing would not have existed if not for an extended/uncertain time frame. A salutary outcome was always dependent upon a recovery in the shipping supply/demand balance, and these are long multi-year cycles. The developing trade tariff disputes may well extend the time to a recovery, but Maersk is an operator to own to be exposed to this differentiated sector (e.g., market leader that historically emerges from each down cycle in a stronger global competitive position; family controlled, and who are intelligent long-term capital allocators; balance sheet intact and cash flow positive; trading below tangible book value; etc.)

*Cash and Asset Allocation: An Uncorrelated Asset with Highly Elastic Purchasing Power*

In an ordinary portfolio the three basic asset classes are common stocks, fixed income securities, and cash. In classical portfolio theory cash was treated as a much more strategic asset than it is today. Today, many think of it as a wasting asset or a strictly temporary refuge during so-called 'risk-off' periods. During the Credit Crisis a decade ago, many investors liquidated much or all of their bonds and stocks and fled to cash as a default. The original idea, though, was to select an asset allocation mix that would suit your long-term risk tolerance level, measured by the price volatility of your portfolio. If you wanted less volatility, you could increase the cash level. If you wanted more return, you could decrease it. If you wanted yet more return potential and could accommodate the volatility, it was not intended that you seek out more esoteric or risky stocks, say in Lebanon or Pakistan. Rather, you would just decrease your cash to a negative figure – that is, buy additional stock by borrowing, so that you could be, for example, 110% invested.

In our case, we don't mind interim stock price volatility; we're more concerned with long term returns. But the opportunity set for attractively priced securities is quite narrow, and the systemic risks quite great. One shouldn't feel compelled to take one's cash and place it at risk just because you've allocated it as available to be invested. In this regard, there are two additional features to portfolio practice we might add.

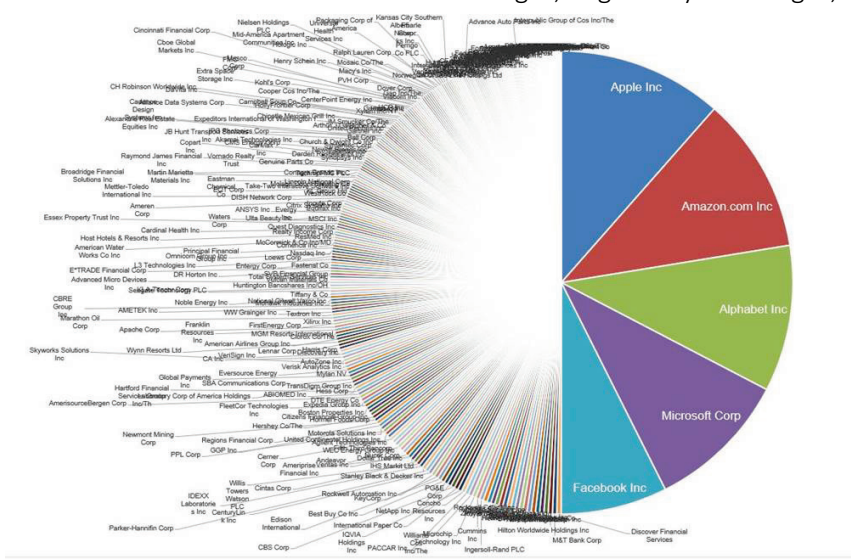
One is time diversification, which is not much discussed; discussion almost exclusively centers on security diversification. But the long-term return you get is powerfully determined by when you start: at the top of a market, or 6 months later at the bottom? Why should your long term return be dominated by the month or season when you happened to make the decision to open an investment account, or by whether, after all the meetings and interviews and vacation schedules, you started just after Labor Day instead of Memorial Day? There's value in a measured approach to capital commitment, and with time comes opportunity.

The other element of cash is that its value is far more dynamic and elastic than people give it credit for – in that its purchasing power rises dramatically when other assets decline. Here's a quick Rorschach test, an inkblot picture of a serious global trade war. What do you see? If you're fully, optimally invested, as is said, in the various global equity and emerging markets and investment grade and non-investment grade bond funds, it might look like a terrible storm. If you have a meaningful cash reserve, it might look a lot like a candy jar, for heaven knows what goodies might be inside.

And then there's the notion that 20% or 30% cash will be a serious drag on performance. Let's test that with my own made up but entirely plausible scenario. Say that the stock market is up about 6% this year so far, which is the case. There's a fully invested account, and a less conventional account that invested 70% in the S&P 500 and 30% in cash. The latter would be up by only 4.2%, so it's 1.8% points behind at mid-year.



But during the balance of the year the technology sector, which is 29% of the S&P if you include Amazon.com, has a little upset, just a little 10% correction, but only because it is outrageously valued and might shortly be threatened by various forms of market saturation challenges, regulatory challenges, technological disruption from blockchain applications, which are expanding explosively and, of course, a looming global trade war. That would cost the fully invested account 2.9% points, and the partially invested account 2.0% points. Now their respective performance is 3.1% and 2.2%. Repeat this exercise for Apple, Alphabet, Microsoft and Facebook, which happen to have approximately the same total market cap as the bottom 200 or so companies in the S&P 500.



Source: [www.irrelevantinvestor.com](http://www.irrelevantinvestor.com)<sup>8</sup>

And what if the partially invested account, also because of the looming trade war, took a 4% position in an amalgam of marine shipping companies trading at 50% of book value, and which have virtually no representation in the S&P 500. And what if, for whatever reason, by year's end there was a strong glimmer of good news. What kind? How about recognition of pending regulations about reducing sulfur gas emissions from bunker fuel, so that a large portion of the global marine shipping fleet would have to be scrapped. (I didn't make that up, by the way.) And what if, in response to that news that supply will come down, those shipping companies were to rise to merely book value? That would add 4% points to the portfolio return. Now the score, all else equal, is 3.1% for the fully invested account and 6.2% for the less conventional account. And, to boot, the partially invested portfolio still has 26% in available 'dry powder', as they say in the private equity biz.

<sup>8</sup> <http://theirrelevantinvestor.com/2018/07/19/pareto/>

**DISCLOSURES:**

*Note that indices are unmanaged and the figures shown herein do not reflect any investment management fee or transaction costs. Investors cannot directly invest in an index. References to market or composite indices or other measures of relative market performance (a "Benchmark") over a specific period are provided for your information only. Reference to a Benchmark may not reflect the manner in which a portfolio is constructed in relation to expected or achieved returns, portfolio guidelines, correlation, concentrations, volatility or tracking error targets, all of which are subject to change over time.*

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