DAVE JANNY AUGUST ONE 2017 INVESTMENT LETTER

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"LISTEN TO WHAT THE MAN SAID: ACCIDENTS WILL HAPPEN"

"An accident, also known as an unintentional injury, is an undesirable, incidental, and unplanned event that could have been prevented had circumstances leading up to the accident been recognized, and acted upon, prior to its occurrence."

That is the definition of "accident" I came across in Wikipedia. I very much relate to the part about "recognizing" the potential of an "accident prior to its occurrence". This is one of the central themes in this Investment Letter. "Accidents Will Happen" is the song title I felt was appropriate in communicating my message. Hopefully you recognize "Accidents Will Happen" as the 1979 Elvis Costello song from his breakthrough album "Armed Forces". The song was an early "new wave" hit that established Costello as one of the early standard bearers of the "new wave" music invasion. Yes, 'accidents will happen", but critically, if one is able to recognize the potential for an "accident"" prior to its occurrence", I'd argue that there is much benefit to be garnered. This fact is particularly true in investing. First you avoid the undesirable effects of any downturn and secondly you put yourself in a position to take advantage of the opportunities that the "accident" creates.

When it comes to investing, how do you know that an "accident" is about to happen? I say you "listen to what the man said". First let me credit Paul McCartney and Wings with that 1975 song. Cruelly, my two song choices are 38

years and 42 years old. Man, does time fly! Secondly, getting back on track, for the purposes of this Letter, Howard Marks will be "the man". Howard Marks may not be a household name, particularly with retail investors, but many in the investment business regard his "Oaktree Memos" he writes to clients as "investing advice" gems. Oaktree Capital Management is the firm Marks founded in 1995 and continues to successfully run to this day. The billionaire Marks, has become one of the most successful money managers ever. He and the firm are best known as "distressed debt" investors. The lessons of "distressed debt" investing transfer very well into the ongoing asset allocation decisions we as investors are faced with. One of the most interesting things about the investment business is that it always requires a willingness to learn. Yes, the details of the latest and greatest investment phenomena are always different than they were before, but being a market historian is a prerequisite to long term investment success. The details are different but cycles and human emotion play out in very similar ways. Whether you're a professional investor, an experienced retail investor or even an investing novice, Howard Marks' 7/26/17 Memo entitled "There They Go Again . . . Again" is an absolute must read. Rather than "reinventing the wheel", I will make his brilliant Memo the centerpiece of this Investment Letter.

Before we get into it, I want to share the link to my Investment Letters that are posted on my website. Thanks for your interest and viewership of the last one which was called "Suspicious Minds: The Weight and The Waiting".

http://fa.morganstanley.com/david.janny/from_my_desk.htm

I look forward to your comments and communication. Feel free to reach out to me and please connect with me on LinkedIn https://www.linkedin.com/in/david-janny-ba2734115

ARE YOU EXPERIENCED?

"Are you experienced?" Jimi Hendrix

I couldn't quite fit the Hendrix song title into my Investment Letter title, but it certainly is a question whose answer lays a strong foundation for the importance

of appreciating Marks' memo. Marks, is without a doubt an experienced and successful manager. In my Letters I always try to share comments, articles and research from experienced market participants or observers, who I have historically followed and respected. Theirs are views and opinions that I feel can provide valuable insight into current market and economic conditions. In the recent past I've shared the views of famous money managers like Bill Gross, Jeff Gundlach, Ray Dalio, Paul Singer, Seth Klarman, Robert Rodriguez and Lacy Hunt. Additionally I've included views by well-respected prognosticators like Jim Grant, Art Cashin, Fred Hickey, John Hussman, Peter Boockvar, Danielle DiMartino Booth, John Mauldin, Mohamed El-Erian and Lance Roberts. All of these individuals, in my opinion, have regularly distinguished themselves with prescient views on global markets and economies. They're all "experienced". If you're familiar with the names, I hope you'd agree with me that they are a formidable group. An additional commonality is that they all share some level of concern with the current state of the global markets and economy; that in of itself should at least create some reasonable level of concern in any rational investor's mind. To top it off, add Howard Marks to the list.

Alas, all market investors may not be rational; especially at approaching market tops. Human emotion has a tendency of getting in the way of successful investing. That's exactly why I highly encourage you to read Marks' Memo. Investing is about constantly learning and understanding the history of markets. This piece is one that allows all of us, no matter what experience level we have, to learn and understand more about the markets. It is written in a very easy-to-comprehend style.

https://www.oaktreecapital.com/docs/default-source/memos/there-they-go-again-again.pdf

I strongly urge you to read the Memo. It may be a little long, but print it out and read it at your own pace. Every once in a while you read a research piece that makes an impression and ends up either making or saving you some significant amount of money. In the long run this piece has that kind of potential. I hope

we'll be talking about it in a very favorable light for a very long time into the future.

At the expense of you possibly not reading the piece, I'll share some of my favorite parts. If you haven't read it, I hope it whets your appetite.

"I think it's better to turn cautious too soon (and thus perhaps underperform for a while) rather than too late, after the downslide has begun, making it hard to trim risk, achieve exits and cuts losses."

That's my sentiment exactly. The late-cycle nature of where I feel we are in the investment and economic cycle makes this one of the foundations of my current cautious view (more on this later).

"Today's financial market conditions are easily summed up; there's a global glut of liquidity, minimal interest in traditional investments, little apparent concern about risk, and skimpy prospective returns everywhere. Thus, as the price for assessing returns that are potentially adequate (but lower than those promised in the past), investors are readily accepting significant risk in the form of heightened leverage, untested derivatives and weak deal structures."

The above-the-surface complacency currently is masking the magnitude of the underlying risk that markets actually present. In my 34 years in the financial services industry, I feel these risks today are at one of the most elevated levels that I've experienced. That doesn't mean that markets realize that risk immediately, but being aware of the risk is essential.

Here, Marks gives us a glimpse into the conversations that he's been having with sophisticated institutional investors:

"And there's one thing we hear a lot these days:

- **We agree things can't go well forever – we agree the cycle is extended, prices are elevated and uncertainty is high –**

but we don't see anything that's likely to bring the bull market to a close anytime soon.

In other words there'll be a time for caution, just not today. In that connection, Andrew (his son) **reminds me about Saint Augustine, who said "Give me chastity and continence, but not yet." Is there something other than the punitive returns on safe assets that keeps this from being a time for caution?"**

Well said. I love the St. Augustine quote; it's meant to describe the sinner who wants to repent but who just wants to have a little more fun first. It very succinctly sums up the rationale of the "more bullish" Wall Street investment strategists who are calling for that "one more big rally" before the secular bull market ends despite "late cycle" fundamental concerns that they may have. It also accurately describes the average investor who thinks he or she will easily be able to get out before the downturn.

Here is a nice summary list from Marks of some of the concerns he details in the Memo:

- **Some of the highest equity valuations in history.**
- **The so-called complacency index at an all-time high.**
- **The elevation of a can't-lose group of stocks.**
- **The movement of more than a trillion dollars into value-agnostic investing**
- **The lowest yields in history on low-rated bonds and loans.**
- **Yields on emerging market debt that are lower still.**
- **The most fundraising in history for private equity.**
- **The biggest fund of all time raised for levered tech investing.**
- **Billions in digital currencies whose value has multiplied dramatically**

If you read the Memo, you'll know that his current one is titled "There They Go Again … Again" which actually is a word play on his May 2005 Memo titled "There They Go Again". In the 2005 Memo he wrote:

"… there's no easy answer for investors faced with skimpy returns and risk premiums. But there is one course of action – one classic mistake – that I most strongly feel is wrong: reaching for return."

There is a lot of "reach for return " going on in today's investment world. As I've mentioned many times before there is also a lot of "TINA" (There Is No Alternative) and " FOMO" (Fear of Missing Out) going on out there as well. Then from the current Memo:

"The events of 2007 and 2008 showed this observation to have been prudent and appropriate. And given today's similarities to the last cycle, I think it's applicable again."

"Where are we today? As I said earlier, risk is high and prospective return is low, and the low prospective returns on safe investments are pushing people into taking risk - which they're willing to do – at a time when the reward for doing so is low."

This is exactly what is happening again today; low return for high risk. Many investors don't realize how much risk they're actually taking. I'll touch on this again a little later as it pertains to some of the risky less-than-plain-vanilla strategies that are thriving in today's marketplace.

Summing things up, Marks tells us how to avoid "accidents". "Listen to what the man said":

"On the other hand, the keys to avoiding the classic mistakes also recur, and I listed them in "There They Go Again":

- **Awareness of history**
- **Belief in cycles rather than unabated, unidirectional trends**
- **Skepticism regarding the free lunch, and**
- **Insistence on low purchase prices that provide lots of room for error.**

Adherence to these things – all parts of the canon of defensive investing – invariably will cause you to miss the most exciting part of bull markets, when trends reach irrational extremes and prices go from fair to excessive. But they'll also make you a long-term survivor. I can't help thinking that's a prerequisite for investment success."

"The basic proposition is simple: investors make the most and the safest money when they do things other people don't want to do. But when investors are unworried and glad to make risky investments (or worried but investing anyway, because the low-risk alternatives are unappealing), asset prices will be high, risk premiums will be low, and markets will be risky. That's what happens when there's too much money and too little fear."

I concur completely; that's exactly where we are today. Marks' line **"worried but investing anyway, because the low-risk alternatives are unappealing"** is representative of a lot of people's views. Ultimately fundamental justification will be required. I urge you to be prudent, patient and heed Marks' sound long term investing advice.

PATIENCE DEAR PRUDENCE

Speaking of prudence, you may remember that title from my APRIL ONE 2017 Investment Letter of the same name:

http://fa.morganstanley.com/david.janny/from_my_desk.htm

I recently posted an article on LinkedIn from the New York Times written by Arthur Brooks of the American Enterprise Institute titled "How the Modern World Made Cowards of Us All". It struck a chord with me because he argued that "**we have refashioned prudence into an excuse for cowardice".** If you read Howard Marks' Memo, I would argue that currently the "prudent" and at the same time "brave" thing to do is resist the temptation of following the crowd when there are many flashing "danger" signs in the market. As Brooks further elaborates:

“The connotation of prudence as caution, or aversion to risk, is a modern invention. “Prudence” comes from the Latin “prudentia,” meaning sagacity or expertise. The earliest English uses from the 14th century had little to do with fearfulness or habitual reluctance. Rather, it signified righteous decision making that is rooted in acuity and practical wisdom.”

“Righteous decision making”, doesn’t that make sense? Be prudent! It is my opinion as well as Marks’ that the temptation at the moment is to chase the market, which may be the easy but more likely “imprudent” thing to do. It may even work for a while longer. Remember again the quote from Marks I showed you before: “i**nvestors make the most and the safest money when they do things other people don’t want to do**

https://www.nytimes.com/2017/07/21/opinion/how-the-modern-world-made-cowards-of-us-all.html

AM I EXPERIENCED?

I want to share a little bit of my experience and journey to today’s Investment Letter as it will give you a better idea of where I’m coming from.

I’ve been in the financial services business for 34 years, so I do actually have a little experience. One day that I often think about is Monday October 19th, 1987. According to Wikipedia, the market fell 508 points to 1738. An astonishing 22.61% move. I was at Merrill Lynch in NYC at the time. I had been a financial advisor for less than two years. The day was a blur as I like many people were mesmerized and in shock in what we were seeing on our screens. Thankfully as a neophyte, I had a very small book of business. Actually, an equally if not more interesting day was the next day Tuesday October 20th 1987. I’ll never forget riding the Metro North train to Grand Central Station that morning. There was an eerie silence and a feeling of fear so thick you could feel it all around you. The market again opened down dramatically but managed a monumental reversal that morning. In hindsight, with some help from the Fed, the markets were saved. Besides the shear emotional, technical and physical cratering of the markets, one of the other

interesting aspects of the decline was that it was not induced by a recession. The "crash" was more a case of the markets acting rather independently of the economy (more on that later). The whole experience was of course a tremendous on-the-job learning experience.

At the time of the 2000-2002 "tech wreck", I had been a branch manager and regional sales manager for Paine Webber in CT; contemplating a return to becoming a financial advisor. Being in branch management, I didn't have much of a "book of business", but rather was able to witness the bursting of the "tech bubble" from a bit of an "arm's length". Nonetheless it was a tremendous learning experience in terms of witnessing what a "bubble" both on the way up and on the way down looks like. It was an informative step on my way to trying to become "a student of the market". Very importantly, it became my working assumption that we had re-entered a secular bear market after the great 1982-2000 secular bull market. This view was instrumental in my decision to become a full time financial advisor again (with UBS who had acquired PaineWebber).

My secular bear market view coupled with my suspicion that the mortgage bubble was headed toward an ugly conclusion allowed me to "prudently" prepare for the 2007-2009 financial crisis. I was able to not only avoid the damage but also to benefit from the downturn. It was the third bubble/crash in my career and being prepared for the "accident" allowed my clients and I to first-hand experience some of what Howard Marks' Memos talk about.

The "tech bubble" was of course a case of extreme overvaluation and speculation in one sector which of course was tech. Extremely "easy" Fed policy was evident in the buildup of the bubble. Similarly, "easy" Fed policy contributed to the excessive leverage and speculation created in the financial sector of the economy in the lead up to the financial crisis. Finance/credit sectors of the stock market this time around were the hardest hit. In both instances the S&P 500 experienced approximately 50% corrections that set back and damaged investors' portfolios. Personally, I learned a great deal about how markets work.

WHERE ARE WE TODAY? DIVERGENCE AND DANGERS

I walked you through my “experience” because there are a lot of cautionary divergences and frightening “reach for return” events and strategies that have had undue influence on market indices again today. Awareness of these “cause for concern” trends is important, ignorance of these “cause for concern” trends could prove more than a little troublesome. Current market conditions could persist for longer than I and other people think but it is my obligation to warn you about some of these troubling signals and developments.

As I mentioned earlier, 1987 was more of what I would describe as a “technical” rather than economic event. The “crash” was exacerbated by the “portfolio insurance” vehicles and strategy that actually accelerated the selling pressure.

This leads me to the VIX. The VIX is the “Volatility Index” better described as the “Fear Index”. I’ve written before about the VIX “shorting” strategies that have completely suppressed volatility. Before I share some of the details with you, I’d like to point out one very important opinion of mine; this volatility suppression trend is the most dangerous short term risk in the market. Some of you may be aware of it, but more likely many of you are not. Please read the following 7/30/17 article from Zero Hedge on “Why Does Extraordinarily Low Volatility Matter”, where Jim Mooney of Baupost explains the risk:

http://www.zerohedge.com/news/2017-07-30/why-does-extraordinarily-low-volatility-matter-baupost-explains

Read the article, I think it is very important. I will share some stats from the article describing how low the VIX actually is from a historical standpoint:

“The most commonly referenced measure of equity market implied volatility; the VIX has traded at an average of 11 since late April. To put this level in context, since 1990 when the VIX was first created, the index has closed below 10 on only 16 days; seven of those days have been since May 1, 2017. The average closing of the VIX between 1990 and 2016 was about 20 versus a 2017 year-to-date average of roughly 12.”

Again if you read the article, I'm sure you'll realize why a spike back only to the historical VIX average of 20 could create plenty of short term adverse consequences. Morgan Stanley "derivatives strategist" Chris Metli estimates that a one-day S&P 500 spike of only 3.5% could potentially cause the VIX to double from its' current low level. I know it feels like in this ultra-complacent environment a 3.5% S&P 500 move would be difficult, but historically that really isn't that big a move.

One of the reasons I walked you through the October 1987 "crash" experience was because one of the most recognized factors for the "crash" was the prevalence of "portfolio insurance". I earlier described to you how that "portfolio insurance" created a chain reaction of sell orders that exacerbated the down move. Remember that it wasn't even an economic event or geopolitical event that caused the "crash". Similarly the very large amount of "short VIX" strategies run the risk of creating a "VIX squeeze" which would sharply push up the VIX and at the same time create selling pressure on the stock market. That's not a prediction of a "crash" but rather an acknowledgment of the realistic possibility that the ingredients are in place for some sort of "accident" to potentially occur. "Volatility" is a very interesting topic; it's also a "new" wrinkle to the market mechanism (VIX was only created in 1990) that very recently has had a lot of products created (including leveraged ones) to trade it. It's worth noting that the creation of exotic and leveraged mortgage products certainly was a significant contributing factor in the financial crisis. If you're interested in learning more about "volatility", I'd point you to the research of Chris Cole of Artemis Capital. I regard Cole as the "man" in that investing space.

There are other larger strategies like "risk parity" that base their position sizing on volatility targets. Simplifying things for a moment, this would imply more leverage the lower the market volatility goes. Therefore spikes in volatility could eventually cause selling of equities in a repositioning. I would be happy to speak to you more directly on these topics as it is difficult to relate the scope of this issue in the context of this Investment Letter. I urge you to call me.

Marks writes about "**the elevation of a can't-lose group of stocks".** In previous Investment Letters I've been writing about the impact of FAANG (acronym for Facebook, Amazon, Apple, Netflix and Google) on the NASADAQ 100 and S&P 500 indices. Those stocks have had an undue influence that has not only caused more money to flow into the FAANG stock themselves but additionally helped create strong performance in the indices as well; which then has attracted even more performance-chasing money. I, and Marks in his Memo, have written about the frenzy in passive index ETF buying.

One divergence not getting enough attention has been the downturn in the Dow Jones Transportation Index. Historically, divergence between the Dow Transports and Dow Jones Industrials has potentially flagged market inflection points. According to Thomson, the Dow Transports traded an intraday high of 9,709 on 7/14/17. By 8/2/17 it traded as low as 9,111. That was a move of greater than 6% while the Dow Jones Industrial Average was moving in the opposite "up" direction crossing 22,000 for the first time on that 8/2/17 day. In his 8/3/17 "Cashin's Comments", Art Cashin of UBS pointed out that:

"So, of the 2000 point rally in the Dow this year, more than half of those points have come from just three stocks –Boeing, Apple and McDonald's. So just 10% of the Dow provided over 50% of the gains. The narrowness almost guarantees divergence. "

Do you want an amazing stat on this "strong" market we've had for the last couple of years (if you sense some sarcasm you'd be right). According to my Thomson quotes, the Dow Jones Transports closed at 9,198 on 11/28/14, while on 8/3/17 the index closed at 9,202. Unbelievable! No gain in almost 3 years! If you look at the Dow Jones Industrials, the 11/28/14 close was 17,828 versus the yesterday 8/3/17 closing price of 22,026. Talk about divergence! I think it's another example of the outsized returns that a couple of stocks can provide to indices; making certain indices look better than they really are.

CONCLUSION

Many "accidents", from auto to household incidents, occur when people become complacent or distracted. To avoid "accidents" you have to be careful and cognizant of the potential risks. It's no different in investing. Hopefully Howard "the man" Marks and I have been of some help in that regard in this Letter.

If you "liked" this Letter I encourage you to let me know via LinkedIn with your "likes" and "comments". More importantly, I encourage you to reach out to me directly via phone, email or LinkedIn to discuss in more detail how these observations may apply to your personal financial situation. Stay safe and "listen to what the man said".

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Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Interest on municipal bonds is generally exempt from federal income tax; however, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax-exemption applies if securities are issued within one's state of residence and, if applicable, local tax-exemption applies if securities are issued within one's city of residence. The tax-exempt status of municipal securities may be changed by legislative process, which could affect their value and marketability.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of investment grade securities, including greater credit risk, price volatility, and limited liquidity in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Foreign currencies may have significant price movements, even within the same day, and any currency held in an account may lose value against other currencies. Foreign currency exchanges depend on the relative values of two different currencies and are therefore subject to the risk of fluctuations caused by a variety of economic and political factors in each of the two relevant countries, as well as global pressures. These risks include national debt levels, trade deficits and balance of payments, domestic and foreign interest rates and inflation, global, regional or national political and economic events, monetary policies of governments and possible government intervention in the currency markets, or other markets.

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that past participants were not entirely rational in their past purchases or sales of the security being analyzed. Investors using technical analysis should consider these limitations prior to making an investment decision.

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Past performance is no guarantee of future results.

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The NYSE Arca Gold BUGS Index, also known as the AMEX Gold BUGS Index, is a modified equal dollar weighted index of companies involved in major gold mining. The index was designed to give investors significant exposure to near term movements in gold prices by including companies that do not hedge their gold production beyond 1½ years. The index was developed with a base value of 200 as of March 15, 1996.

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