April 2016

Dear Investor,

Over the past month, the U.S. stock market continued a swing higher that began in February. The S&P 500 and other major indexes crossed into positive territory for the year by a few percent in April, but the recovery has not been universal; indexes such as the small-cap Russell 2000 and the Nasdaq remain in negative territory for the year. Global equity markets have also risen into positive territory for the year, but again, only by a few percent.

None of the short-term swings this year, or over the past two and a half years, has cured the illness underlying market prices today: extreme over-valuation. After rising into bubble territory in 2013, the broader market has essentially trended sideways, and on an inflation-adjusted basis stock prices remain just where they were 16 years ago at the peak of the tech bubble. This muted result over such a long period of time should not be surprising, let alone disappointing, given the high starting valuations. It should at the very least be concerning that many valuation measures remain near their highest levels in history, but it seems that two full decades of almost continuous over-valuation have conditioned investors to live without fear of loss from over-valued markets.

We certainly remain concerned about the risk of permanent loss of value from today's prices and valuations. However, we are less concerned about the risk over the next quarter, or even the next year, and much more concerned with the risk over the long-term. Markets have been devalued a number of ways in the past, and the devaluation following the current bubble could prove to be quite different from the strong, relatively rapid declines following the tech bubble and the housing bubble, or the bubble peak in 1929 (the only other times valuations have been this high). In fact, if history is any guide, the next decade may prove to be more like a devaluation by 10,000 drips than by a single market swoon. Such a long, drawn-out trend of volatility and modestly negative returns would certainly imperil retirement plans of many investors, including pension funds, but it would fit the general market pattern seen following prior large monetary expansions.

We have thought long and hard about the market environment we are likely to muddle through following the current bubble, and our current portfolio allocations represent our answer to current market conditions—both short term and long term. In this month's letter we'll take a few pages to shares some thoughts about Benjamin Graham, before giving updates on precious metals.

In this month's letter:

- Benjamin Graham, Simplicity and Potential Returns in Today's Over-Valued Market
- An Update on Precious Metals and the Volatility We Expect

Benjamin Graham, Simplicity and Potential Returns in Today's Over-Valued Market

> ***In selecting the common stock portfolio, do you advise careful study of and selectivity among different issues?***
>
> *In general, no. I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity, say, 40 years ago, when our textbook "Graham and Dodd"* [i.e. Security Analysis] *was first published; but the situation has changed a great deal since then. In the old days any well-trained security analyst could do a good professional job of selecting undervalued issues through detailed studies; but in the light of the enormous amount of research now being carried on, I doubt whether in most cases such extensive efforts will generate sufficiently superior selections to justify their cost.*
>
> ***What general approach to portfolio formation do you advocate?***
>
> *Essentially, a highly simplified one that applies a single criteria or perhaps two criteria to the price to assure that full value is present and that relies for its results on the performance of the portfolio as a whole – i.e., on the group results – rather than on the expectation for individual issues.*
>
> - Benjamin Graham, in an interview with the Financial Analysts Journal shortly before his death in 1976

If you are familiar at all with Benjamin Graham, the short passage above may be surprising to read. Graham is known as the father of value investing, and in that role he is most often thought of as a tireless advocate of combing through the financial markets in the search for hidden gems of value, regardless of Mr. Market's gyrations. As we all know, his most famous protégé, Warren Buffett, became the modern embodiment of that ethic. Yet, in the passage above, we have Graham recommending investors shun such deep research in favor of a portfolio of low-valued stocks based on simple criteria, and he advises investors be content with results more or less in line with the broader market.

As happens with all of those who reach a certain level of fame, myth tends to overshadow reality as time passes. The mythology surrounding Ben Graham has continued to grow since he first published *Security Analysis* and *The Intelligent Investor* in the 1930s and 1940s, even though times—and market conditions—have changed quite a bit since then. Those treatises contained timeless investing advice, and they were also well suited to the market environment of the day, as they were written when financial markets were modestly valued and the dollar remained firmly anchored by the gold standard. But as early as the 1960s and 1970s, market conditions had changed to such an extent that Graham himself had come to question the practical usefulness of some of the lessons taught in his books.

At the very heart of all of Graham's teachings is the importance of investing in securities that represent a significant value. As Graham said in *Security Analysis*, "An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative."

When Graham wrote those books in the 1930s and 1940s, finding value in individual equities was helped along by the fact that the 1920s bubble had already burst, and the broader market was modestly valued in the wake of the 1929–1932 collapse; in 1934, when *Security Analysis* was first published, the S&P 500 was less than half of today's valuation. The search for value was also

helped by the fact that the investment management industry was much less developed than it later became. At the peak of the market in 1929, there were only 19 mutual funds operating in the U.S., and that number remained below 100 until the 1950s. In contrast, today there are now over 10,000 mutual funds—more funds, in fact, than there are publically listed stocks.

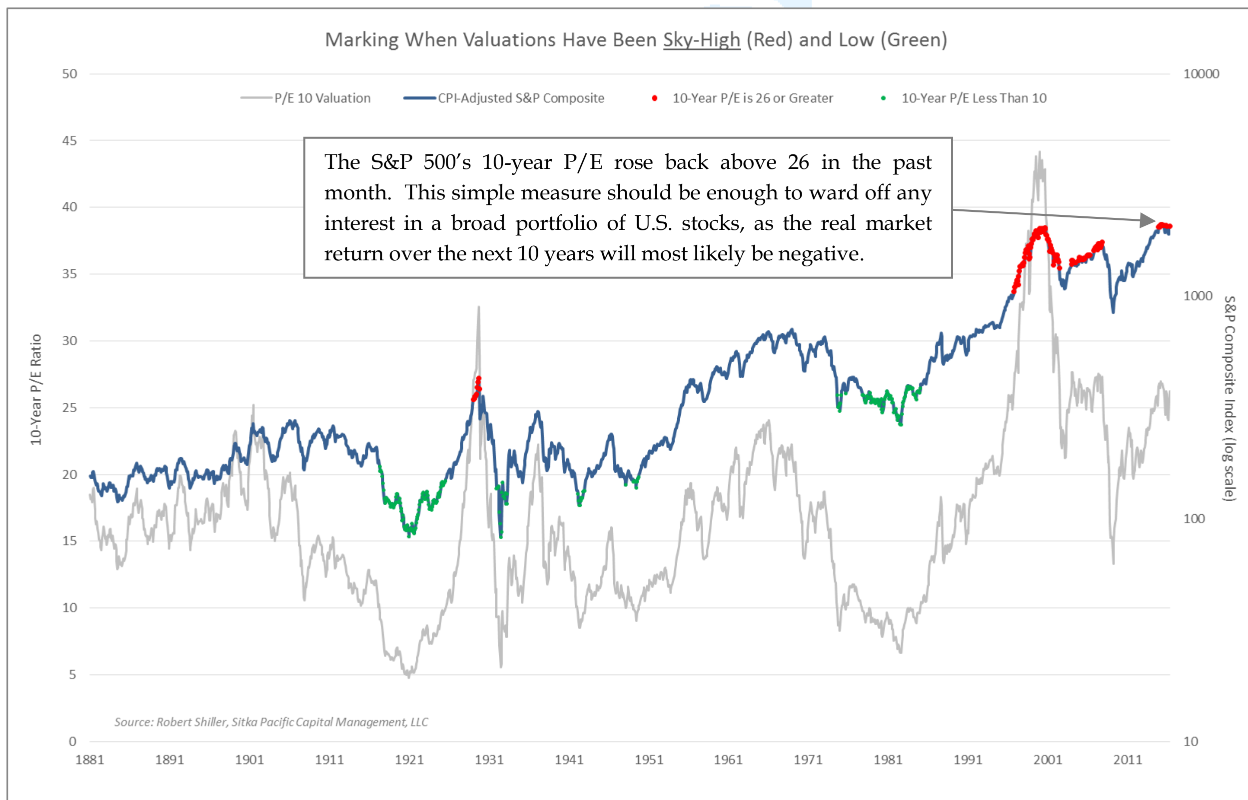
Although Graham's Depression-era thoughts on finding value continued to inspire investors in the decades that followed, by the early 1960s he had soured somewhat on the outlook for funding undervalued securities due to the rise in the market over the preceding decade. We detailed this in an annual letter a few years ago when we discussed a speech Graham gave in November 1963 entitled *Securities in an Insecure World*. At that time the 10-year P/E of the S&P 500 had risen to above 20, and this rise in the market's valuation had shifted Graham's thoughts toward the risk of remaining invested, instead of potential returns. Although he continued to recommend investors keep at least some of their savings in a broad basket of stocks as a long-term inflation hedge, he also recommended significantly reducing that exposure at the high valuations that prevailed at the time.

By the 1970s, Graham's thoughts on seeking out value in the markets had shifted even further away from the idea that investors should spend their time trying to find hidden value in individual stocks and bonds. Although the market's valuation had become more attractive a decade after his 1963 speech, the fund industry's influence on the financial markets had mushroomed. This left the market, to paraphrase Graham, *over-analyzed*. As he said in the 1976 interview we quoted above, "In the old days any well-trained security analyst could do a good professional job of selecting undervalued issues through detailed studies; but in the light of the enormous amount of research now being carried on, I doubt whether in most cases such extensive efforts will generate sufficiently superior selections to justify their cost." In other words, the father of value investing had, toward the end of his life, recommended investors shy away from the search for value at the individual security level, and instead invest in broad portfolio of stocks (and bonds) weighted according to their investment merit—i.e. their valuation.

We relate this short story for a few reasons. As dramatic as the transformation of the financial markets was in the decades following the Great Depression, it *accelerated* after Graham's death in 1976. Although we cannot know for sure what he would make of the tick-by-tick news coverage that is focused on the financial markets these days, we suspect that he would be surprised to learn that the number of mutual funds in the U.S. now outnumbers the number of listed stocks. And he probably would be shocked to learn that three-quarters of daily volume on the major exchanges now comes from high-frequency trading—computers trading with computers, all in fractions of seconds, and none with any thought of the value of what's being traded. Although the market conditions in the 1960s and 1970s had caused Graham to reassess whether real value was worth looking for amid all the attention the markets were garnering at the time, we suspect he would be utterly flabbergasted by how far things have gone since then.

He would also likely be surprised to learn just how high investors pushed valuations during the tech bubble, and in the years afterward. Graham lived and managed money during the 1920s

bubble, and nearly lost it all during the crash from the peak in 1929. This experience galvanized his focus on value and the risks associated with investing in over-valued securities—and over-valued markets. Yet, during the tech bubble, the market soared far above the highest valuations reached during the 1920s, and the market has returned to those 1929-like valuations twice since then. Here in April, the valuation of the S&P 500 is again in rarefied air—30% higher than when Graham made his speech warning of high valuations in 1963. In fact, prior to the late 1990s, a market valuation like we have this month (or higher) was only seen for a few months near the peak in 1929. We have a feeling that at these valuations, Graham would likely at least pause to consider whether even a small allocation to stocks would be worth the risk.



Another transformation the markets have gone through since the 1970s has been monetary. Back in 1963, Graham wondered whether the dramatic rise in the stock market over the prior decade had been a signal that investors were expecting inflation rates to rise. However, it's likely he had no inkling (nor did anyone) of the dramatic monetary changes that would transpire in the years that followed.

Inflation of the kind seen in the 1940s and 1950s was a relatively new experience in the U.S.—it was the first time in the nation's history that wartime inflation of consumer prices had not reversed in the years following the war. Of course, part of the reason it was Different That Time was that the Federal Reserve had allowed the money supply and prices to fall back toward their prewar level after World War I, but not after World War II. When World War I ended the Fed was not yet a decade old, and Fed officials considered it their duty to bring relative prices and exchange rates

back toward prewar levels. However, the economic downturn that accompanied that adjustment proved to be so severe that Fed officials decided on a very different policy path following World War II: they kept the wartime monetary expansion in place, and allowed prices to revalue upwards.

In the 22 years between the attack on Pearl Harbor and Graham's speech in 1963, consumer prices in the U.S. doubled and the S&P 500 rose 325% on an inflation-adjusted basis. Thus, in the early 1960s it appeared that stocks did quite well as an inflation hedge, as Graham pointed out at the time. However, in the 22 years that followed 1963, consumer prices more than tripled, the U.S. shed the restrictions of the gold standard in favor of guns-and-butter monetary expansion, and inflation-adjusted stock prices *fell* by 23%.

One of the main lessons from those periods is that while it's clear that stocks do indeed provide a good long-term hedge against inflation, such a positive result is <u>subject to reasonably low starting valuations.</u> When starting valuations are high, stocks fail to live up to that billing. The main difference between gains during the 22 years leading up to 1963 and the losses during the 22 years after 1963 is that the market's valuation was twice as high at the beginning of the latter period. If an investor was to follow Graham's advice to keep it simple in deciding on an allocation to the stock market, and was only able to know one number in order to make a smart, it would simply be the market's valuation based on 10 years of earnings.

Of course, the market's valuation today is far higher than at any time during those 22-year periods before and after 1963, and in fact the market action over the past few years bears a striking resemblance to the last time the market put in a long-term top. The two charts below, the first of the tech bubble peak and the second of the market over the past few years, highlight a very similar "rolling top." Given this high starting point, it should come as no surprise if the next decade (or two) leaves inflation-adjusted losses in its wake; this is simply the nature of sky-high valuations, and the potential returns that follow.

If Graham were alive today, we suspect that he would urge extreme caution about potential returns from stocks going forward, just as he did just a few years before the long-term bear market that began in 1966. He would also almost certainly recommend investors steer clear of notes and bonds which now yield next to nothing. Leaving out both stocks and bonds doesn't leave much available, but we also suspect that Graham would recommend exposure to precious metals in the face of today's high market valuations, the lack of any stable anchor underlying the value of the dollar and the Fed's recent monetary expansion—a point we will elaborate on next.

An Update on Precious Metals and the Volatility We Expect

Our monetary-policy measures have been supporting growth. With rare exceptions, monetary policy has been the only policy in the last four years to support growth.

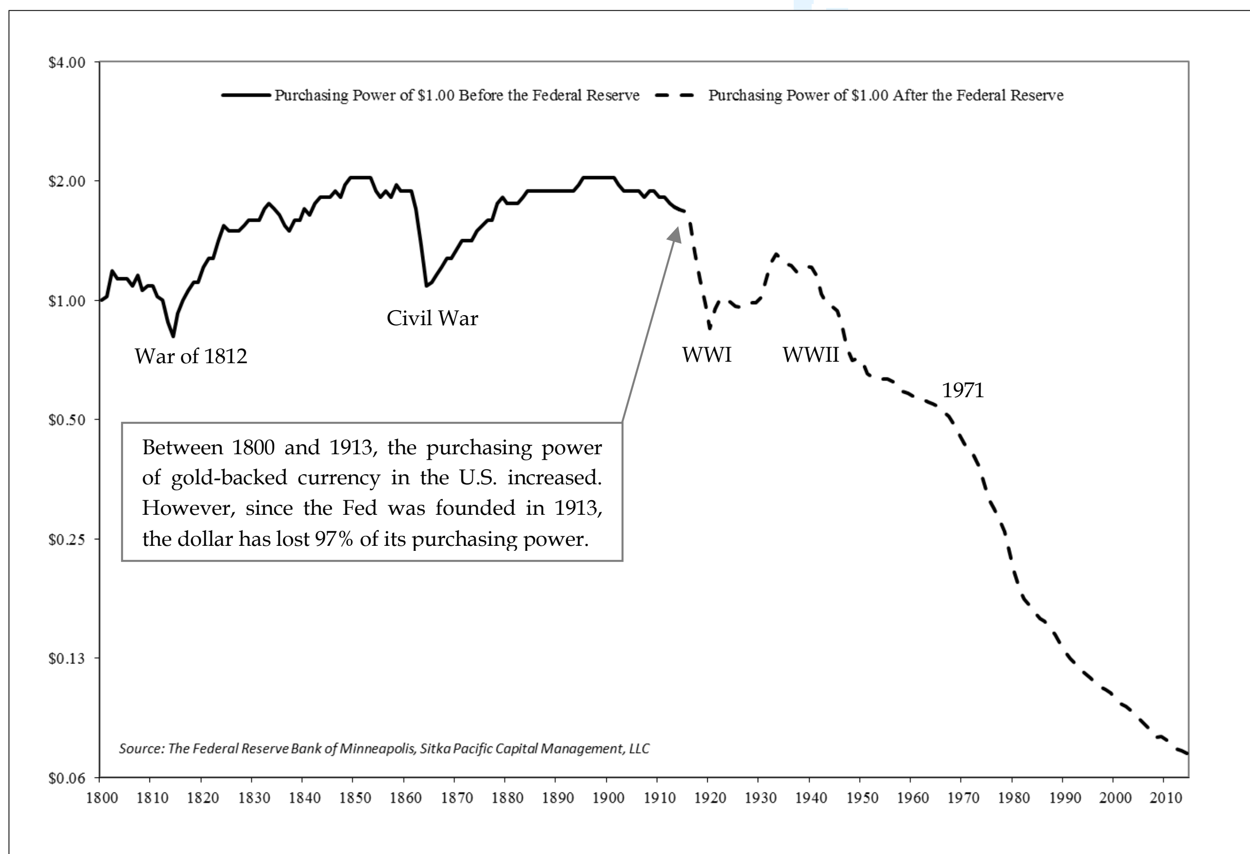
- Mario Draghi, European Central Bank President, April 2016

To this day, we still do not fully understand the hostility many investors have toward gold. There are those who hold that gold is a "barbarous relic" of a more primitive monetary age that the world has since evolved from. This argument tends to emphasize how much better the economy has performed since the U.S. began to move away from the gold standard during the Great Depression. Others say that gold does not make sense in anyone's investment portfolio because there is no way to value it; it generates no earnings, it pays no dividend, it has no balance sheet, and, worst of all, its value does not compound the way the value of a well-run corporation can. These arguments tend to all end at the same question: Why would you invest in gold, when stocks have done so much better over the long term?

Of course, the response to these arguments is relatively simple: gold is a store of value, not a compounding investment, and not a tool to manage the economy. Gold has never been nor ever will be an asset that compounds or something that can aid the government in the management of

the economy. However, it will remain an asset that will maintain its purchasing power over the long term, regardless of the government's debt and monetary expansion, and there are times when that can prove to be very useful.

Until the Fed began actively using the money supply as a tool to manage the economy and financial markets, gold provided the foundation underlying the stable value of the dollar and all other bank notes that circulated in the 1800s. But gold proved to be an obstacle and limitation for such central bank interventions in the economy and financial markets, which partially explains why policy makers are usually quite hostile to gold. If the dollar had continued to be based on gold, the Fed would not have been able to expand the money supply at will over the past century; an expansion that resulted in a 96% decline in the purchasing power of the dollar.



We think it's possible that some, or perhaps even most, of the hostility investors have toward gold may never have evolved in the first place if Benjamin Graham, the venerated father of value investing, had lived a little longer. If he had been given a chance to see the full spectrum of consequences in the decades following Nixon's final abandonment of the gold standard in 1971—the plunge in the value of the dollar, rapid consumer price inflation and the unchecked credit expansion up to unsustainable levels in the present day—he may have opted to weigh in on the value of gold and other precious metals in an investor's portfolio. He may even have resurrected his idea of a dollar backed by gold and other commodities in order to stabilize relative prices, an idea he promoted in the 1930s.

During all but the last few years of Graham's life, it was taken as a given that the dollar was backed by something tangible that anchored its value, and the decision to "go to cash" in one's portfolio really meant "go to gold-backed cash." Had he lived to see the last few decades of inflation and unrestrained credit growth, he likely would have had some strong opinions about the value of the dollar and other currencies that were, after 1971, restricted only by the central bank's willingness to print or not.

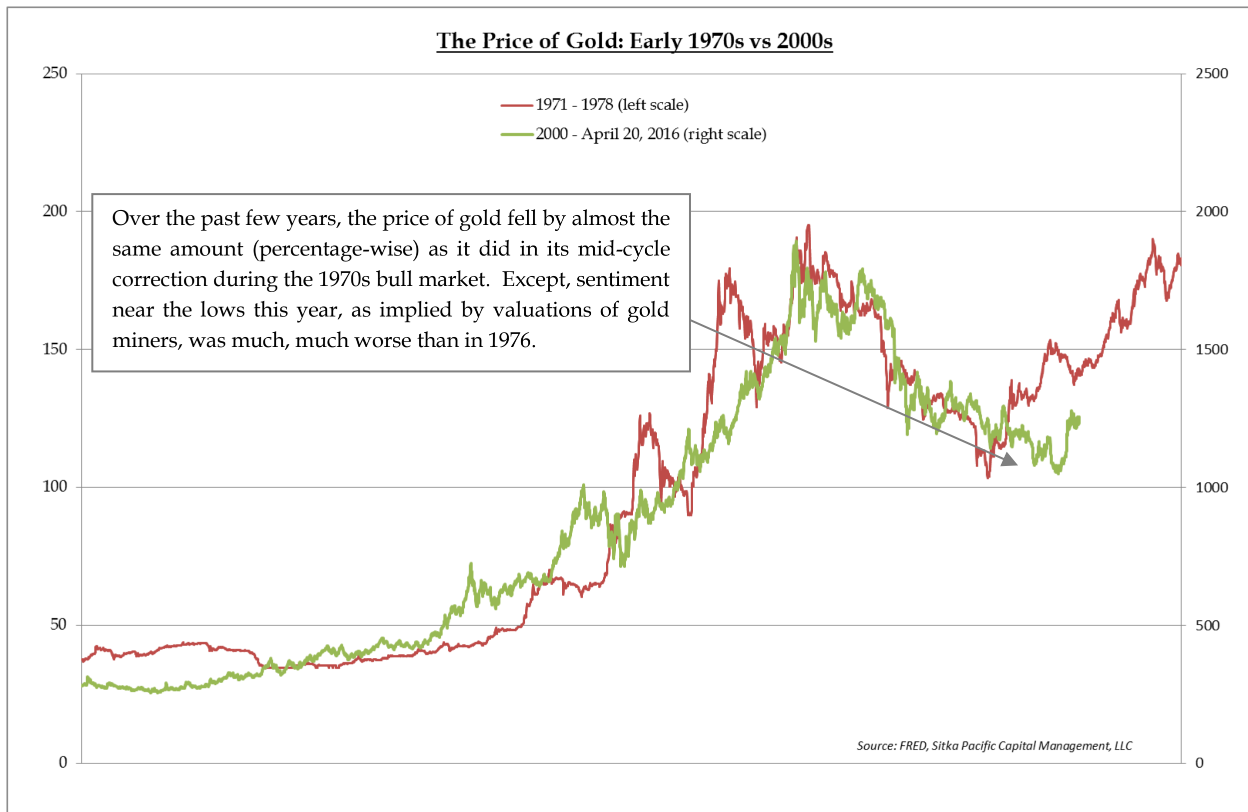
Unfortunately, Graham was not given the chance to take in the consequences of the abandonment of the gold standard in 1971, and as a result, the investing world lost what would have likely been (in our estimation, at least) a strong voice for gold in the canon of value-investing literature. Instead, there has been a relative vacuum of understanding about the very denomination of all our financial assets, and very little conversation about the alternating long-term cycles in real assets and financial assets.

Although we do not count ourselves among those who believe in gold's investment merit regardless of circumstances, we do count ourselves among those who see that we are currently in a market environment that will likely favor gold and other real assets over financial assets for some time—and we are going with the trend. Gold outperformed stocks by a wide margin following the peak of the tech bubble in 2000, and it has also outperformed stocks by a wide margin since the peak of the credit bubble in 2007. This gold outperformance came directly from willingness of the Fed and other major central banks to use monetary policy counter the effects of the tech bust and the house bust, but in some ways these were short-term cycles within a much larger emerging trend away from six decades of credit growth and toward deleveraging.

It has not been a straight line higher for gold, of course, but over the past 16 years gold has acted just as it has in past periods when the economy and financial markets descended from bubbles. We have expected gold to act that way again following the current bubble, we also expect gold to continue to respond as the Fed and other central banks use monetary policy to counter negative drags from long-term issues of over-indebtedness, deleveraging and demographics.

Shortly after the beginning of this year, a strong tailwind began blowing behind precious metals. This tailwind came up rather suddenly in January, but as you may know from reading these letters, it was not unexpected. In fact, from our point of view, the only unexpected part was how long it took for this tailwind to arrive.

Over the past few years it has become increasingly clear that major central banks around the world have painted themselves into an increasingly tight corner, from which they would inevitably react by implementing increasingly expansionary monetary policies. This has gone from an emphasis on zero percent interest rates and temporary quantitative easing programs immediately following the financial crisis, toward open-ended (and permanent) balance sheet expansions and negative interest rates. Yet as this global monetary policy evolution progressed, the price of gold drifted lower after 2011.

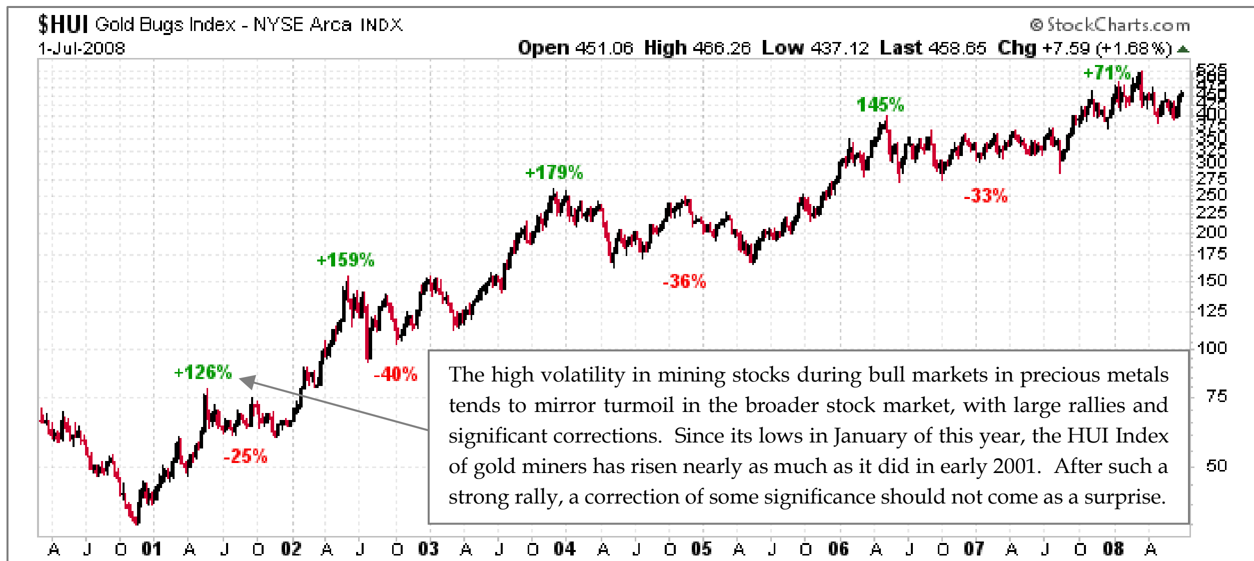


However, since the beginning of this year, gold has started to rise, and gold mining stocks have more than doubled from their lows in January. Given the context in which these rallies have occurred, it should be no surprise that we think the recent rally could be the start of a much larger trend. At least so far, the rally in gold mining shares since the beginning of this year has been very similar to the initial rise off the low in 2000 – which was the last time precious metals began a multi-year trend higher.

When the HUI Index of gold mining shares first began to rise after the tech bubble started to burst, the initial rally took the index up 126% from its low. It was a strong rise, but it was accompanied by only a modest rise in the price of gold and silver. However, because valuations in gold mining stocks had basically priced in falling gold prices far off into the sunset, even a modest rise in gold prompted a significant reassessment of the value of gold mining stocks by the market. This re-assessment continued as gold prices continued to trend higher during the early years of that bull market, as there were a number of strong rallies in mining stocks, which were all followed by corrections ranging from relatively shallow (-25% over 6 months) to severe (-40% over 2 months).

If a new post-bubble trend higher in precious metals has commenced, we should expect market prices to be volatile, as in this sector such volatility is inherently part of a healthy long-term bull market trend. Short-term corrections, like those that occurred between 2000 and 2008 (shown in the chart below), were part of the process of periodically “clearing the decks” of shareholders with only tentative holds on their shares. This happens during bull markets in nearly every kind of asset, but

gold, and mining stocks in particular, are particularly good at creating short-term corrections fueled by sheer panic selling.



We mention this because even if the long-awaited trend higher in precious metals has commenced, we certainly anticipate that corrections will happen, and some of them will undoubtedly be severe. However, our goal with our allocation to precious metals is not a short-term one—it is a long-term allocation that we think will likely have a tailwind for some time. The issues of debt, deleveraging and demographics we have discussed at length in recent years will likely continue to favor real assets, and over the past few years gold and gold mining stocks have been ideally positioned for another long-term bull market to begin.

* * *

Graham famously advocated a very simple investment strategy of focusing on stocks that were trading at less than their book values (preferably less than 2/3 book value), or stocks that that were trading at very low levels relative to their earnings—i.e. a P/E ratio less than 7. In his analysis, investing in sound businesses whose securities met these simple criteria would achieve his twin goals: safety of principal and attractive return.

It has been a long time since the broad U.S. market represented a good value that offered some semblance of safety of principal and an attractive long-term potential return, and it is no coincidence that over this period of time we have witnessed some of the most severe declines in market history, with no net inflation-adjusted gain. High valuations and poor returns go hand in hand, and at today's elevated market valuations we don't think stock-picking prowess, even using much more complicated methods than Graham advocated, would be enough to overcome a fall from today's high valuations back to a neutral valuation.

Our approach will be quite different when we are presented with a less hostile market environment. When we are able to find values that we think will offer an acceptable long-term return within an overall market environment that will at the very least be a benign influence on those returns, we will be far more active in seeking out value in equities. However, until then we remain focused on and allocated for the market environment we are faced with today.

As always, if you would like to discuss investments in your account, or topics discussed in this letter, feel free to contact us—we would be happy to talk with you.

Sincerely,

Brian McAuley
Chief Investment Officer
Sitka Pacific Capital Management, LLC

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