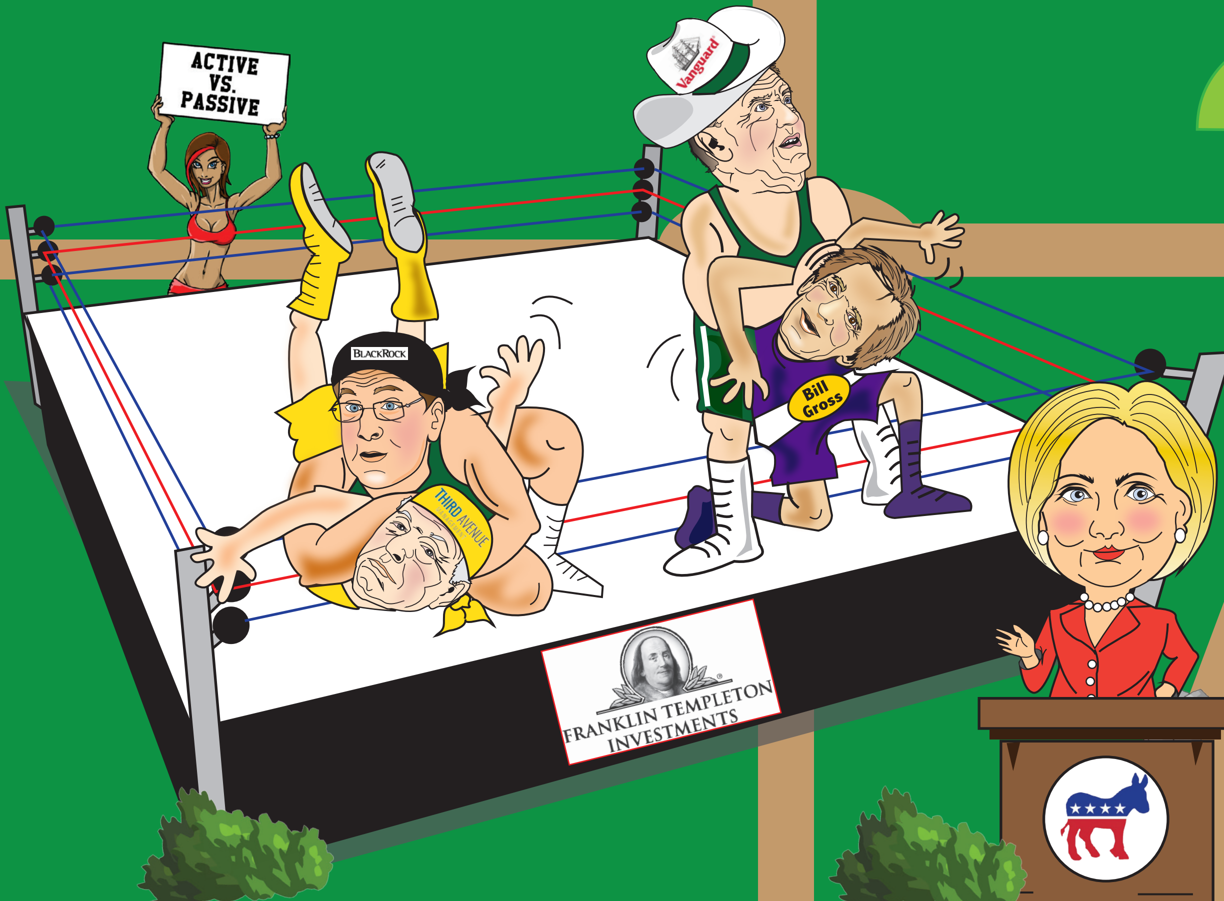
Boyar research

Boyar's Guide to

Profiting from Uncertainty



September 15, 2016
Volume XLII, Issue VII & VIII

Boyar research

Introduction – Boyar's Guide to Profiting from Uncertainty

Today's financial markets are sending a number of conflicting signals that have created a great deal of uncertainty for investors. While the domestic equity markets continue to hit new highs, individual investors remain concerned about the markets. Typically, new highs are accompanied by euphoria among retail investors. Meanwhile, consumer sentiment has reached pre-recession highs, but retail sales have remained under pressure. In the political arena, there is a tremendous amount of uncertainty created by two presidential candidates that are equally reviled by their own party members. Global macroeconomic conditions are tenuous and the recent decision by the U.K. to exit the European Union has created an additional layer of uncertainty about future growth conditions.

In this year's Summer Issue, we begin with a review of behavioral finance and come to the conclusion that uncertainty cannot be arbitraged away (unlike some common pockets of opportunities such as spinoffs), and will continue to produce mispriced investments. So where should an investor look in the current environment to benefit from uncertainty? This summer we have highlighted several out of favor or overlooked themes within the stock market that, once mined for high quality companies, offer some attractive investment opportunities whose potential success should be relatively uncorrelated with the broader market. We have attempted to find high quality companies that have been mischaracterized for various reasons. This includes a play on the reversal of the underperformance of value vs. growth and active vs. passive investment management strategies; a growing hotel franchise recently disrupted by its derivative oil and gas industry exposure; a high quality global industrial company overly punished by macro/currency headwinds; and a unique health care opportunity created by M&A/regulatory overhang.

Uncertainty and Behavioral Finance

As we explored topics for this year's Summer Issue, we were drawn to the theme of top-down uncertainty and why it results in attractive investment opportunities. More so than just stating the obvious—as we believe most value investors understand that pockets of the market where uncertainty/controversy loom are fertile hunting grounds for undervalued equities—we were curious to understand the "why" behind this phenomenon. Interestingly, the question led us to behavioral finance and ultimately the very makeup of the human brain.

To those with little interest in behavioral finance, we will offer the punch line right up front. The old Wall Street adage "the market hates uncertainty more than any known negative" is all one really needs to know on the topic. Where uncertainty is present, there will be fewer analysts doing deep fundamental research, resulting in pricing inefficiencies. However, this understanding has been around for decades. Why has the opportunity not been eliminated? After all, Joel Greenblatt's *You Can Be a Stock Market Genius: Uncover the Secret Hiding Places of Stock Market Profits*, which was originally published in 1999 and became required reading at many funds, contributed to a noticeable shrinkage in the bargains available in spinoffs. By shedding light on what was once an area of large neglect, Greenblatt's book sparked the narrowing of the massive margins of safety that used to be available in spinoffs in the 1990s. While spinoffs still outperform the market, old hands are keenly aware that there are a lot more eyes watching the spinoff niche than before Greenblatt spilled the beans.

So are we about to spill the beans and forever ruin the uncertainty theme? Well, no, because we do not believe this niche can cease to exist due to the intrinsic wiring of the human brain. David Rock, co-Founder of NeuroLeadership Institute, a research organization pioneering the marriage of neuroscience and leadership, explains that much of human behavior is governed by an overarching principle of minimizing threat and maximizing reward. His SCARF model details the brain's threat/reward circuitry in five domains of human experience: Status, Certainty, Autonomy, Relatedness and Fairness. Our focus here will be on Certainty, or the lack thereof.

> *"The brain is a pattern-recognition machine that is constantly trying to predict the near future…The brain likes to know the pattern occurring moment to moment, it craves certainty, so that prediction is possible. Without prediction, the brain must use dramatically more resources involving the more energy-intensive prefrontal cortex…Even a small amount of uncertainty generates an 'error' response in the orbital frontal cortex…This is like having a flashing printer*

Boyar research

icon on your desktop when paper is jammed – the flashing cannot be ignored, and until it is resolved it is difficult to focus on other things…[On the other hand] the act of creating a sense of certainty is rewarding…[and] generates an increase in dopamine levels in the brain, a reward response."[1]

Warren Buffett, in a November 2008 *Forbes* article, essentially demonstrated that the human brain is threatened by uncertainty by highlighting the poor capital allocation decisions of pension fund managers. Buffett referred to data showing that this group collectively allocated more money to bonds when economic conditions were uncertain and stocks were cheap, and directed increasing amounts into stocks as uncertainty diminished and stocks sold at greater premiums to book value. Buffett then offered his perspective:

"The future is never clear; you pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values."[2]

Followers of Buffett know that he has been saying essentially the same thing in different ways for decades ("be fearful when others are greedy, be greedy when others are fearful"). So why is his advice so hard to implement? Why is it not as simple as merely paying attention to spinoffs? The answer, we found, is that our brains actually work against us in executing on the perfectly logical strategy of buying when uncertainty creates bargains.

"It turns out the brain craves certainty in a similar way, and using similar circuits, for how we crave food…and other primary rewards. Information is rewarding. A sense of uncertainty about the future generates a strong threat or 'alert' response…Your brain doesn't like uncertainty – it's like a type of pain, something to be avoided. Certainty on the other hand feels rewarding, and we tend to steer toward it."[3]

"Contrarian" is the name given to people, like Warren Buffett, who can stand apart from the crowd and buy when others are paralyzed by uncertainly and/or fear. Between October 2008 and February 2009, a period marked by the panic of the Great Financial Crisis, Buffett invested over $25 billion in six companies (Mars/Wrigley, Goldman Sachs, Bank of America, General Electric, Dow Chemical and Swiss Re). Is Buffett's brain simply wired differently from the rest of us? While this may certainly be possible (it is more likely that through experience his brain became re-wired to see opportunity where others see risk) we would propose an entirely different possibility. In our view, Buffett's genius is that he switches his attention away from the uncertainty, which cannot be analyzed and therefore produces a debilitating response in the brain, to something of far greater certainty: the competitive advantages, or "moat," of the business in question. History has proven that wide moat businesses with strong balance sheets often emerge from difficult conditions even stronger. Wide moat businesses frequently gain share during uncertain times, either organically or by acquiring distressed competitors.

It is entirely possible that Buffett's brain is not wired differently, but that he simply uses his brain differently, creating an advantage for himself. While others become paralyzed by focusing on the uncertainty (e.g., reading articles and sell-side downgrades relating to the uncertainty), Buffett directs his brain toward an empowering reward response. By finding wide moat businesses whose stocks are on the bargain counter due to the uncertainty, his mind is in the pleasurable state of certainty (or near certainty) as he has history and data on his side supporting the outperformance of wide moat businesses through crises. In Berkshire Hathaway's 1994 shareholder letter, Buffett essentially confirmed that this very switch of focus is one of his advantages in investing:

"We will continue to ignore political and economic forecasts, which are an expensive distraction for many investors and businessmen…Indeed, we have usually made our best purchases when apprehensions about some macro event were at a peak…If we can identify

---

[1] *NeuroLeadershipJournal*, 2008, David Rock, "SCARF"
http://www.scarf360.com/files/SCARF-NeuroleadershipArticle.pdf

[2] Forbes, November 2008, Warren Buffett, "You Pay A Very High Price In The Stock Market For A Cheery Consensus"
"http://www.forbes.com/2008/11/08/buffett-forbes-article-markets-cx_pm-1107stocks.html

[3] *Psychology Today*, December 2011, David Rock, "A Hunger for Certainty"
https://www.psychologytoday.com/blog/your-brain-work/200910/hunger-certainty

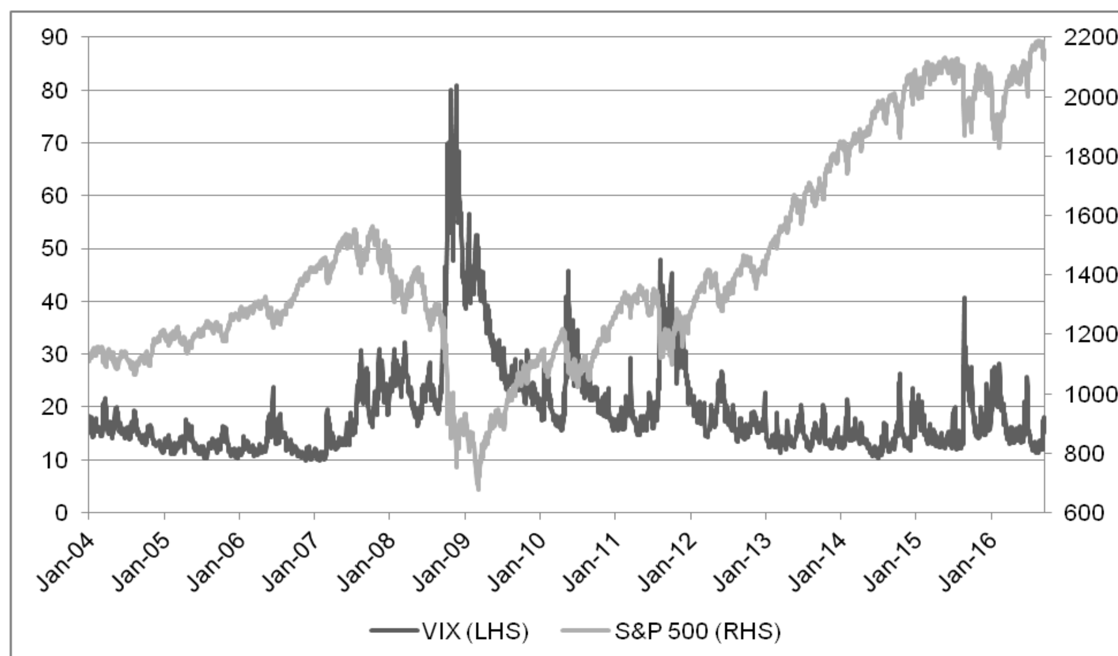
businesses similar to those we have purchased in the past, external surprises will have little effect on our long-term results."[4]

The human brain is wired for physical survival. It was very appropriate in pre-historic times that anything remotely uncertain should produce a threat response in the brain. In modern times, however, a person can live a long life and never encounter a wild tiger a hundred feet away. While we can't change the nature of our brains, astute investors should become aware of how we are wired and use their brains to their advantage. Since we don't expect a substantial portion of the investing public to adopt the change of focus that helped Warren Buffett become extraordinarily wealthy, we would argue that the theme of uncertainty will continue to produce mispriced securities. Indeed, in a U.S. stock market near all-time highs, we have uncovered situations where the dark clouds of uncertainty have resulted in wide moat businesses trading at substantial discounts to intrinsic value.

Market Complacency?

Are the markets as a whole reflecting complacency or uncertainty? As this issue headed to press, the slow but steady post-Great Recession recovery had passed the 7-year mark. As we are all aware, much has changed over that time. The major stock indices continued to set new highs this summer, with the S&P 500 up 220% from the market bottom. But in many ways, current market signals appear to be full of contradictions. Throughout the summer, the CBOE Volatility Index (VIX) hovered around 12 or little more than half its longer term average (2004-present) of 19.25 and just above its pre-recession low of 9.89 reached in January 2007. This combination typically signals extreme investor complacency in an upward trending market. In fact, after a brief post-Brexit spike, realized market volatility in July-August was among the lowest periods on record looking back over the past half-century.

CBOE Volatility Index vs. S&P 500 (2004-Present)



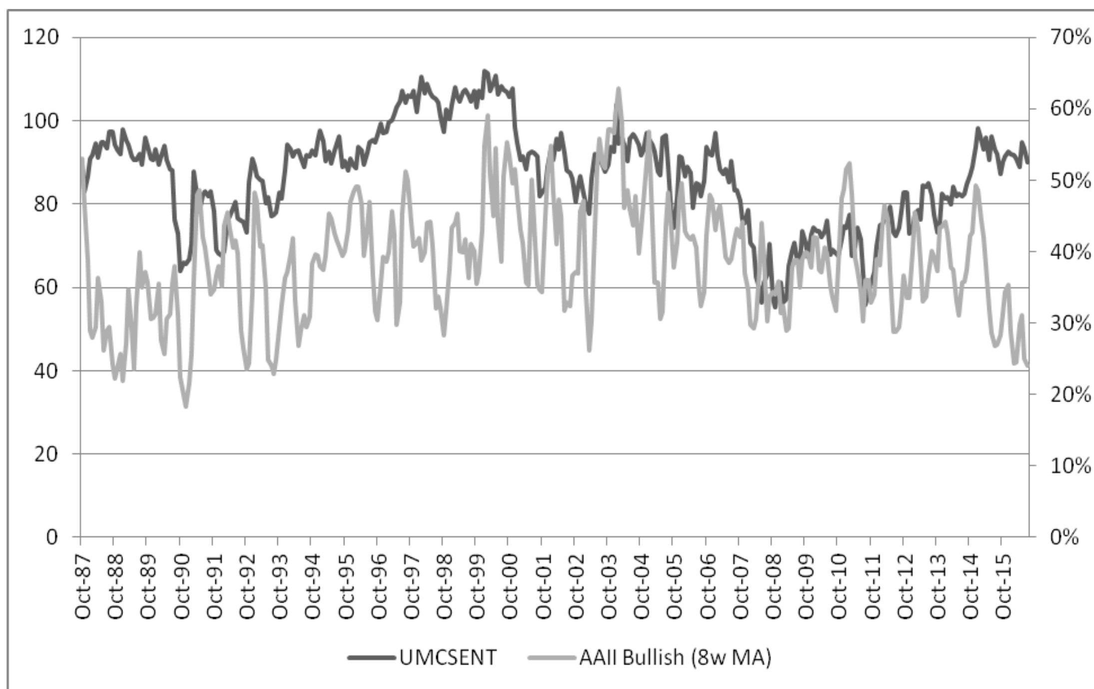
Despite the record highs and low volatility, the average individual investor remains wary of the stock market. Bullish sentiment as measured by the American Association of Individual Investors (AAII) survey has averaged just 28.1% YTD which would be the lowest annual average since 1990's 27.3% reading. This figure has rebounded with the market somewhat in recent months, but bullish sentiment remains well below long term averages—currently 28% versus a long-term average of 38.5%. Normally individual investor sentiment is

[4] Berkshire Hathaway Inc., Shareholder Letter, March 1995 http://www.berkshirehathaway.com/letters/1994.html

positively correlated with recent market performance, and some studies suggest it is a contrarian indicator.[5] The current divergence between market performance and investor outlook likely reflects lingering investor wariness after so many painful experiences in the stock market since the turn of the millennium. Perhaps it also reflects the underlying sentiment among so many in middle America (as made apparent in the unusual current political environment) that they have been left behind during this recovery. Equity fund flows also suggest many investors remained on the sidelines for the recent rally.

To further muddle the picture, this negative investor sentiment is at odds with broader consumer sentiment levels. The University of Michigan Consumer Sentiment Index is close to post-recession highs and within the range of long-term averages. As illustrated in the following chart, the current divergence between the two statistics is at near-record levels.

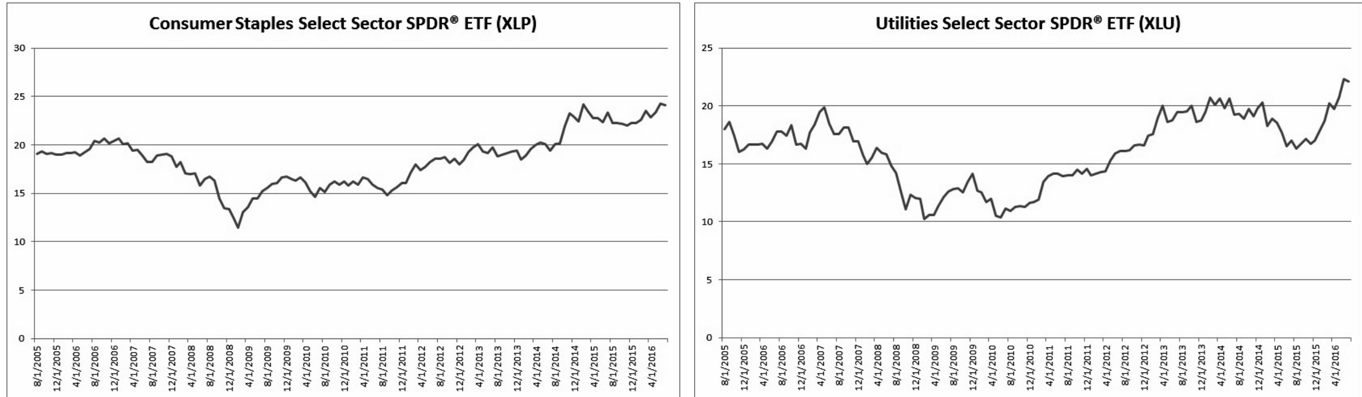
AAII vs. UM Consumer Sentiment: Record Divergence



This negative investor sentiment also appears to be reflected in recent market performance across different sectors and styles/themes. We would highlight a few (related) factors that appear to be driving flows and diverging performance in the stock market of late. Defensive/low volatility investing and yield seeking is particularly evident in recent performance. During 1H 2016, more defensive, higher yielding sectors within the S&P 500 dramatically outperformed with utilities up 23.4%, telecom shares up 24.8%, and consumer staples up 10.5% versus the broader index's modest 3.8% return. While this trend has moderated somewhat in recent weeks, S&P 500 Dividend Aristocrats (companies that have increased dividends for at least 20 consecutive years) have outperformed the broader index YTD, at +7.9% vs. +4.7%, respectively. Utilities were up 15% YTD through August (as measured by the SPDR utilities ETF, XLU), roughly tracking the appreciation in long-term Treasury bonds. As illustrated in the following charts, trailing P/E ratios for both the utilities and consumer staples sectors are well above levels reached during the previous market peak.

[5] *AAII Journal*, June 2013, "Is the AAII Sentiment Survey a Contrarian Indicator?" http://www.aaii.com/journal/article/is-the-aaii-sentiment-survey-a-contrarian-indicator

Staples, Utilities Sectors at Record P/E Multiples

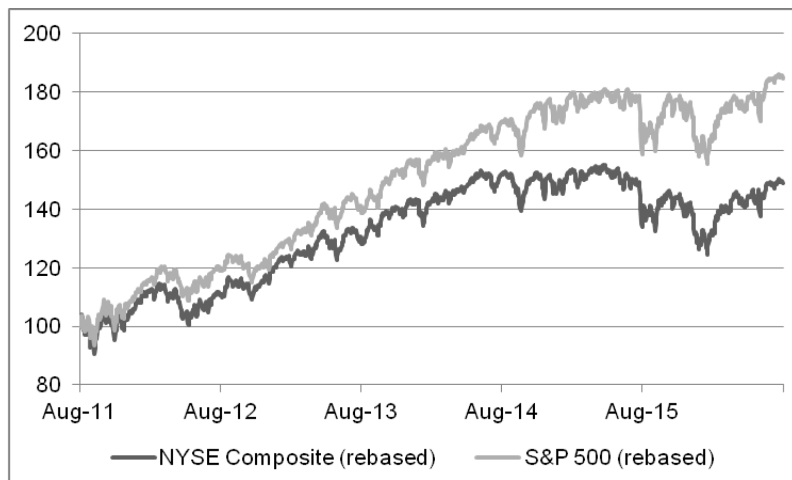


This relative outperformance of "safety stocks" corresponds to investor caution as well as extreme yield seeking behavior. Global central bank easing/bond purchasing has continued to expand, driving bond yields in many cases to zero—literally, with $13 trillion in negative yielding debt globally and TIPS offering negative real yields out for more than a decade. It appears the ever-expanding hunt for "safe" assets has increasingly moved to the U.S. stock market. Additionally, we believe the continued surge in passive investment strategies (ETFs) is exacerbating herding patterns and is behind the recent trends. As we detail later in the introduction, fund flows support this theory. High yield and low volatility fund flows have exploded, and their resulting recent outperformance has been amplified by momentum-driven investment strategies.

At this point, we cannot help but recall the summer 2010 issue of *AAF* which focused on high-quality dividend paying stocks with strong pricing power, with a concentration in consumer staples companies. While our caution on bonds proved to be misplaced, as a whole our "bond-like equity" picks have performed remarkably well. Today, it appears the pendulum has swung the other way, with these stocks generally among the most expensive areas of the market. At this point, we believe too many investors are treating certain stocks like bond substitutes—which they definitely are not.

So where are investors to find value in this market? As we detail in the following section, macro conditions suggest a certain amount of investor caution is reasonable. The S&P 500 currently trades at 18x operating EPS—not quite nosebleed territory, but above pre-crisis levels and the highest reading since the dot-com boom. However, the market does not appear uniformly expensive; recent market performance has been concentrated in a few pockets with limited market breadth. The broader market as measured by the NYSE Composite has underperformed the S&P 500 by a whopping 52 percentage points over the past 5 years and actually remains 6% below its 2014 peak.

S&P 500 vs. NYSE Composite, Trailing 5 Years (rebased)



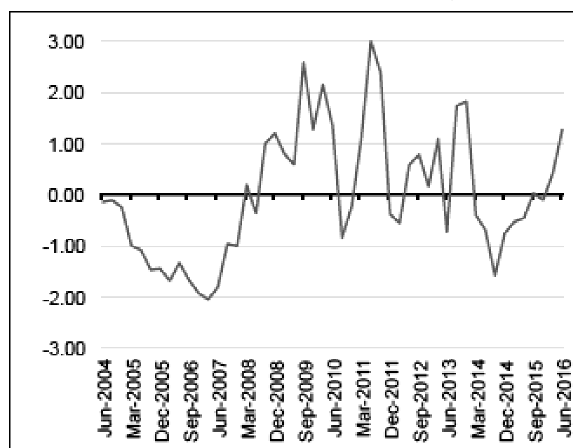
Introduction

The most recent outperformance aside, cyclical stocks like energy and materials have drastically underperformed since both the prior market peak and the 2009 bottom and are the most statistically cheap sectors. Later, we provide a brief outlook for the energy sector. However, *Asset Analysis Focus* has generally shied away from commodity-driven, cyclical stocks given our aversion to macroeconomic forecasting. While we feature one derivative energy play in the lodging industry in this issue, this year we have also hunted for less cyclically exposed stocks overly punished by various types of investor uncertainty.

Macro Environment Overview & Disconnect

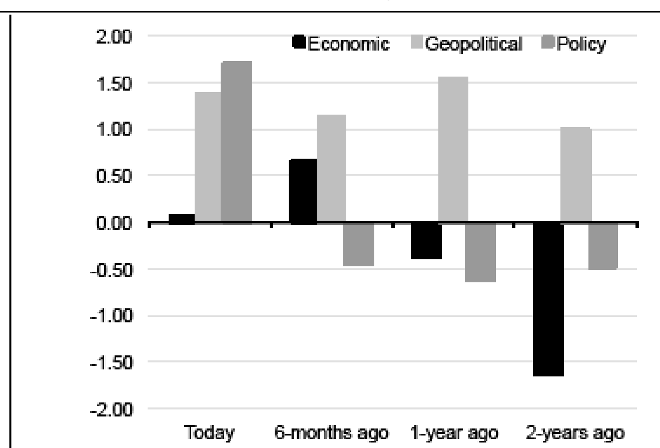
The performance of the equity markets in both the United States and abroad has been relatively robust over the past year. The returns by themselves have been impressive, and these gains are even more striking when one considers the risks and uncertainties that have persisted across the global markets. In our view, this apparent disconnect between market appreciation and underlying market fundamentals suggest that some measure of caution is warranted when assessing the investment landscape. Although some pockets of attractive valuations certainly exist, a discriminating approach to stock selection becomes more crucial with each new day of market gains and new highs. As we consider the outlook, it is important to recall the various uncertainties that have arisen, and that could continue to have relevance going forward. Among the most noteworthy sources of risk and uncertainty, we would highlight a few particular issues that merit continued monitoring. First, the recent and unexpected vote in the United Kingdom to exit the European Union could have significant ramifications for both Europe and world markets. Second, the deceleration of economic expansion within several emerging markets (such as Brazil and China) has been an unfavorable development hindering growth prospects on both a global and company-specific level. Third, the uncertainty related to U.S. Federal Reserve monetary policy and the unexpected persistency of low interest rates and U.S dollar appreciation relative to other currencies have also presented its own set of challenges, and will likely remain a relevant factor for investment fundamentals. However, we would argue against completely abandoning equity markets in response to these various issues. Such considerations can also create attractive opportunities, especially among high quality stocks that have been disregarded by market participants during this recent period of strong appreciation.

BBVA Research Uncertainty Index



Source: BBVA Research & Haver Analytics, July 2016

BBVA Research Uncertainty Index Components



Source: BBVA Research & FDIC, July 2016

The decision by British voters to leave the European Union, commonly referred to as "Brexit," occurred on June 23rd of this year. Although most polls and surveys predicted a different outcome, voters in the United Kingdom supported the "leave" option by a margin of 52% to 48% (supported by a referendum turnout of 72%). The drivers of this outcome will likely be debated by economists and political scientists for years to come. However, the immediate take-away from this event was that it represented a new source of uncertainty that had not been anticipated by the financial markets. Following the news, European markets experienced a swift one-day sell-off (at least 3%-5% in most cases), and in the U.S. the S&P 500 declined by 3.6%. In addition, the value of the British pound approached 30-year lows relative to other currencies while gold prices approached 52-week highs. Yet, the fall-out for equity markets proved to be short lived, as investors largely shrugged off this issue once the initial surprise from the vote had been processed. Since the initial post Brexit sell off, the S&P 500 has

appreciated by over 7% from its June 27th close of 2000.54. (Curiously, the rebound of the U.K. stock market has been even stronger.) We do not want to overstate the potential ramifications from Brexit, but it is an additional uncertainty that will not gain full visibility for several years (formal Brexit process will take at least 2 years to complete). The trading relationships between the U.K. and the European Union will likely undergo changes. Moreover, the economic and political viability of the remaining European Union could be under pressure, posing a whole new set of questions for markets in both Europe and across the world. To the extent that this vote represents a political trend that translates to other regions of the world, there could be additional risks not fully appreciated by investors.

Over the past decade, global economic expansion has been enhanced by several key emerging markets (including countries such as Brazil and China). However, the growth trajectory from these areas has weakened materially during the past 1-2 years, adding to the already uncertain market landscape across the globe. After recording robust economic growth for several years, the situation in Brazil has significantly deteriorated. The economy there has been in a recession for over a year (3.8% GDP decline in 2015), partially attributable to the significant correction in commodity prices. These headwinds have been compounded by political unrest in Brazil, as well as publicized reports of high level government corruption that ultimately led to charges against former president Luiz Inacio Lula da Silva, and suspension from office of his successor Dilma Rousseff. To make matters worse, the country's bond ratings have returned to junk status. Brazil remains the fifth largest country in the world with ample natural resources (including massive offshore oil reserves). It would be premature to disregard the country's long-term potential, but the near term outlook remains uncertain at best. A recent assessment by Moody's helps to capture the situation, and confirms that Brazil is likely to remain a complicating factor for global market fundamentals:

> *"Despite the recent improvement in market sentiment…Brazil is still grappling with a range of problems. Slowing investment, rising household debt, accelerating inflation and high unemployment are still weighing on the economy…The ongoing political turmoil complicates the government's fiscal repairs and delays structural reforms to support growth and curb the government's debt burden."*
>
> *– Moody's Investor Service, August 1, 2016*

Among the emerging markets, no country has been a bigger player than China. The size and growth profile of the Chinese market has been among the most significant economic stories of the past decade, and has been a key driver of global expansion. However, the rate of growth for China has clearly slowed during more recent years, having broad reaching ramifications for world economies and multinational corporations. The precision of economic data provided by the Chinese government is sometimes questioned by market participants, but the overall slowing trend is difficult to refute. After annual GDP growth rates reported to be consistently above 10% for many years, Chinese GDP growth has fallen below 7% during recent quarters, and other recent economic indicators have also indicated a less robust level of activity. In July for example, Chinese exports (the life blood of the economy there) fell by 4.4%, representing the 12th monthly decline within the past 13 months. Additionally Chinese imports declined by 12.5% during the same month, representing the 21st consecutive monthly decline for the country's imports. These various signs of economic weakness have occurred despite significant efforts by government officials to stimulate growth (relaxation of banking regulations, interest rate reductions, etc.). The future outlook is equally uncertain, as projections for Chinese GDP continue to be revised downward. In a recent analysis by the IMF, Chinese economic growth was forecasted to further weaken with GDP growth expected to fall below 6% by 2020. Clearly China's long-term potential and significance should not be disregarded by investors, but the robust growth profile of the past may be difficult to replicate. Moreover, the near-term outlook for the economy continues to be ambiguous at best, providing another source of uncertainty for investors attempting to assess the market landscape.

The economic backdrop in the United States retains its fair share of challenges as well. Given the new highs recently established by the U.S. equity market, investors seem to be largely disregarding the uncertainties that are present. Domestic economic indicators have been a mixed bag at best, and the post-recession economic recovery has been anemic from a historical perspective. Annual GDP growth has been approximately 2% since mid-2009, representing the weakest economic recovery of the post World War II era. Labor trends have improved during this period, but have been short of robust. The U.S. unemployment rate has been trending around 5% during recent months (a significant improvement from the recessionary period). However, labor participation rates are at 40-year lows in the U.S., suggesting that employment fundamentals are still

somewhat tenuous. Consumer confidence has recovered to pre-recession levels according to the University of Michigan's Index of Consumer Sentiment. Yet, other indicators of consumer behavior such as retail sales and weak earnings comparisons for the retail industry suggest that a general mood of apprehension remains in the U.S. economy. Not surprisingly, these mixed signals have caused many market observes to conclude that the outlook for the U.S. economy is far from strong. Apparently, this less than optimistic view is shared by the U.S. Federal Reserve which has maintained a historically easy monetary policy despite over 6 years of GDP growth.

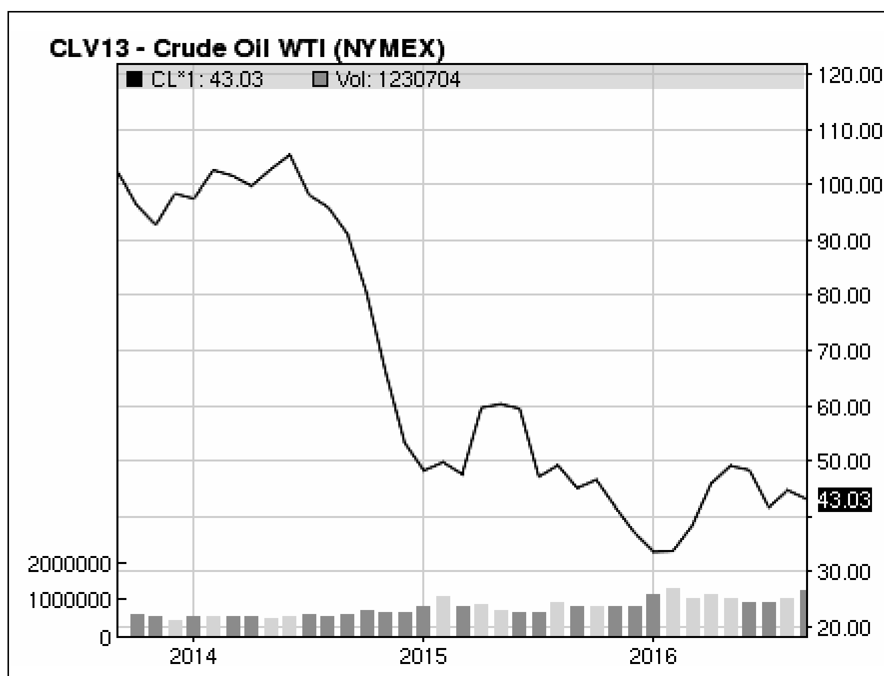
The actions by the Federal Reserve Open Market Committee (FOMC) during recent years have reflected the uncertainty of the U.S. marketplace as long-anticipated increases in interest rates have largely failed to materialize. With the exception of a lone 25 basis point increase to the federal funds rate last December to 0.50%, monetary policy remains highly accommodative. Investors have expected a tightening of policy for several years (a topic we have covered extensively in past issues of *Asset Analysis Focus*). According to a recent poll conducted by Reuters, economists believe there is a probability of roughly 70% that another rate hike will occur by the end of this year. A recent statement from the FOMC suggests that openness to further hikes may be increasing (see following excerpt from their July 27th press release). Despite these historically low interest rates, the U.S. dollar has strengthened considerably relative to other currencies: the U.S. dollar index has gained more than 20% over the past 5 years. In our view, this somewhat surprising strength of the U.S. dollar likely stems from a "flight to quality" as investors view the U.S. as a relative safe haven in an uncertain global market. In our view, it would be erroneous to assume that these interest rate and currency trends represent a new long-term paradigm for the markets, though the timing of any potential normalization remains difficult to predict.

> *"The Committee currently expects that, with gradual adjustments in the stance of monetary policy, economic policy will expand at a moderate pace and labor market indicators will strengthen. Inflation is expected to remain low in the near-term…Near-term risks to the economic outlook have diminished."*
>
> *– FOMC Press Release, July 27, 2016*

Regardless of the timing of these events, investors should consider high quality stocks that have become temporarily out of favor in this environment. In particular, we would highlight companies such as **Harley Davidson Inc.** (profiled in *Asset Analysis Focus* in 2015) and **Tiffany & Co**. (profiled in 2016) as potentially attractive stocks that could benefit from an eventual normalization of global currency markets. Each firm has a significant sales exposure to overseas markets: Harley Davidson and Tiffany have foreign sales exposures of 37% and 56% respectively. The strength of the U.S dollar has negatively impacted financial results and stock performance for both companies. Yet in both cases, we do not believe that share underperformance reflects any impairment in underlying brand power or long-term competitive position. An eventual uptick in interest rates could also be beneficial to several high quality firms, especially within the financial services sector. As rates eventually climb higher, companies such as **BNY Mellon** (last profiled in October 2014) and **Charles Schwab** (profiled in Summer 2013) could exhibit a meaningful increase in earnings power as net interest margins expand and money market fee waivers are eliminated.

Energy Overview: Beware or Be Bold? Derivative Energy Theme

Global macroeconomic factors will also feed directly into the energy sector, which as noted has been the most obviously out of favor sector in recent years. Oil prices have rebounded from early 2016 lows, but are still nearly 60% below peak 2014 levels. Likewise, while the energy sector has been a strong outperformer since February 2016 (up over 20% from its lows as measured by XLE, the S&P 500 energy sector SPDR ETF), the sector is still the worst performer since the market bottom in early 2009.

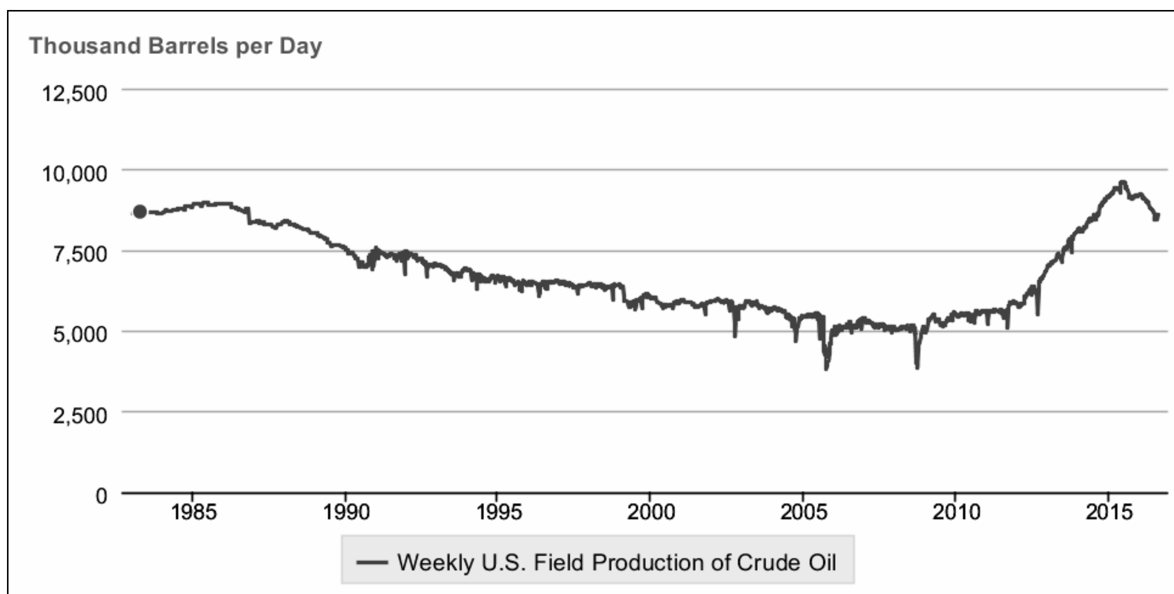


Source:Nasdaq

Does this represent an opportunity for long-term investors? We believe some areas are safer than others. Beginning with the exploration and production (E&P) industry, performance will be driven by oil and gas prices, and assessing the fundamental outlook for energy prices remains a challenge as always. From a supply perspective, global oil production surged from 90 million barrels per day (BPD) at the start of 2013 to over 97 million BPD by mid-2015, reaching significantly oversupplied levels. This was driven by the development of fracking technology in the U.S., as U.S. crude oil production nearly doubled from 2010 to 2015 to nearly 10MM BDP. Domestic drilling activity has fallen in response to oil prices since 2014, with the U.S. oil and gas rig count cut from >1,800 in late 2014 to 700 in 2015 and close to 400 by early 2016. However, rig count stats can be misleading and there are signs that the recent slowdown could be short lived. As illustrated in the following chart, U.S. production of crude oil has declined by only ~10% from a peak of 9.6 million BPD in mid-2015 to 8.6 million BPD currently. Production levels have stabilized in recent months and rig counts have already moved back up modestly from a low of ~400 to ~500. The short fracking drilling times and a lower cost curve driven by recent efficiency gains among U.S. producers (production costs have been cut by as much as 40% since 2014) suggest domestic supply will quickly return with a modest increase in prices. There is also a large number of drilled but uncompleted wells (DUCs), and companies with liquidity issues could feel pressure to bring these online. An estimated 1,800 DUC wells would translate to 300K-1MM BPD of additional supply if all are brought online at once.[6]

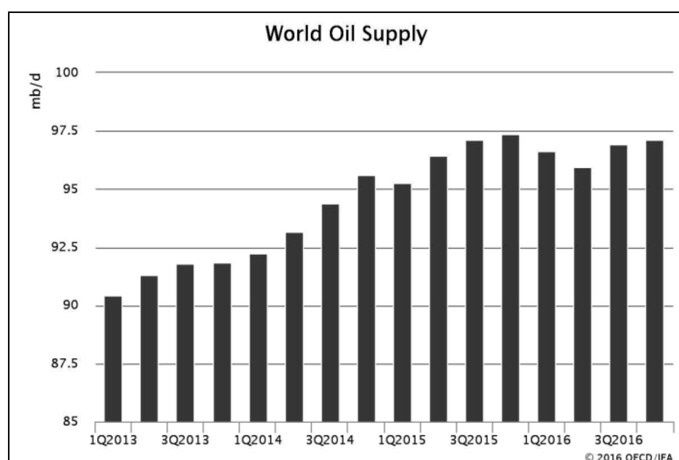
[6] Reuters, *Commodities*, March 2016, http://www.reuters.com/article/us-usa-shale-ducs-idUSKCN0WN0BK

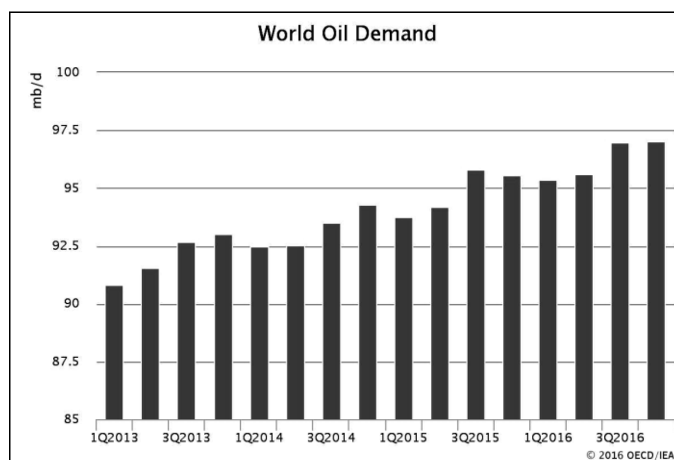
Weekly U.S. Field Production of Crude Oil



Source: U.S. Energy Information Administration

So where does this leave us? Given these dynamics, the prospects for a significant rise in oil prices within the next couple years appear dim—barring either unexpected global macroeconomic improvements or OPEC and other major producers implementing production freezes. Barring an agreement, Saudi Arabia continues to pump out oil at record levels while Iran and Iraq are expanding production. Russian output is expected to grow by 590K barrels per day (BPD) over the next 3 years unless the country participates in a coordinated output freeze with OPEC. Meanwhile, the International Energy Agency (IEA) recently downgraded their forecast for 2016 oil demand growth to 1.3MM BPD, and they expect global growth to decelerate further to 1.2MM BPD in 2017. At this pace, global supply/demand is not expected to reach equilibrium again until at least the second half of 2017.



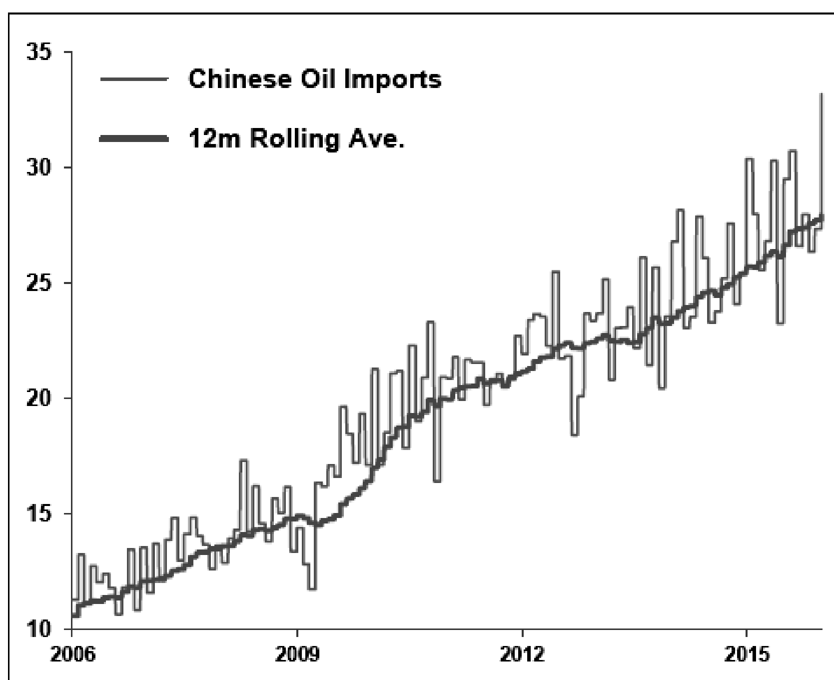


Source: International Energy Agency, Oil Market Report, September 2016, https://www.iea.org/oilmarketreport/omrpublic/

From a longer-term supply perspective, exploration spending has recently fallen off a cliff after a period of overinvestment, and a significant long-term investment gap for bringing new supply to market may be developing. Some large long-term projects like the Brazilian deepwater projects (est. 1MM-2MM BPD potential) are in question. Russian sanctions have also limited Russian companies' ability to find partners for large-scale

development projects. But sanctions will likely fade and technological advances continue to lower the break-even cost for new projects. Demand growth may have to reaccelerate beyond 2017 to exceed current supply expectations and push oil prices significantly higher. Emerging markets consumption patterns are a key factor, which presents some additional downside risk. China has been a long-term driver of demand and now accounts for ~12% of global oil demand. But Chinese oil demand growth has fallen to <1% in recent months and is only expected to average a meager 2% in 2017. As noted, there are signs of slowing growth it China. If the Chinese growth engine continues to slow, this would pose significant downside risk to longer term demand growth and the timeline for oil prices to return to pre-2015 levels. India could pick up some of the slack; India is expected to account for 1/4th of global oil demand growth over the next 25 years. But at just 4MM BPD in 2015, Indian demand is unlikely to move the needle in the next few years. Any additional U.S. dollar strength—which appears very possible if the Fed continues to be the only major central bank raising interest rates—would further crimp the upside for oil prices.

Chinese Oil Imports



Source: Bloomberg/EAM

While *AAF* remains positive on select companies in the energy sector (e.g. **Devon Energy**, profiled in March 2015), we do not believe it is necessarily the most fruitful place for value investors to hunt for out of favor stocks at this point given the recent outperformance and lingering global macro uncertainties which dampen our expectations for a quick further rebound in commodity prices. Instead, we have directed our attention toward non-energy businesses with varying degrees of exposure to customers/consumers in energy regions. In a classic case of "throwing the baby out with the bathwater," many of these higher quality, less cyclical companies were overly punished over the past 12-18 months due to temporary hiccups caused by derivative energy exposure.

In assessing the impact of the energy sector stress on the U.S. consumer and the most affected regions/workers in particular, it is important to note that the oil and gas industry only accounted for ~500,000 jobs prior to the market collapse. A whopping 119,600 oil and gas jobs (22%) were eliminated from Sep. 2014 to early 2016 according to Dallas Fed.[7] For some states like Wyoming (oil, gas, and mining contribute 70% of

[7] *The Wall Street Journal*, April 2016, "Laid-Off Oil Workers Struggle to Pay Loans, Credit Cards" http://www.wsj.com/articles/texas-oklahoma-wyoming-oil-woes-start-to-hit-hard-1461749401

Wyoming state revenue) and South Dakota, the impact is stark. But larger, more diverse states have managed the downturn; the unemployment rate in Texas remains below the national average at just 4.6%. With energy company cost structures drastically reduced and prices stabilizing, it appears the brunt of the job losses and related hit to affected consumer spending are behind us. On the flip side, lower energy prices are having a less concentrated but collectively substantial positive impact for the average consumer's wallet.

A recent AAF name that fits the theme of higher quality businesses with large energy customer exposure is **Colfax** (profiled in January 2016). In this issue, we highlight **La Quinta** (LQ), a hotel operator whose heavy exposure to oil and gas regions (11% of hotels) has caused a 55% decline in shares since early 2015 highs. LQ shares now trade at the lowest multiple among its major hotel peers. LQ will have much easier Y/Y comparisons going forward, and we believe the recent challenges have led investors to overlook the long-term opportunity presented by LQ's refranchising and real estate divestiture strategy.

Political & Regulatory Uncertainty

In our view, the upcoming 2016 presidential election is another significant source of uncertainty for the stock market as we cannot recall an election as controversial as the one coming up in November. It seems that for many Americans the major party candidates offer a lesser of two evils choice, as both candidates have received the highest disapproval ratings in U.S. history. For many voters, Hillary Clinton elicits serious ethical and credibility concerns. Despite her substantial political experience, a significant portion of the nation does not want a Washington insider. Donald Trump, on the other hand, certainly embodies the anti-status quo. For a position where diplomacy and consistency were historically seen as desirable attributes, Trump is unfiltered and unpredictable. He promises to shake things up in Washington, and his supporters crave just that.

The election may ultimately come down to who is disliked the least. Suffice it to say that, given the strong negative opinions facing both candidates, whoever is elected will likely leave a substantial portion of the nation unhappy and concerned about the future. Unpredictability coming out of the White House in the next four years is virtually a given and the uncertainty over whether the economy will improve or deteriorate under either candidate has rarely been so high.

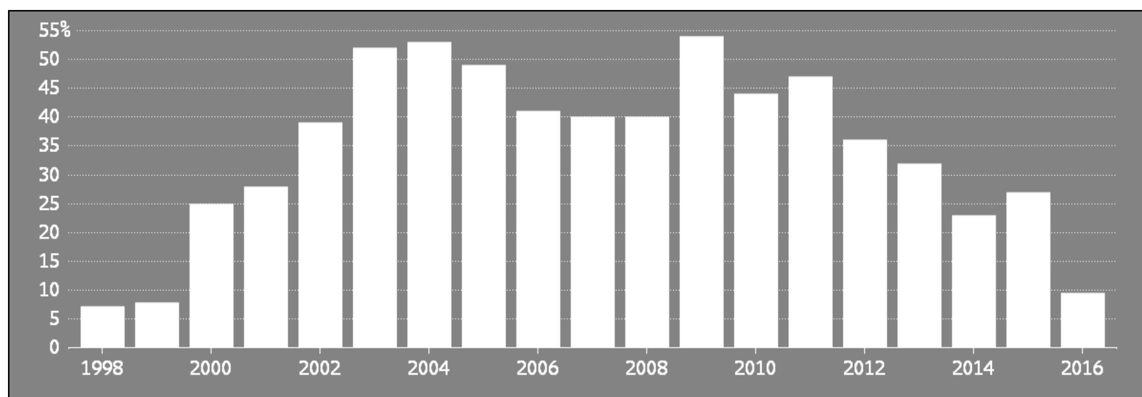
Adding to the presidential uncertainty, the U.S. Department of Justice (DOJ) seems to have become less consistent regarding the criteria it uses to approve mergers. This was evidenced in the recent blocking of the Staples/Office Depot deal. In addition, this summer the DOJ announced it will go to court to prevent two proposed health insurance mergers: Aetna/Humana and Anthem/Cigna.

Health insurance appears to be ground zero for the political and regulatory uncertainty hanging over the stock market as no matter who gets elected, the industry faces threats. Hillary Clinton is the long-standing rival of the industry and her anti health insurer comments often cause the stocks to sell off. Before Donald Trump entered the race, any candidate would have been seen as more favorable to the health insurers than Clinton. However, Trump has called the Affordable Care Act a "disaster" and has stated that, if elected, he would repeal it. While such a change would need to pass Congress, the possibility of another overhaul to healthcare regulation, so soon after the Affordable Care Act which was implemented in 2014, means Trump offers potentially more uncertainty to the industry than Clinton. It comes as no surprise that the large health insurers -- Aetna, Humana, Anthem and Cigna -- are down double-digit percentages from their all-time high share prices, in a market near record highs. We chose **Anthem, Inc.** (ANTM) for our Summer Issue not only because it is the cheapest stock in the group but also because its shares offer a rare risk/reward profile: solid downside protection in a worst case scenario coupled with spectacular return potential in a best case scenario.

Active vs. Passive Management and Value Investing Implications

The continued flow of funds into passive investment products has created challenges for active managers in recent years. Not only have active managers of all sorts found it difficult to attract retain/new assets, but an increasing amount have failed to keep up with their benchmarks. As illustrated in the following graphic, just 9.5% of actively managed large cap domestic equity funds outpaced the return of the S&P 500 on a rolling five-year basis as of August 2016 according to fund researcher Morningstar.

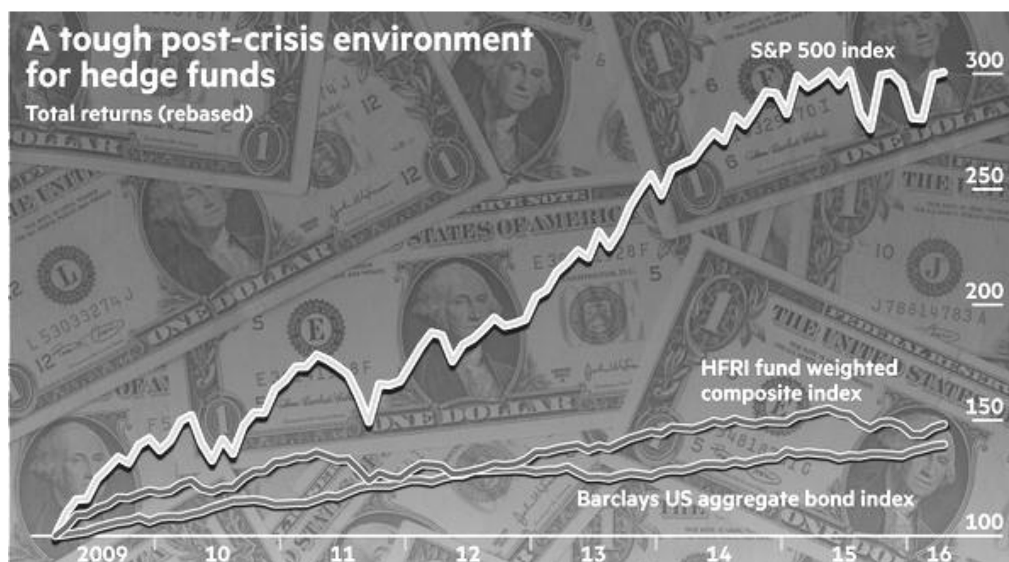
Active Managers of Large-Cap Stocks Post Worst Performance Since 1999



Note: Results show percentage of active large-cap U.S. stock funds that beat the S&P 500 over rolling five-year periods ending August 31

Source: Morningstar via Bloomberg Markets, September 2016

The underperformance has driven assets out of these active managers and into passive products. Over the past five years, the ~3,000 actively managed funds in the large cap category have experienced $422 billion in redemptions compared with inflows of $480 billion into passive strategies over that same time period. The performance challenges have not been limited to traditional long only, large cap asset managers as hedge funds have also found it difficult to beat the S&P 500 in recent years. As illustrated in the following graphic, the S&P 500 index has outperformed the HFRI fund weighted composite index by a factor of two to one since 2009.



Source: Thomson Reuters Datastream; Investment Company Institute; Eurekahedge via Financial Times, May 2016.

The inability to keep pace with the S&P 500 Index coupled with the high fees associated with the asset class has prompted institutional investors to eliminate or significantly reduce their exposure. In 2014, public pension fund CALPERS liquidated its ~$4 billion in exposure to the asset class while New York City Employees' Retirement System announced its decision to exit its hedge fund holdings in April 2016. A number of other high profile institutional investors have decided to pare their hedge fund exposure including the state of New Jersey, which had $9.1 billion invested in the asset class as of May 2016. In August 2016, the New Jersey Investment Council stated that they will reduce their hedge fund allocation to 6% from 12.5%.

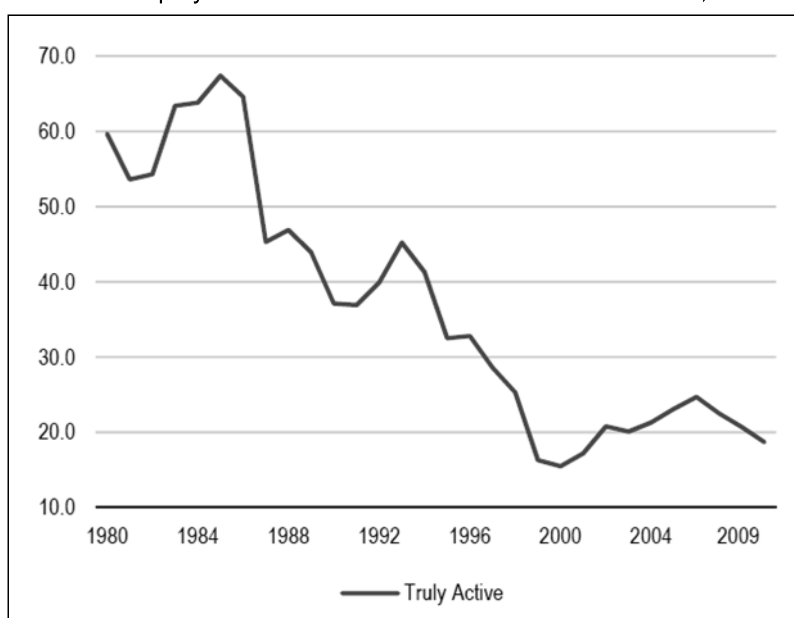
According to hedge fund industry researcher eVestment, investors withdrew $28 billion from hedge funds during the first half of 2016, representing the largest monthly outflows since they began tracking flows in 2009. In addition to the outflows, the challenges facing the hedge fund industry can be seen by the record number of hedge fund shutdowns with 979 funds closing their doors in 2015 compared with 968 launches, which was the first time closures outpaced openings since 2009 according to industry researcher HFR.

Passive Investing Continues to Gain Traction

Fund flows toward indexing from passive investors are not a recent phenomenon as index-based products have continued to capture an increasing market share. Two important milestones that helped give rise to the significant influence of index investing include the formation of Vanguard, a pioneer of low cost mutual fund investing in the mid-1970s and the debut of the first S&P 500 exchange traded fund in the early 1990s. In 1976, Jack Bogle of Vanguard introduced the first S&P 500 market weighted fund while the first exchange-traded fund (Standard & Poor's Depositary Receipts AKA SPDR) was launched by State Street Global Advisors in 1993.

Assets in Active Funds Have Plunged

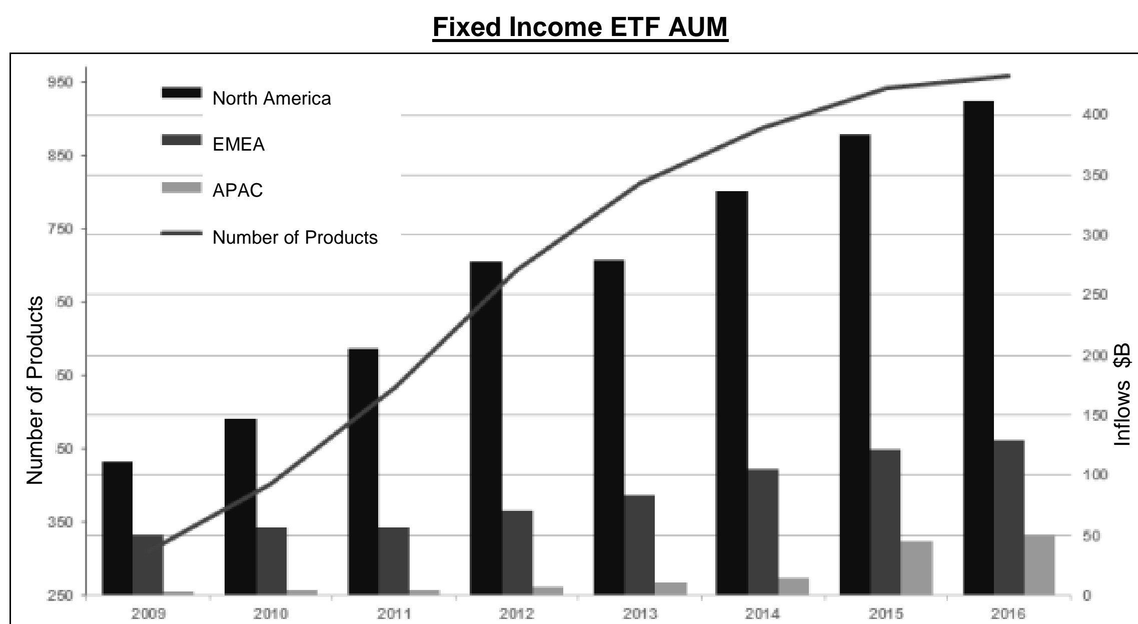
% of U.S. All-Equity Mutual Fund Assets Held in Active Funds, 1980-2009



Source: Financial Analysts Journal, 69/4 (2013) via Company blog, February 2015

More recently, the growth of the ETF industry has been a catalyst for continued growth into passive based strategies. The amount of assets worldwide in ETF products increased from $715 billion in 2008 to more than $3 trillion by the beginning of 2016. It should be noted that the growth of the ETF industry AUM is not confined to the equity asset class with approximately $585 billion invested in fixed income ETFs accounting for about 20% of industry ETF assets.

Fixed Income ETF AUM



Source: IHS Markit March 2016

A recent study by PwC suggests that there will be continued growth in global ETF assets. Specifically, the firm's recent survey projects that Global ETF assets will likely increase to $8.2 trillion by 2021 with U.S. assets increasing to $6.2 trillion from $2.3 trillion over that same time frame.

Safety Investment Products Gaining Traction – Low Vol' and Smart Beta

A recent phenomenon that is driving some of the growth of ETF assets is the rise of "safety strategies" including low volatility funds and so-called "smart" or "strategic" beta funds. Low volatility strategies invest in stocks that are believed to go down less in market selloffs, but appreciate less during bull markets. According to Morningstar, low volatility mutual funds and ETFs attracted $15.1 billion during the first seven months of 2016. The rise of this strategy recently prompted Jeffrey Gundlach of asset manager Doubleline to state in a recent *Financial Times* article, "Low volatility stock funds are probably the most dangerous thing out there." Mr. Gundlach went on to say, "People that own them think that they don't go down. It's when you think it's safe and it starts going down that you get mass selling." In addition to low volatility funds, "smart" or "strategic" beta products are another recent category that is garnering a lot of attention. iShares, which is the world's largest manager of exchange traded funds (ETFs), recently announced that it projects smart beta ETF assets will reach $1 trillion globally by 2020 and $2.4 trillion by 2025, up from $282 billion in current smart beta assets. In contrast to investing in cap weighted indices, smart beta products utilize a "rules based" approach that puts more weight on other factors, such as valuations, dividends, momentum or volatility to determine which stocks to buy and their weighting. The impact from the flow of funds into low volatility and smart beta ETFs can be seen by looking at sector valuations.

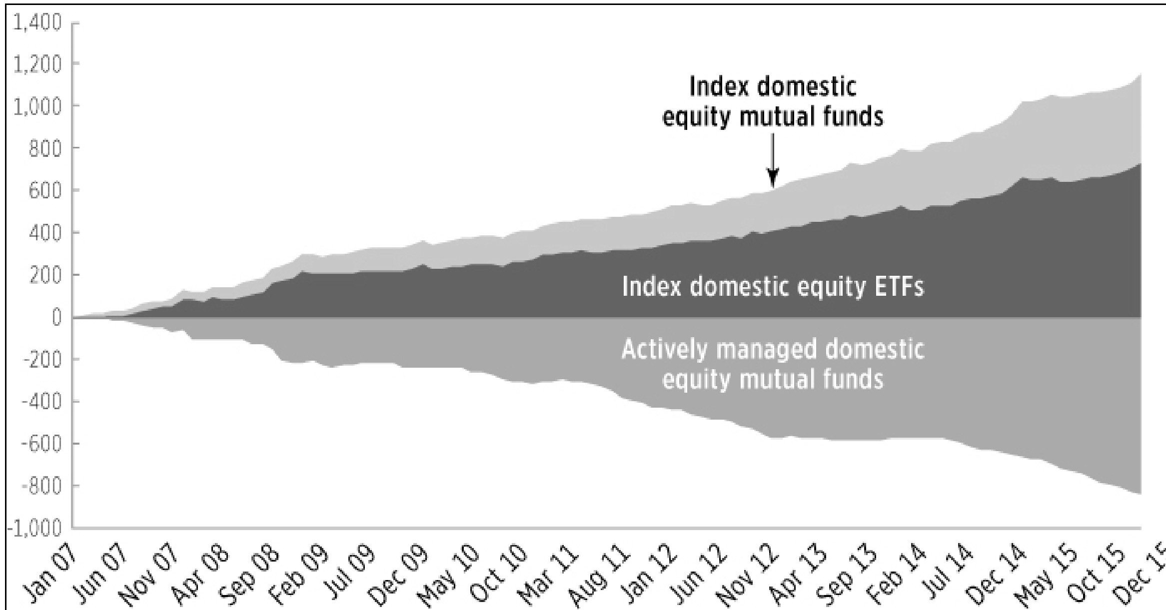
Value Investing Under Pressure, but Cycle Could be Reversing

In our view, the fund flow trends into ETFs and safety products discussed above have been a contributing factor in the multi-year outperformance of the growth style. While there are other factors that have been cited for the growth dominance including the low interest rate and low economic growth environment, we would not dismiss the impact from flows into passive products. Between 2007 and 2015 there was $1.2 trillion cumulative net flows (including reinvested dividends) into ETFs while domestic equity mutual funds have seen a net outflow of $835 billion over that same time frame despite the inclusion of reinvested dividends.

Boyar research

Some of the Outflows from Domestic Equity Mutual Funds Have Gone to ETFs

Cumulative flows to and net share issuance of domestic equity mutual funds and index ETFs, $B; monthly, January 2007–December 2015



Note: Equity mutual fund flows include net new cash flow and reinvested dividends. Data exclude mutual funds that invest primarily in other mutual funds.

Source: ICI, 2016 Investment Company Factbook

The fund flows have powerful implications for growth and value stocks since money flowing into index products is typically bidding up growth stocks (index funds/ETFs as a rule generally purchase more of stocks that have increased in price and therefore weighting). Meanwhile, the assets flowing out of active strategies, many of which are attributed to value managers, create selling pressure on value stocks. In last year's summer double issue we cited the underperformance of the value investing style relative to growth in recent years. In that issue we stated that the value's underperformance may be coming to an end. While 9 months may not mark the start of a long-term trend, we note that the Russell 1000 value is currently pacing ~250 bps ahead of the Russell 1000 growth (8.4% vs. 5.9%) as of September 2016. With the prospect for higher rates going forward including a high probability that the Fed will increase rates during 2016, we would not be surprised if value was able to sustain its current momentum. This would go a long way towards a more sustained increase in the value style with its outsized exposures to financials (~28% of Russell Value vs. 6% of Growth) and Energy (14% vs. 7%).

Index – Weight by Sector June 2016

	Financials	Technology	Health Care	Industrials	Energy	Cons. Discr.	Cons. Staples	Telecom	Utilities	Materials	S&P 500 Index
S&P weight	15.7%	19.8%	14.7%	10.2%	7.4%	12.3%	10.6%	2.9%	3.6%	2.8%	100.0%
Russell Growth weight	5.7%	29.2%	17.2%	10.8%	0.6%	21.0%	10.5%	1.3%	0.1%	3.6%	100.0%
Russell Value weight	27.6%	9.5%	11.4%	9.8%	13.6%	4.8%	9.1%	4.3%	7.1%	2.8%	100.0%

Source: FactSet, Russell Investment Group, Standard & Poor's, J.P. Morgan Asset Management via JPMorgan Market Insights, June 2016

Boyar research

Identifying Opportunities Created by the Flow of Funds Into Passive Investments

> *"Because passive funds take no view of business fundamentals or valuation, they bear significant and unnecessary investment risks, in our view. For example, investors buying a global index fund in 1989 would have had the bulk of their investment (44%) in Japan at the absolute worst time to buy Japanese stocks. A decade later, they would have had nearly 25% of their investment in technology companies that were grossly overvalued."*
>
> *– Franklin Templeton Investments, February 2015*

With fund flows into ETFs purchasing shares of stocks regardless of valuation, some stocks and sectors undoubtedly get left behind. Companies in the S&P Staples and Utilities sectors, which have been a beneficiary of fund flows to "safety products", as discussed above are currently trading at premiums to their long term averages. For example, the Consumer Staples sector is trading at 23.7x trailing earnings compared with a 20 year average of 21.2x and the utilities sector is trading at 22.1x trailing earnings compared with 20 year average of 15.5x (as of June 2016). Meanwhile the S&P Financials sector is currently trading at 14x trailing earnings compared with 17.2x for its 20-year average and the Industrials are trading at 18.8x compared with a 20-year average of 20.4x. We believe that shares of **Franklin Resources** (BEN), which have been adversely impacted by the flow of funds from passive to active managers and the growth style outperformance in recent years, look attractive. While its current investment style is out of favor, history has shown that styles can remain out of favor for a number of years, but for the most part eventually come back into vogue.

This page intentionally left blank.