



***The punchbowl has been spiked and some of the guests are getting sloppy.***

Since 2009 global central bankers infused a staggering \$15 TRILLION of debt and equities into government balance sheets. With so much “easy money” sloshing around for so long, examples of sloppy investing are surfacing. This occurs towards the end of every economic cycle.

**When abundance begets waste:** One advantage to working with Blue Oak is that we have access to seasoned portfolio managers around the world and recent conversations with bond managers are unsettling. Anecdotes abound of corporate debt deals being priced with yields so low that it causes sardonic laughter. Every bond manager we speak with is concerned about the state of financial markets. There are vast quantities of money chasing yield without regard to risk – that is, a lack of adequate protection for the price paid. Investment bankers are taking advantage of Fed sponsored liquidity by creating the largest supply of “junk bonds” *ever* for investors to swill in a drunken search for yield.

A recent bond deal offered by an electric car manufacturer provides an example of savvy management taking advantage of sloppy investors. The company sold \$1.8 billion in junk bonds (oversubscribed by 20%! ) which were devoid of adequate covenants and carried such a low yield that it left us dumbstruck. No seasoned bond investor concerned about their client’s money should/would/could touch them. Ask us in seven years if buying the skinny annual yield was worth it. (doubtful)

For another example, we turn to one of our managers who specializes in institutional preferred securities. He recounted recent incidents of supposed professional investors chasing “high” yielding coupons that were **guaranteed to lose money**. The securities will mature at a lower price than investors paid even after accounting for the coupon income! During periods of tight money, sloppy mistakes like this are rare because the focus shifts to return of capital rather than just return on capital.

Warren Buffet would not use shareholder money to buy Berkshire Hathaway stock today. Why? Because the current stock price exceeds its intrinsic value. Buffet’s discipline and logic is lost on most corporations that are, today, actively buying their own stock which by and large exceeds its own intrinsic value. Corporations use debt (which is currently inexpensive due to central bank policies) and take that borrowed money to buy back stock, regardless of

price, which in turn drives stocks higher. This is another example of sloppy investing.

Even under normal borrowing circumstances, and absurdly, corporate stock buybacks tend to be largest when stock prices peak and then, when stocks falter, buybacks are reduced or eliminated. Corporations interested in long term shareholder value should do the opposite. However, executives typically receive a meaningful portion of their incentive compensation based on the stock price increasing as opposed to actual value created. This incentive should keep markets upwardly biased until borrowing costs rise high enough to slow momentum to a tipping point. (Note: the dominant buyers of stocks the last few years were corporations. And, as of August, corporate buybacks are down nearly 20% year over year.)

Earnings enhanced by a shrinking supply of shares rather than increased sales and operating improvements are finite. Several years ago, we wrote a piece positing that when central banks switch direction on their low or negative interest rate policies a game of musical chairs will begin. Well, the when is now. The Federal Reserve changed their accommodative pace. This does not mean markets are going to crash, but it does mean chairs are beginning to disappear.

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A debt unwind of this enormity has a high probability of encountering periods of disequilibrium resulting in upset markets and disorderly economic growth. Will this be a multi-year or multi-decade process? Thus far, the process is, thankfully, slow and measured. And, while our portfolios are prepared for both fast and slow scenarios, our expectation and portfolio structure bias is for a protracted unwind with implied low single digit returns for domestic stocks and bonds over the next several years.

As with the beginning of any game of musical chairs, the music paused for the first time yet abundant chairs remain. The needle can stay on the record a long time or it may suddenly be lifted and kick people out of the game in rapid succession. The point is NOBODY knows how this will play out and, therefore, portfolio strategy should reflect this reality.

**Bottom Line:** What worked during the central bank easing process no longer works in the same way during tightening. Abundant money supply should keep global stock markets afloat but circumstances overall remain precarious. For now, interest rates and inflation are low, global central banks remain relatively accommodative, earnings are upward trending, and both U.S. and international investments are performing admirably.

This contextual overview translates directly to our portfolios by being:

- In the middle of allowable stock allocations with an emphasis on international markets which have relatively attractive earnings growth and valuations
- At the low end of bond allocations which retains an anchor of capital preservation using short maturity high quality bonds but stays away from too much exposure to a low returning asset
- At the high end of alternative investments which exhibit less risk than stocks and generate a return not fully dependent upon the music continuing to play as more chairs vanish



Thank you for your continuing trust in our stewardship of your money.