



### Be Careful Chasing Returns

Bill Connors

BC@valuefin.com

One important effect of extremely low interest rates is that investors get frustrated earning little or nothing in traditional safe fixed income assets, certificates of deposits, treasury bonds, etc. Many observe that other investments, like common stocks and stock mutual funds, have gained nicely in the last couple of years, so they re-allocate monies to those assets. This may turn out well in the short-term, but for a lot of investors it will likely end badly in the longer-term.

The process of Asset Allocation teaches that almost all investors should have some of their portfolio held for short-term safety and liquidity. This provides easy access to money should you need it at a price that doesn't fluctuate up or down. The industry calls this 'liquidity' and the appropriate amount changes depending on age, health, net worth, investment experience, and other factors.

Likewise most investors benefit from having investments aimed at the long-term. Stock and stock mutual funds, for example, serve this function well as they tend to generate much higher average rates of return. It is very important,

however, to keep in mind that stock prices fluctuate much more than safe assets. Twice already this century U.S. Stock Markets tumbled 50 % !

As regards this issue, the current situation is the most dramatic I've seen in my 30 years of giving investment advice and is one of the most significant in our country's history. Never before has our Federal Reserve held interest rates near zero for this long; six years and counting. Folks from all walks of life, young and old, working and retired, have seen their money market and bank balances essentially un-changed over this extended period while stock prices climbed. This tests even the most patient investors. But there's a huge potential downside if you 'chase returns' because you dramatically change the 'risk' you are taking.

History is full of disastrous periods when folks took their 'safe' money and put it in 'risky' assets. At the time, of course, folks thought they were simply going to make higher returns. In 2014 \$Billions flowed into the S&P 500 helping push the Index to another + year. There are lots of reasons not to follow this trend, including that prices are over-

valued, profits are declining, and at six years this is one of the longest bull markets in history without a correction.

I understand the anxiety investors feel when their CD's and money market returns are yielding practically zero. Most of us were taught to 'keep our money working', so we react to low returns by wanting to 'do something'. That works well if you're trying to dig a ditch or complete some physical task. In investing, however, the secret to success isn't just to do something, it's to 'do something smart'. Most of the bright investors we follow currently hold more cash than at any time in their careers. This isn't because they have secret-safe-investments that earn more than you can, they don't. It's simply because they understand it's okay and smart to keep an appropriate amount of liquidity regardless of its low yield.

My advice: do what wise investors do, keep your safe assets safe and liquid. Don't chase returns, in most cases you'll just end up buying- high and selling-low.

# Bond Bizarro World

Scott Taylor

Scott@valuefin.com

Until now, no government 10 year bond had ever been issued to yield less than zero. But on Wed., April 8th, the Swiss Natl. Bank (SNB) sold \$378 million Swiss francs (about \$391 million) of bonds maturing in 2025 & 2049, with the 10 year portion yielding minus 0.055%. That's right – buyers are guaranteed to lose money when lending to Switzerland over the next decade! This, from the Gnomes of Zurich, has me marveling how the world has changed to some sort of financial Twilight Zone.

It's difficult to comprehend how broken global bond markets have become in this "new normal" era of central bank manipulation. QE (quantitative easing), ZIRP (zero interest rate policy) and financial repression have become part of the financial lexicon since our Federal Reserve cut rates to near zero in the midst of the '08-'09 global financial crisis. We were the first to use these seemingly radical, untested methods to avoid a deflationary depression, but now pretty much everyone is on board. The Fed's QE3 ended last October, but the Bank of Japan (BoJ) and the European Central Bank (ECB) are now running full tilt to create yen & euros by the trillions to buy sovereign debt and other securities. Beyond these main global reserve currencies, there have been 500+ central bank and regulatory easing measures around the world over the past 3 years. The amounts at stake are truly breathtaking.

The result? Besides the SNB sub-zero new issue, well over \$2 trillion of European govt. bonds are trading at negative yields, led by German bunds out to 7 years. Among benchmark 10 year issues, Germany yields 0.16% & Japan 0.36%, making our 10 yr. T-bond yield look absolutely princely at 1.95%. Short term "safe" money held in banks or govt. securities pays nothing (or less than nothing) pretty much everywhere. In the history of money and banking, which dates back to the Florentine bankers of the 14th cen-

tury Italian Renaissance, this has never happened before.

The tsunami of liquidity from these QEs has had little effect on the underlying economies outside of the U.S., with much of the world's growth slowing, if not contracting. Instead, stock and bond markets have surged and companies have used cash & record low cost debt to fund M&A transactions totaling more than \$5 trillion over the past 15 mos. alone. This is a global trend spread across all industries. Organic growth in revenue and profits has been elusive, so public cos. pursue deals and/or buy back shares to compensate. Valuations rise as investors justify ever higher prices based on zero risk-free rates.

As with subprime mortgage lending that helped inflate the RE bubble a decade ago & whose securitization was a primary cause of the financial crisis, today's cheap (free?) and easy credit will result in a massive misallocation of capital in the desperate search for returns. Traditional fixed income investors like insurance cos. & pension funds will be hard pressed to meet their commitments to policyholders and retirees. Retired savers who don't embrace risk will spend down their principal.

Now in year 7 of this strange new financial world, it's hard to tell when it will end. But something so obviously unsustainable must end at some point. With our Fed done with QE (for now) and intending to raise short term rates as soon as June, we'll soon find out if they've painted themselves into a corner. Capital markets will become more volatile. Crises will occur, most likely in foreign markets as hot money flees. Systemic failures will occur, perhaps in places we least expect. Be ready for anything, because we've never been here before.

*(Continued on pg. 3)*

# Initial Public Offering = The Greater Fool Theory

Phillip Haydn Connors

Phillip@valuefin.com

"IPO's are back! And they are hot! Ah yes, the IPO craze is back. Seems folks have grown bored with existing companies and are looking for something new. Hot IPO's are common in Bull markets, so we are not surprised to see so many companies going public, though as value investors, we have our doubts.

So, let me define the Greater Fool Theory. It means you are willing to pay more than something is worth because you believe another person will pay you even more. So you are the 'Initial Fool', waiting for a 'Greater Fool' to come along and make you profitable.

How does this apply to IPO's? Insiders set the number and price of shares to sell to the public. Their goal is to make as much money as possible for their insider activities: work and / or investment. And while it is unlawful for these sellers to lie or be fraudulent, IPO sellers will put the highest price on their shares that the 'market will bear'. In the last 12 months, for example, 80% of American companies who 'went public' through IPO's were NOT making a profit.

The history of IPO's is a mixed bag. Occasionally companies succeed fantastically and their IPO prices turn out to have been bargains. Much more often, however, they either fail or produce mediocre results, and investors lose all or part of their money. The rare success makes people giddy with possibilities even though the statistical likelihood is stacked against them. It's much like buying a lottery ticket: extremely low probability of a large payoff.

The last time IPOs were this hot was 1999 (remember the dot.com era?). A few insiders made a fortune, those monies coming from all the Fools waiting for a Greater One to come along. Today's hot IPOs are often in social media and high-tech.

My advice: be a fundamental investor. Buy things of high quality selling at a low price. Done correctly neither you nor someone buying your shares later are Fools. Even though you are unlikely to make a quick lottery-ticket hit, the statistics suggest you will be much more successful over the long-term. It makes a lot more sense to buy an established, sound investment than shares of a non-profitable company priced by the seller.

Note too that when IPOs are hot, other assets are often in bubble territory. Around the world today art, cars, and collectibles of all types are selling for record amounts. Denver homes get multiple offers the day they are listed for sale. I believe we'll look back at this time and remark that investors of various stripes were complacent about the risk they were taking. One way to not be hit hard by bubbles is to be a Value Investor. Oh, and avoid being a Greater Fool too...

Note: for those of you on social Media, our Facebook page will provide more frequent updates and information than this Quarterly Newsletter. We want to share the opinions of those we value and trust, and help our clients understand the issues we see impacting the economic outlook going forward.

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## **Bond Bizarro World (Continued from pg. 2)**

As value investors who recognize bubbles and outperform in bear markets, we expect our next big op-

portunity will arrive sooner rather than later. Being in Bond Bizarro World is a sure sign of that.



# “This Market is Hyper Over-Priced in My View.”

Richard Fisher, former head of the Dallas Federal Reserve Bank; March 19, 2015

William Mason CFA

The valuation of the stock market is at one of the highest levels in history. This is occurring during a very weak economic recovery. It is also occurring because the Fed has helped to boost the market through ZIRP (Zero Interest Rate Policy) and multiple QE programs. Initially I have some warnings from two of the best stock mutual fund managers ever.

## Bob Rodriguez

The following quotes are taken from a speech he delivered on October 30, 2014:

“What I have learned in my career is that few will listen to you when you have a viewpoint that diverges materially from the general consensus. I didn’t realize this when I first entered the investment field in 1971.

“I wish I could be optimistic but I just can’t bring myself to it. Too much has unfolded during the past decade that dictates a far more cautious outlook, in my opinion. For the record, I’ve maintained this view since 2011, so some of you may think that I am unwilling to throw in the towel. You may be right but I don’t think so.

“I’ve been highly critical of the Fed’s monetary policies for years and particularly the various add on QE programs since they first began. I believe this policy will lead to one of the present day future shocks.

“With heightened pressures to be fully invested, I believe the utilization of liquidity as a proactive investment strategy is warranted. There will come a time when it will be wonderful to be investing again.”

## Jean-Marie Eveillard

On February 6, Jean-Marie was interviewed by

Consuelo Mack.

“I think there are risks which relatively few people seem to perceive. Because so few people seem to worry about the risks I see, and maybe they are right and maybe I’m wrong, the valuations seem to be on the high side.”

Consuelo asked: “What is the one investment that we should all own some of in a long-term diversified portfolio?”

Jean-Marie answered with: “My answer would be gold bullion.”

## Valuation

John Hussman of the Hussman Funds wrote the following on March 16:

“Aside from that 2000 peak, the S&P 500 itself is now more overvalued than at the 1929 peak, not to mention the lesser 1972, 1987 and 2007 extremes.”

On March 6, *Morningstar* interviewed Ben Inker of investment management firm GMO. He had the following to say:

“U.S. large-cap stocks don’t look as expensive as they did in 2000, but we’re trading at valuations today that are higher than we saw at the market peak in 1929 or 1965.”

Goldman Sachs recently admitted: “The S&P 500 index trades at a forward P/E of 17.2, the highest level in the past 40 years outside of the Tech Bubble.”

## Fed Involvement

Economist Ed Yardini, a former economist with the New York Fed, had the following to say on March 19:

“I don’t think anybody would argue that stocks are cheap here. The Fed shouldn’t be in the business of asset bubbles.

“This is not about investing, this is all about the central bankers. These markets are all rigged, and I don’t say that critically, I just say that factually.”

## 1965

Warren Buffett once pointed out that the Dow went from 874 at the end of 1964 to 875 by the end of 1981. We are now at a valuation level above 1965. Economic growth during that former period was 9.5% per year. We have been growing at 2.8% for the last 6 years.

## Value Financial Advisers Quarterly



**VALUE FINANCIAL ADVISERS, INC.**

9185 E. Kenyon Ave., Suite 250

Denver, Colorado 80237

303.770.3030 Fax 303.773.9122

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