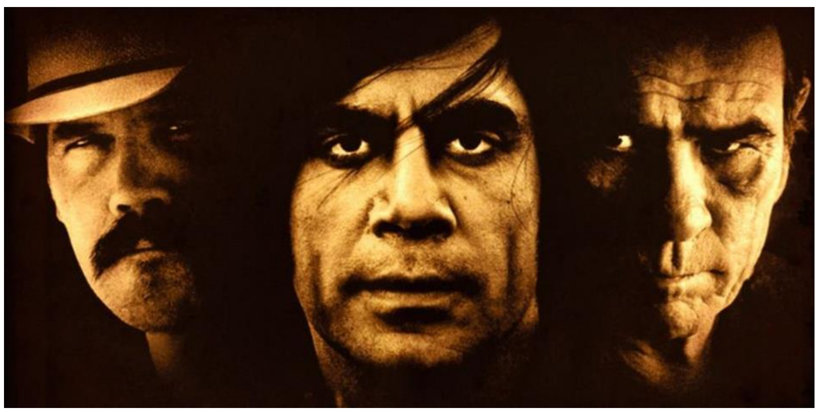
December 6, 2021

No Country For Old Men

"You think when you wake up in the mornin yesterday don't count.
But yesterday is all that does count. What else is there?
Your life is made out of the days it's made out of. Nothin else."
— Cormac McCarthy, No Country for Old Men



One of the cool things about growing older is being able to share some of your favorite movies with your children who were too young to watch them years ago. Movies like Shawshank Redemption, Pulp Fiction, Silence of the Lambs, or No Country for Old Men. Well, this weekend I got to rewatch No Country for Old Men with my youngest daughter, and expose her to the writings of Cormac McCarthy.

The title refers to the idea that the nature of evil has changed and old value systems no longer apply. Our protagonist, Sheriff Ed Tom Bell, feels that as he nears retirement, he can't cope with modernity or the increased levels of violence and lack of respect for human life. *"It starts when you begin to overlook good manners. Any time you quit hearing Sir and Ma'am the end is pretty much in sight..."*

For me the movie personifies the struggles I've been having trying to understand some of the craziness going on in our economy and markets. Do old rules no longer apply, has the world changed so much that I'm just an outdated old stock picker?

I was taught that the value of an investment was the net present value of all future cash flows. Bonds are easy because we know the annual interest payments and the maturity. Stocks are a bit more difficult since we have to make estimations of cash flows, growth rates, and expected terminal values. Investments in real estate are very similar, you're calculating your expected future cash flows and terminal value and discounting it back to the present. If this is the case, how can you justify some of the silly valuations that seem to be spreading like wildfire throughout the investment landscape?

When we talk about valuations, we often use the Price-to-Earnings ratio (P/E) to compare stocks across industries. Unfortunately, P/E doesn't work very well when stocks don't have any earnings, in that case we can look towards the Price-to-Sales ratio to help us determine valuation. Another nice thing about using P/S versus P/E is that sales (the top line) are not as subject to accounting manipulation.

The chart below shows two ways of looking at Price-to-Sales. The bottom line shows that over the last several decades the median P/S ratio on the S&P 500 has been around 2x, and it is currently around 3.5x. The top line is more of a reflection of the craziness going on in certain segments of the market. **We currently have 80% more companies trading above 10x sales than we did during the internet bubble of 1999-2000!**

Many of these companies trading at extremely high P/S ratios are in segments of the market that are long on promise but short on results, such as Electronic Vehicles, Space Flight, Green Energy, Artificial Intelligence, and Special Purpose Acquisition Company's (SPACS). They have great stories, but very little in the way of revenues. Overvalued companies are not necessarily dangerous, unless a lot of people buy into the hype and they attract outsized sums of money. Which is exactly what is happening today. **In the history of the stock market, we've never seen so much money flow into "story" stocks.**

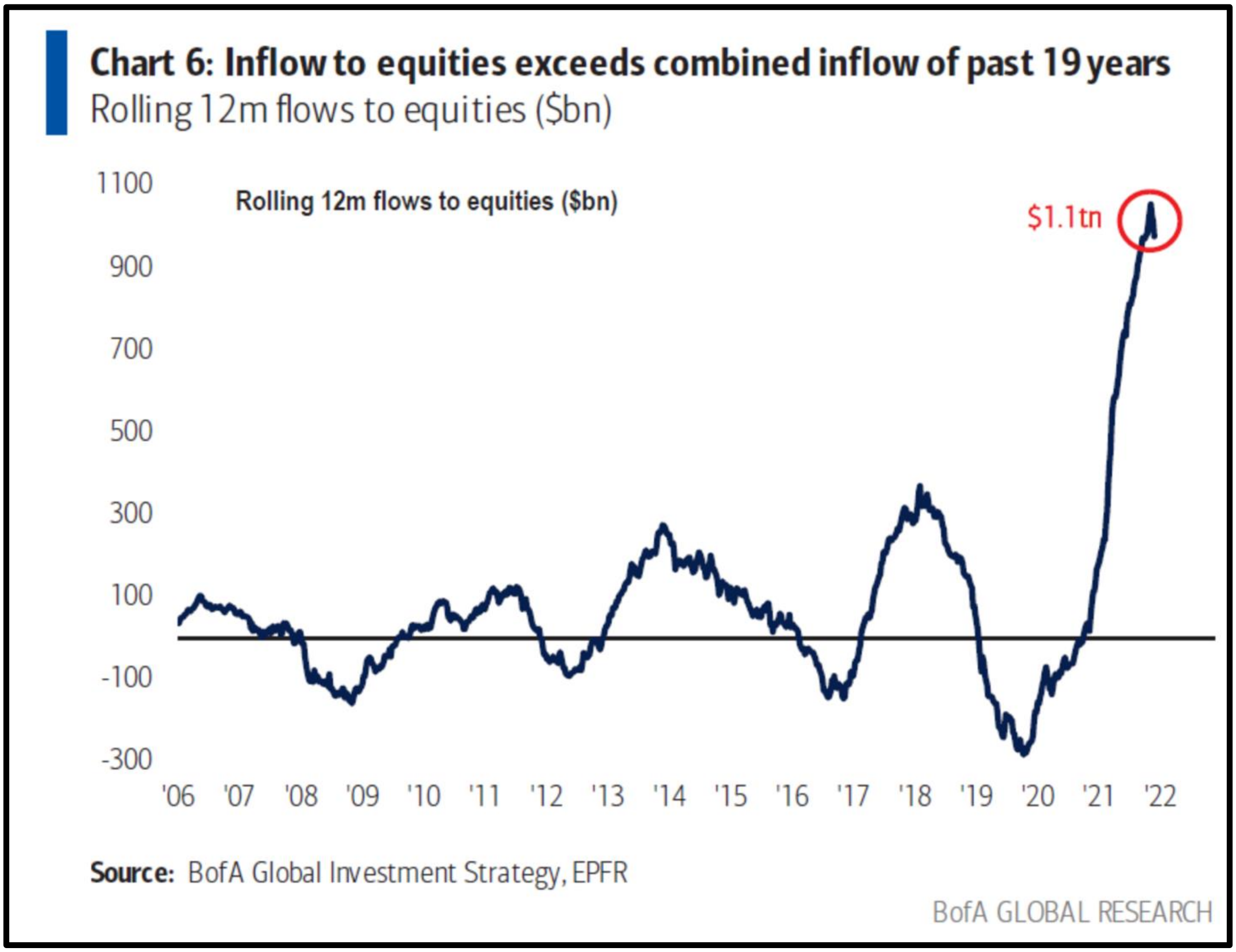
Compliance doesn't like when I mention individual stocks, but please take a look at some of the market capitalizations of old incumbent auto companies compared to their new electronic vehicle competitors. Are all of the incumbent auto manufacturers going to cease to exist? What about this NFT (Non-Fungible Token) "art" that recently sold for $3.4 million? Cryptocurrencies? No one is buying these things because they have some intrinsic value. They are only buying them because they think someone will come along and pay them more than they paid. **The supply of greater fools is finite or at least I think so, but we obviously haven't found the limit yet**.

I have said repeatedly in these monthly missives that it is not our job as investors to predict the future because we can't. It is our job to interpret the present, and most of that boils down to observing what people are doing rather than what they are saying. And what they are almost always doing is acting very human, making the same mistakes their forebearers did, being greedy when they should be fearful, and being fearful when they should be greedy. And reacting – overreacting – to the news of the day; listening to the noise and missing the market signals. Today is certainly no exception and in fact, may well be the most vivid demonstration of greed winning out over prudence in modern history. Or maybe just history.

For many people the pandemic has been a financial boom; they don't have to make student debt payments, they don't need to worry about paying rent, they get free cash from the government, and nearly all assets go up in value. The pandemic has also reminded them that life is short, we never know when our Anton Chigurh will show up flipping a coin, therefore what do we have to lose. With the Fed's never ending ZIRP (zero interest rate policy) how can a young person hope to pay off their student loans or buy a house without speculating. Gambling on asset prices is how they hope to break free of the Central Bank's financial repression.

Ever since 2008 the world's Central Bank's have been pushing people away from savings and into risk assets. The pandemic and free money from the government just threw fuel onto that fire. Risk taking for financial reward has permeated our society (just look at the surge of mob thefts), and buying stocks is seen as one of the only ways to get rich quick.

In fact, inflows into equity mutual funds and ETF's in just the last 12 months exceeded the cumulative inflows over the last 19 years!



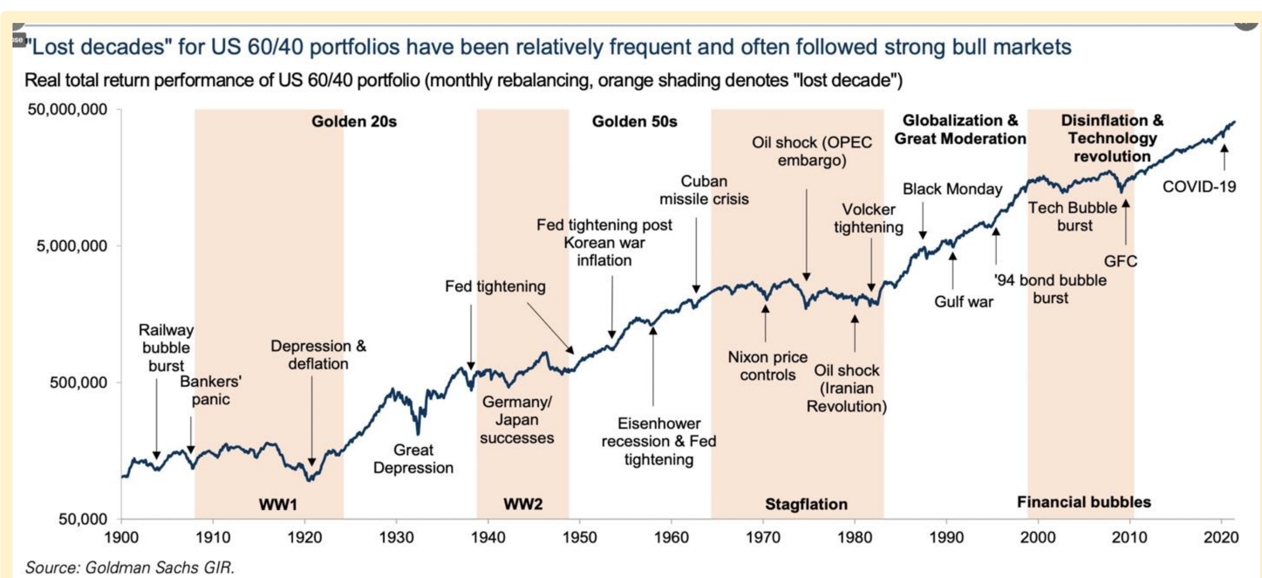
I don't blame people for throwing caution to the wind and taking on excessive risk, I mean what are they supposed to do? In a ZIRP world, if they avoid risk, then they get negative real returns, and get to watch their purchasing power erode every day. The problem with speculation is that it starts to tempt the prudent investor into reckless behavior.

Even fund managers and investment advisers are being forced to take on more risk. If they act prudently for their clients, the clients (some of them) will leave for an adviser willing to take more risk, chase more return. If they make "irresponsible" investments, which will likely be anything that went down in hindsight, they'll get sued out of business. They are merely responding to the incentives placed before them.

This is no country for old men, and this is precisely what this Old Man is struggling with. Trying to stay prudent in a world where prudence is laughed at. I totally get people's desire to get ahead, and their belief (fully supported and encouraged by the Fed) that the only way to do so is ignore risk and buy and sell to the greater fool. I just can't bring myself to participate, especially with someone else's money.

There have been similar periods to today, where caution and prudence were laughed at; the roaring '20's, the Nifty '50's, and the Dot-Com bubble of the late '90's. In fact, there are some striking parallels between our current FOMO era and the irrational exuberance days of the Dot-Com era.

While we all remember those crazy times, when new internet companies were being valued on clicks or eye-balls, we often forget that there was also the Y2K scare. The Y2K scare was the fear that computers wouldn't be able to handle the new millennium when calendars rolled over from 1999 to 2000. Of course, that didn't happen but the dire warnings did spur massive investment in new technology. There was a capital spending boom where years of expenditures were pulled forward into 1999. This was followed by less spending and Fed tightening which led to a recession and the bear markets of the early 2000's.



Today we have a similar environment, where the pandemic pulled forward consumption by consumers seeking to buy cars and homes in the suburbs. Which also led to a huge run on merchandise for those new homes. Add on the pandemic induced supply chain disruptions and you get soaring prices. Now the Fed is faced with tightening monetary policy (maybe even raising rates) in order to combat inflation.

Gee, ten plus years of a soaring stock market, consumption pulled forward, investors who've been converted to speculators, and a Fed looking to tighten, maybe we have seen this story before!

One of the reasons I continue to love this profession is the often head shaking analysis of human behavior. Simple greed and fear have been the primary drivers of human behavior, and I honestly don't believe that that has changed. Even with the Fed and Government encouraging greed, eventually fear will find a way back into the front of our minds and when it does there will be a few old men left.

"I think that when the lies are all told and forgot the truth will be there yet. It don't move about from place to place and it don't change from time to time. You can't corrupt it any more than you can salt salt."

— Cormac McCarthy, No Country for Old Men

Be careful out there,

Chris Wiles

Where trust is Earned