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The Trail

by Jason Hundhausen

Some newsletters come easier than others. A few, the idea hits at once, the line of thought is clear and the progression is natural, like a ribbon of trail through a forest, every section flowing comfortably to the next. Others, the ideas take longer to coalesce as thoughts bounce between disparate pieces of information with no linear progression, and a path that feels more like a Ninja Warrior course, jumping from here to there. This newsletter falls in the category of the latter. Not for lack of interest, no, quite the contrary. The reason is because just *so much is happening right now.*

Historic events, truly (hopefully) once-in-a-lifetime events, and, as such, it leaves a lot to think about. So this time around, instead of focusing on a single theme, let's explore this trail together, not really knowing at the beginning where it's going to end up, but counting on enjoying the thought-journey either way.

Last weekend's run along the ridge of the Bridger Mountains

Diversificated

"If a little engine oil is good, then a lot must be better." – me.

Successful investing is difficult. To extract value from markets requires a person to create new, *material information*. This process of mining, sorting, separating, and condensing massive amounts of information takes work, just like extracting gold from ore. At just 2 parts per billion, you have to dig through a lot of rock to collect a meaningful amount of gold; likewise, with billions of news sources, bloggers, tweeters, redditers, youtubers, younameits'ers, you have to dig and sort through a lot of noise to piece together any valuable information. There's just no way around it: material information and the rewards that it may reap, like gold, can only be extracted through a lot of hard work, or as I like to tell my sons (and myself), "Pay to play."

Naturally, we seek shortcuts to forego some of the work. Take, for example, the construction of a portfolio. We all know the old adage, "Don't put all your eggs in one basket." In investing, it means you probably shouldn't invest all of your savings in the stock of just one company; instead, it would be better to own multiple companies (in different industries). The mistake comes when selecting mutual funds, which are pooled investments comprised of stocks, bonds, cash, and/or other investments. With funds, applying the logic of "two is better than one, so three must be better than two…" may not be getting you diversified, it may be getting you my Word of the Day: DIVERSIFICATED.

Diversificated is a term I made up to describe the mistaken assumption that by owning many different funds you ensure that you are well-diversified. It's common to review a portfolio and see dozens of funds, but a more careful examination of the underlying holdings of each reveals a high degree of overlap. In other words, each fund the client owns holds the same investments as the other funds, or put another way, the client could have held just one of the funds and had about the same performance and risk, or put another way, the clients dun' got diversificated!

Proper diversification takes time and effort and factors in many different variables beyond the basic "how much stock and how much bond" narrative we're all trained to think. Keep in mind, even with proper diversification, you could never eliminate all risk from a portfolio, but, as Mark Twain put it, "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." Those who have been led to believe that their portfolio is well-diversified simply because it owns a lot of different funds are also those likely to be most blindsided when markets make corrections because it's only then that they realize they're holding highly correlated assets—often times the very same assets within each fund. If you're curious about whether or not you've been inadvertently "diversificated," please give us a call.

Scapegoat

Another topic I've been doing a lot of thinking about, mostly while I'm out running trails, is just where the heck are we going next? Not just in markets, but in society, too. I've come to the conclusion that we have not even begun to see the profound effects that the Coronavirus pandemic has had and will continue to have on society. My heart goes out to the 40+ million people (and counting) who have been forced to apply for unemployment. I feel concerned for the 150k people each week, half of them fresh college graduates, trying to enter the workforce, all looking for jobs amidst massive shutdowns, layoffs, and hiring freezes. It saddens me deeply to see thousands of small businesses closed down permanently, temporarily, or operating at diminished capacity and know that many more will follow. But nothing frightens me more than the interventions that lawmakers and central bankers will surely make in their attempt to fix the problem.

As I've written about and talked about for years now, the problem we ultimately face is one of too much debt. Unfortunately, the only tools the Fed seems to be willing to use all create more debt, which is akin to putting out a fire by smothering it with fresh tinder. This, of course, only leaves more detritus and debris that will invariably catch fire again, only the next time it will be that much more difficult to extinguish. Thus, Jim Grant nails it again when he says the Fed, or rather, central bankers in general, are "acting as both fire fighter and arsonist."

Unlike the 2009 Global Financial Crisis, the problem that the Fed now faces is not one of being unable to provide markets with sufficient liquidity. They have no problem printing money—they printed $2.6 Trillion in a matter of weeks (you're welcome, Wall Street!). No, the problem isn't with providing liquidity to markets, it's one of business *solvency*, and there's not a lot that the Fed has in their toolkit to resolve it. The Fed Chair, Mr. Powell, put it well when he said, "The Fed has the ability to lend, not the ability to spend." This means that until businesses open back up and consumers resume consuming, there's not a lot that the Fed can do to boost the consumer engine back to life.

What does this mean for society? My speculation is that we will have some form of universal basic income (UBI) from this time forward. CARES act was the start; the spigot will not be closed. Who knows what this "enhanced social security" program will be called, but one thing is certain in my mind: Because the impact of the pandemic is so pervasive and so lasting, lawmakers will feel they have no choice but to approve some form of ongoing economic stimulus, lest the consequences of 40 million lost jobs be too severe to bear. Sadly, frustratingly, the pandemic is going to be the scapegoat, the source, "the cause," when, in reality, it was the years of debt accumulated, the years of detritus built up on the forest floor, that left us in such a vulnerable state. Assigning all of blame to Covid-19 on the damage to our economy is like blaming the cigarette butt for the fire that

Because the impact of the pandemic is so pervasive and so lasting, lawmakers will feel they have no choice but to approve some form of ongoing economic stimulus, lest the depression be too severe to bear. Sadly, frustratingly, the pandemic is going to be the scapegoat, the source, "the cause," when, in reality, it was the years of debt accumulated, the years of detritus built up on the forest floor, that left us in such a vulnerable state.

incinerates the forest and sterilizes the soil. At first glance, it makes sense, but a closer look reveals it was years of intervention in the natural cycle of the forest that allowed all of the fuel to build up. Making matters worse, Covid-19 was not just a "cigarette butt," but more like a lightning strike on a tank of jet fuel surrounded by dynamite (with a cherry on top). Covid-19 has been the most disruptive event to the economy since the Great Depression, yes, but it's years of central bankers intervening in free markets, preventing the natural purging of poorly-run, overindebted businesses that is going to cause such lasting effects.

The Not-V

With the above scenario, one would not think it possible for the economy to rebound so quickly, yet markets have recovered dramatically (with gold leading the pack). So what gives? This phenomenon has encouraged many to speculate that we're in for a V-shaped recovery. Record numbers of brokerage accounts have been opened since the March Mayhem and new traders are pouring in. Record inflows came in the days immediately following the first stimulus check that went out as millions of investors—many who couldn't tell you the difference between a bond and a bottlecap—take advantage of this "generational buying opportunity." This new money pouring in has driven many popular names to the moon—Tesla was recently trading at 6,350 times last year's earnings, which, put simply, means that at that price, it would take 6,350 years to earn back an initial investment in Tesla. Or, using my favorite hot dog stand analogy, if someone had a hot dog stand that earned $10,000 last year, paying a multiple of 6,350 means you think that hot dog stand is worth $63.5 million dollars. When I put it that way, most folks say you'd have to be out of your mind to pay that, yet many investors speculators are paying just that, and gladly!

In the meantime, many of the most well-respected, legendary investors are holding record amounts of cash and, in some cases, are actually short the market for the first time in over a decade. They can see the coming waves of layoffs, in particular among white-collar jobs, as PPP funds dry up and reduced cash flows take their toll on businesses. These investors also know that at some point the out-of-sync-with-reality mania going on in markets is going to give. The disconnect between price and profitability, between economic expectation and reality, is just too large. The recovery is not going to be "V-shaped" with a large drop and immediate return the way it was before Covid-19—not if business and jobs haven't also returned to normal levels. Instead, I believe the economic recovery from the pandemic most likely will be more protracted, with perhaps a "W-shaped" recovery, that includes another large decline that follows the first, once the weight of such extreme valuations, massive amounts of debt, and widespread business insolvency forces a correction that gains momentum. But whatever shape the recovery takes, I feel confident it's not going to be a "V," so I've taken to calling it simply, "The Not-V."

Like I explained at the beginning of this newsletter, some thoughts and ideas bounce around, jumping from here to there. But what remains steadfast, is my continued commitment to seek and create valuable information on behalf of my clients. I sincerely hope this finds you in good health. Take care and please reach out if you have specific questions or concerns about your portfolio, or just want to talk about V and W curves – I'm always happy to oblige. ■