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Fishing lessons

Doug taught me a few career lessons that have helped me keep my clients in good stead through thick and thin. I am so lucky to have met him when I was still a young'un in the business, circa early '90's. George H. Bush was President, no one ever heard of email, it was before day trading became a national sport, cell phones were called "car phones", and the fax machine was still considered a very cool invention.

Anyway, he was truly a big data guy before "big data" was invented; meticulous was he with his files filled with spreadsheets, graph paper and charts. Then again, you'd expect that from Doug West, who also happened to be the Director of Research of Kidder Peabody before General Electric bought the firm, back when Wall Street research was hard to do and even harder for the public to access. We worked at the same Wall Street firm, Bishop Rosen and Co., in the Trinity Building next door to Trinity Church on Broadway and Wall Street. That's where the information flowed through and you had to be there. If you weren't downtown, you were nowhere.

Here is the lesson I learned from Doug that I use most:

> Banks, Utilities, and home building stocks are supposed to have low P/E ratios to compensate investors for interest rate risk. Continuing on that line, you shouldn't argue that they are cheap because their P/E's are lower than the overall market; it's

supposed to be that way. If their P/E's are in line with the market or above, you're taking too much risk. You're being too aggressive. Eventually, they'll revert back and you'll lose money when interest rise.

Back to Mitch:

It's not that I pray at the altar of P/E ratios, I don't. And some stocks should have high P/E ratios; companies with very reliable growth and that have irreplaceable products and/or brands and companies that need to reinvest all of their earnings to fuel future growth. These two come with their own set of risks, but for now, I want to focus on the aforementioned sectors. Not to mention, by the way, that there is often a fiddled component of the "E" in the P/E.

To me, it meant that back in '07 when talking heads were touting the stocks of home builders because they were "trading at below-market multiples", I knew better than to put that stuff into clients' accounts. It also meant that when bank stocks were trading at levels higher than their average multiples, I didn't stuff accounts with financials despite that sector becoming the largest component of the S&P 500 at that time. In large part, I credit my ability to get my clients through the ensuing bear market, when, you know, these stocks got crushed, to Doug's lesson.

Today, the leverage in the financial system is so much greater than when Doug was still here. The Fed's ZIRP (zero interest rate policy) and 3 rounds of QE have created distortions up and down the entire risk-asset spectrum. For example, high yield bonds, or Junk Bonds as they were called when I got into the business, used to pay upwards of 9% on average pre-2007. Today, they pay approximately 5 to 6%. Interest rates on money market funds and savings accounts are negative in inflation adjusted terms. And stocks with decent dividends have risen mightily.

I believe this still applies today; back when I got into this business, the income seeking client most often was also seeking preservation of capital. **Artificially low interest rates have changed behavior.** Now, we're all speculators. Except that these income/preservation investors, my opinion, face a world of hurt in the not too distant future. They have become stock market investors above and beyond their appropriate risk tolerance and time horizon, but they think they're doing the right thing because all of their collective actions have pushed up the value of their stock portfolios. In Wall Street parlance, many of the financials, utilities, REIT's, high yield bonds, and even many dividend paying stocks in general, are very crowded trades. Many yield-paying stocks now have above-market P/E multiples and lower dividend yields due to past stock price appreciation.

Tapering doesn't mean tightening. But the next logical step IS tightening and everyone knows it. But no one wants to be the first one to lighten up. Actually, I've begun the process. I am not suggesting that every stock in every sector is overvalued, but for the last 5 years, stocks that do well in a declining interest rate environment have been home runs for investors. And just like every bull market in the past, investors chase performance, justifying the decision of yesterday's buyers with even higher stock prices.

-Again, bank stocks have performed enormously well over the 5 year stretch since the nadir of the bear market. And yes, they are expected to increase earnings once interest rates rise, which will improve their NIM (net interest margin - spread they earn on the difference between their cost of capital and the rate they charge borrowers). But I see banks becoming more like regulated utilities; limited in their authority to enter lucrative businesses, higher reserve requirements, among other commercial bank and capital markets regulations that didn't exist prior to the Great Recession.

-Home builders are incredibly interest rate sensitive. They thrive in low interest rate environments; cheap funding to buy land and materials and low mortgage rates to entice buyers.

-Utilities need funding, the cheaper, the better, to reinvest in decrepit infrastructure and gargantuan sized customer bases, regulatory approval to raise rates, and steady, if not cheap, fuel prices. And their dividends make them, in the eyes of yield-starved investors, bond equivalents; regardless that they are still stocks with stock market risk.

The common thread is that they've all benefited enormously from cheap financing. When interest rates rise, the common thread becomes a loss of cheap financing. I'm sticking to the lesson plan. Time to reduce exposure, protect gains, and go elsewhere for returns. Where that place is, is the subject of another article.

You'd think that as a Director of Research, he'd offer up his recommendations freely. But he didn't. His view was always that "that's between you and your clients". His interest lied more in teaching me how to find my own recommendations; in sharing his knowledge accumulated over a lifetime in the business. Doug, thanks for the fishing lessons.

Thanks,
Mitch

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