SEMPER AUGUSTUS
Investments Group LLC

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Twelve Predictions from 2000 Revisited + New Predictions for the Next Fifteen Years

Fifteen years ago, we penned a set of predictions about what the ensuing fifteen years would hold. The investment world had gone mad, caught up in perhaps the greatest stock market bubble in history. The pressure to participate was enormous, particularly as we refused to own the high-flying technology and internet stocks that were making everyone else so much richer. It was all about eyeballs and click-throughs. Value investing was most certainly not en vogue. Laying out our expectations about future stock market returns, economic output and interest rates, we felt would help support the utility of our conservative approach.

As fundamental investors, changes in profit margins, changes in the price paid for profits and top-line growth matter deeply to us. Those are the three drivers of investment returns and measuring them is the bedrock of our investment discipline and process. All three were at incredibly high levels and we had no doubt that over time would decline to more normal levels, inflicting great harm to the average investor. We had built a portfolio of well-capitalized businesses with terrific returns on capital employed. Our businesses had room to grow sales and free-cash profits and we owned them at prices that made economic sense. Our prospective advantages versus "the market" were huge, but so were the pressures to do things differently, to join the crowd. We used the letter to shout out about the insanity which reigned all around us. It was Wonderland.

We didn't know when precisely the bubble would burst, but we did know that when it did the fireworks would be spectacular. The mania had been building for a long time, so looking out many years allowed time for the market and the economy to revert down, *way down*, to more normal levels. At the beginning of the letter, we stated, "Oddly enough, using history and logic as our guide, we think it is probably easier to predict what might happen over the next fifteen years or so as opposed to this year, or even next week."

How true that statement was. Our crystal ball in 2000 was en fuego. Prediction number one couldn't have been better timed. We anticipated that Microsoft shareholders would lose money for fifteen years. As it turns out, Microsoft shares traded at their all time high two days prior to our letter, and until only late last year, held the record for the largest market cap ever. Ironically, Apple, today's new top dog, was bailed out by none other than Microsoft in 1997 with a $150 million investment!

In this year's letter, we'll recap our twelve predictions from January 1, 2000, run a brief snapshot of what's transpired over the interim, and finally take a stab at a new set of twelve for the next fifteen years. Unfortunately for the average investor, we're seeing many parallels today to the world which existed at the end of 1999. Getting changes right at major inflection points can be of huge benefit. Fifteen years ago was just such a time. We think today will also mark a direction change of seminal importance to not only the return *on* capital, but to the return *of* capital.

Recap of Our January 1, 2000 Predictions

At the turn of the new millennium, aggregate stock market prices were so rich and aggregate debt levels so high that a normalization of the excesses would have a profound impact on both future returns and economic output. Ours was far from a consensus view. For nearly two decades, stock market investors had enjoyed compound annual returns averaging more than 17%, fueled by a combination of rapid growth in economic output with expanding profit margins and P/E multiples. GDP was pushed ahead by progressively higher leverage, which saw system-wide debt levels rise from just over 150% of GDP to 250% by 1999. Most investors expected perpetual high returns and robust economic growth, and voted by leaping into all things internet and technology related. Fanciful expectations for growth blinded investors to the cold reality that the price paid is critically important to investment success. We saw differently and thus believed most investors were in for a rough slough. Our first prediction was all about the fact that price matters:

1) *Microsoft shareholders won't be very happy in fifteen years.*

We did not know that Microsoft shares would peak on December 30, 1999, two days before we wrote our predictions, nor that the peak would represent the global record in market cap for almost fifteen years. We knew the valuation made no sense and we included a six-page analysis of the future economics of Microsoft in which we laid out a bear case based largely on a massively overvalued stock price. We predicted, "Microsoft shareholders will see their returns compound at no better than a zero percent return for the next fifteen years. In other words, the stock is at least fifteen years ahead of the company."

Our opinion was neither popular nor conventional. We used Microsoft as a proxy for a whole host of companies with valuations wildly ahead of the underlying economic fundamentals of the businesses themselves.

Microsoft shares traded at a now split adjusted $60 per share, sported a $620 billion market cap (on $20 billion in sales), and was the largest company in the world by stock market value. The stock was either the top holding, or close to it, of the majority of large cap funds and other institutional portfolios. A career highlight early that year was participating in a Denver Post Roundtable interview with, among others, the manager of Invesco's then huge and incredibly popular Growth and Income Fund. When I espoused my thoughts about the prospects for Microsoft's owners to the editors and the panel, Fritz, the bow-tied and by now red-faced manager, dismissed the zero percent, fifteen-year, best case forecast as, "bull s___, just poppycock." The Invesco guru explained the stock was not only his largest holding but also the largest holding across all of Invesco's shareholdings, and that I was simply wrong and immature. Now gone from Invesco, Fritz ultimately learned an expensive lesson about valuation and I learned a new word! In fairness, he was right by one measure: I *was* immature. Still am it turns out…

Microsoft has indeed delivered a negative return to its shareholders over the past fifteen years, destroying a ton of wealth in the process. The stock closed 2014 at $46.45, still far below the $60 price at the time of our prediction.

The delicious irony is that the post-2000 collapse of Microsoft's shares afforded us the opportunity to subsequently invest LOTS of capital in a terrific business at ridiculously low prices. Ultimately, a growing business value surpassed the falling stock price. The stock traded in the low $20's by the end of 2000, was range bound from $22 to $30 until 2007 when it spiked to $37.50. Then it traded down to $15 in the 2008-2009 collapse. The stock was as low as $26 at the outset of 2013. We have bought shares cheaply and sold shares as they approached our growing measure of intrinsic value several times. The stock still sells more than 20% below its 1999 closing high! We never said or wrote there was anything wrong with the company. We believed then and to this day think the business itself is remarkable.

If we had instead predicted that over fifteen years the company would:

- grow sales more than fourfold, from $20 billion to $87 billion;
- grow profits nearly threefold from $7.6 billion to $22 billion;
- grow net-cash on the balance sheet from $19 billion to $70 billion;
- begin paying annual dividends in 2003, totaling a cumulative $6.23 per share through the end of 2014, plus a special dividend of $3.00 per share in 2004;
- retire a quarter of its outstanding shares, even after serious dilution due to option compensation.

Most people would have bought that story. The real story, and the unofficial motto of our firm, is - *Price Matters!*

Although Microsoft, and too many other companies, traded at sky-high prices, it was indeed a real business with real profits. From here our next two predictions moved to the world of internet stocks, where tangible business value and profitability were but a dream.

2) *Many of today's pure internet* **stocks** *will crumble as the* **companies** *run out of the cash raised in recent IPO's.* ***The real internet winners are consumers.*** *The cost-effective distribution channel provided by the internet truly is revolutionizing commerce. Retail and fund buyers of internet stocks will prove to be the losers. As is often the case, Wall Street can easily sell revenue-generating power to the public regardless of realistic financial profitability.*
3) *Today's beneficiaries of the cash raised in internet IPO's will be tomorrow's failures. Hardware companies selling to the dot.coms, advertisers of all stripes, new employees of the internet companies, and insiders plowing their winnings back into the pure-play internet stocks will suffer badly as companies run out of cash and fail.* ***p.s. Wall Street will keep their underwriting fees.***

No need to elaborate on predictions two and three much. Both were written as the population was intoxicated by the internet mania. We were convinced it would end badly. It did, and rather quickly: one only needs the long list of big internet failures such as Pets.com, Webvan, and eToys. On the other hand, consumers have indeed been the internet winners. Consider Amazon, yet to make money, but selling LOTS of stuff to people at cut rate prices. The internet has changed the way business is done around the globe and has displaced numerous businesses and industries. On the data front, the low cost of and ease of access to information are truly remarkable. Even our business has changed dramatically due to the internet. Yet, as predicted, lots of investors lost beaucoup bucks as the internet bubble burst – and yes, Wall Street kept their underwriting fees.

From the stylish and faddish internet stocks, our next four predictions addressed fundamental concerns about corporate profit margins, economic growth, broad market valuation and interest rates.

4) *Aggregate U.S. profit margins will remain bound by historic standards. The average company will earn somewhere between 4%-6%, after tax, over the next fifteen years. This statement has profound implications for the stock market. The U.S. economy is currently earning on the high side of the historic profit margin range. Internet companies, until required by the investment community to generate profits, will exert downward pressure on aggregate margins in the short term.*

After-tax operating profit margins at the time of the 2000 letter were at 7.5% for the companies in the S&P 500 index, second only to 1929's 9% level. Margins did decline substantially on two occasions over the next fifteen years. Our prediction hit pay dirt almost immediately but wouldn't necessarily hold. From the 2000 peak through the 2002 economic trough, after-tax profits fell to 6% on an operating basis and 3% reported, which is after write-offs and write-downs. But by 2007, when the market had recovered to its 2000 peak, margins climbed to 9.5%, a new record, even surpassing 1929's high water mark. Then came the great recession, which drove profits down to 3% on an operating basis and to negative levels on a reported basis.

By 2011, the Fed's printing press was humming; companies had slashed overhead, and margins were fast on the mend. Profits are now at a new all-time record 10.3% operating and 9.4% reported, using Q3 2014 final data. We are believers that profitability is mean-reverting and that, in capitalism, labor and capital tug at profitability over full cycles. At present both have been sacrificed at the expense of the bottom line.

So, while profits did fall to the 4% to 6% range, we can take only partial credit for getting our prediction right. With the profit measure presently far above where it stood in 2000, we can't say this was nailed. Certainly the topic deserves further discussion and makes an appearance in our current set of predictions for the upcoming fifteen years. The historic 4-6% range may be obsolete or at least the normal range may be somewhat higher for a host of reasons.

5) *U.S. Gross Domestic Product, basically the total output of final goods and services in America plus net exports, unadjusted for inflation, will grow somewhat slower than historical precedent. At 5% annual growth our $8.9 trillion economy doubles over the next fifteen years. The historic growth rate of nominal GDP has been roughly 6.5% per year. We think the capital stock in this country is greatly overbuilt due to capital expenditure growth, well in excess of output, for too many years.*

Nailed it. Once tallied, nominal GDP is going to come in at roughly $17.6 trillion for 2014, which is 4.3% growth per year (final adjustments had nominal GDP closing 1999 at $9.3 trillion). Shortly after we penned the letter in 2000, we actually revised our very long-term economic growth forecast downward even more. We have used a nominal rate of 4% for more than a decade, and were way in front of Bill Gross and his "New Normal" call for slower growth. Aggregate debt levels are far in excess of serviceable and will exact a toll on economic output for a long, long time. Deflation comes from excessive debt and diminished growth comes with deflation.

6) *The valuation of the U.S. stock market will equal between 30% and 60% of GDP at some point in the next fifteen years. Today's valuation is currently twice that of GDP.*

This is one of the best yardsticks for measuring the level of market valuation. The all-time high for this measure was made at the market peak in early 2000, making at least the direction of our prediction an easy one. It dropped from nearly 200% of GDP in March 2000 to 80% at the market low in 2002. It then climbed to 130% in 2007 only to collapse to 56% at the washout low in February 2009, validating our prediction and inflicting pain on the average investor in stocks in 2000 and in 2007.

As a technical aside, it is worth noting that the market cap-to-GDP measure is universally misapplied. We've neither seen anyone who references or publishes the data series or chart attempt to adjust for the percentage of profits in the economy earned by publicly trades companies versus private ones over time. Nor, has anyone attempted to adjust for the percentage of net profits earned outside of the U.S. over time. In both cases, an upward trend line or range should be applied to the market cap-to-GDP measure over its history. Incorporating both adjustments would drive the "normal" range higher than in older periods. We have done a fair amount of work with the data sets on this measure and hope to someday have the time to assemble it into a formal presentation. Even with proper adjustments, market cap totaled 135% of GDP at the close of 2014, the second highest reading ever, only trailing the 2000 bubble peak.

7) *Interest rates, as measured by the 30-year U.S. Treasury Bond, may fall as low as 3% over the next fifteen years. Long-term U.S. government bond yields have averaged 4.3% over the past two centuries. The high yields of the late 1970's and early 1980's, while consistent with tight labor markets and rising commodity prices, were aberrantly high. Rates are ultimately driven by demand for capital. If the capital stock is indeed overbuilt today, the time required to fully utilize current levels of fixed assets will keep a secular lid on interest rates.*

The 30-year U.S. Treasury yielded 6.48% on January 1, 2000. The call for a sub 3-handle was driven by our belief that aggregate debt levels were already unsustainably high and would exert deflationary pressure on the economy and on monetary policy for a very long time. Following the 2000 to 2002 market rout, which saw the S&P 500 halved and the NASDAQ clobbered by 80%, the 30-year traded at 4.24% on June 13, 2003. After climbing to 5.35% in June of 2007, the financial crisis saw the bond yield again fall to 2.53% by December 18, 2008, scoring a success for our interest rate prediction.

Since the crisis, yields recovered and subsequently plummeted again. From the 2008 lows, yields climbed (prices fell) to nearly 5% in 2010 and 2011. The Federal Reserve launched its most recent iteration of QE (money printing), where it actively bought long-dated Treasuries and mortgage-backed securities with freshly printed dollars, sending yields lower again. The 30-year yielded 2.46% in July 2012. It sold off to 3.96% at year-end 2013 and has since been in a virtual free-fall. Long-dated interest rates are collapsing throughout the industrialized world, reflective we think of ongoing and perhaps accelerating deflation. Debt levels remain far too high and are now even well in excess of where they stood on January 1, 2000. The 30-year closed 2014 at 2.75%.

The predictions so far centered on the prices of financial instruments and the economic drivers of valuation. The next three involved a burgeoning federal state which, then and now, encroaches on liberty.

8) *Despite current government projections from both political parties, the U.S. government will not eliminate the federal debt. Currently at $5.74 trillion, the debt figure does not include the present value of future Social Security, Medicare and federal employee retirement liabilities. Government will invariably tax and spend as much as it can.*

This seemed a no-brainer, given a multi-century history of fiscal irresponsibility. It had looked like the government had things under control in the late 1990's, and in fact, for a brief moment, it ran a small surplus. So much money was being made on the back of the stock market and internet bubbles in the form of capital gains, especially from stock option compensation, that there was a legitimate conversation taking place in academic and media circles about paying down the debt. We laughed and penned prediction number eight, an easy layup.

The Federal debt now stands more than three times higher - at a cool $18 trillion, north of one multiple to GDP and still exclusive of the present value of future Social Security, Social Security Disability, Medicare and federal employee retirement liabilities, which are all unfunded. Proposals are afoot by the current President for more taxing and more spending. We could score a perfect 10 by making this prediction every year for time immemorial.

9) *Unbelievably, the tax code will become more complex. Special interests and favoritism will not recede in Washington. The size and scope of government will continue to slowly suffocate the true potential of this country. Despite this trend, the United States will continue to be, by far, the greatest nation in the world and the land of opportunity.*

This was a layup as well.

The Federal Register has been published since 1936, a time of an activist White House and of growing government intrusion. Sound familiar? The Register is a daily digest of federal proposed regulations from agencies, finalized rules, notices, corrections and presidential documents. The 2010 edition weighed in at a record 81,405 pages (it has topped 60,000 pages every year for the last 20 years). It amounted to nearly 300 pages per workday.

Since 2000, we have Sarbanes-Oxley, Dodd-Frank, ObamaCare, a weightier EPA, FDA, FCC and FTC. The financial crisis brought the TAF, TSLF, TARP, a list of QE's and a fast growing Federal Reserve balance sheet which has mushroomed from $850 billion in 2007 to $4.5 trillion today. We've seen unemployment benefit extensions and expanding student loan guarantees. We have again lowered the bar for mortgages and car loans. We gave cash for clunkers. We "saved" the auto manufacturers and suppliers, AIG, Fannie and Freddie.

On taxes, Congress has made more than 5,000 changes to the tax code since 2000. We spend six billion hours complying with filing requirements each year. The tax code has grown from approximately 50,000 pages in 2000 to 75,000 today. Neither of your investment gurus can complete a personal or corporate tax return. In 2000 your author prided himself with knowing the tax code, or at least thinking he did. He was still racking his brain and consuming three full days to complete his federal and state individual returns. We should have predicted it would become impossible to complete a tax return without help!

We continue to believe the United States is the greatest nation in the world and the land of opportunity. We only wish it had better policies and better political leaders.

> 10) *Defense spending will increase as a percentage of GDP, having fallen to 3.9% in 1999 from 7.5% in 1987, 12% in 1960, and 25% during WWII. The ability of the U.S. to defend itself and its interests will clearly be a priority over the next 15 years.*

Defense spending as a percentage of GDP bottomed out in 2001 at 3.5% of GDP, a post World War II low. The tragedy of 9/11 changed all that and was perhaps no coincidence. Defense spending began a substantial increase in two stages. It initially increased to 4.6% by 2005 for the invasion of Iraq and three years later to 5% for the "surge". Escalation of the effort in Afghanistan took spending to 5.7% in 2011. It seems clear that though we need to prudentially measure government spending, we can't sacrifice spending to the point where our freedom and our safety are compromised. We're not thrilled at the reason our prediction was correct, and are equally troubled that defense spending is expected to decline to 4.6% this year. Those in positions of power who put in place policy which under-invests in defense and our safety should bear full moral responsibility for disastrous outcomes.

Moving on from the intrusions of Big Brother, our next to last prediction highlighted an investment theme we employed at the time.

> 11) *Education will continue to privatize, particularly at post-secondary levels. Ivory towers of isolation will crack from irrelevance, and the education of America will join the real economy.*

Our premise was a then active investment theme of investment in for-profit education companies with a huge growth curve. Our investments in this area worked out well and we closed them out several years ago. The percentage of 25-29-year-olds with a bachelor's degree or higher rose from 29% to 34% between 2000 and 2012, a phenomenal gain in a fairly short time. There were 766,000 students enrolled in for-profit higher education schools in 2001. By 2010, enrollment had grown to 2.4 million. The University of Phoenix alone had an enrollment of nearly 500,000 in 2010, making it by far the largest school in the country. Of course, too much growth has come with consequences, some unintended but many intentional. Shady recruitment, low graduation rates and low rates of graduates being successfully hired in their field of study are leaving a black eye on the industry.

Our prediction and our investments in the area worked out well. Not lost on us, however, is the $1.3 trillion in student loan debt now outstanding, a number that exceeds total credit card debt. One in ten graduates accumulates more than $40,000 and the average borrower in the class of 2014 is saddled with $33,000. Many with sizable loan balances never earn a degree. We have long believed that we overeducate the masses in this country. For many, a degree will never translate into a successful career, monetarily or otherwise. Our society would do a world of good by encouraging those not well-suited for higher education to pursue trades. Based on how much we pay electricians and plumbers to maintain an old house, there is surely a supply and demand imbalance.

As football bowl games were on the television throughout the writing of the letter, our final prediction was really a statement about money corrupting the beauty of sport.

> 12) *The commercial nature of sport will decline. In penning these predictions on New Year's Day, it is not hard to find college football bowl games boring. Utilizing a playoff system would help. Changing sport enough that "student-athlete" is not an oxymoron would be even better.*

Okay. You can't win 'em all. The commercial nature of sport has done anything but decline. We wrote this as the big college bowl games were about to kickoff with a yawn. For too many years, panels of journalists (and coaches for you who misguidedly believe Colorado, the clear cut AP national champ, actually shared the 1990 title with undeserving Georgia Tech) arbitrarily decided the national champion of college football. While we got the beginnings of a good playoff format this year, only a dunce would have said the money in sports was going to decline. We sit in the corner donning the cap on this one. To wit:

- A 30-second Super Bowl spot will run $4.5 million this year, up from $2.2 million in 1999 and $2.9 million in 2000, a peak that held for nine years.
- St. Louis' then five-year old football stadium is now obsolete. The stadium cost $280 million to build.
- Jerry Jones, with the assist of those paying sales taxes in Arlington, TX spent $1.3 billion to build a sports cathedral in 2009.
- Boone Pickens gave $250 million to Oklahoma State athletics.
- Phil Knight has given $100 million to Oregon over the past 20 years, seemingly getting a higher ROI than Boone. The Nike Ducks play in the first round of the four-team playoff in tonight's Rose Bowl.
- ESPN is paying the NFL $15.2 billion for TV rights over eight years.
- ESPN generates over $11 billion in revenue and $4.5 billion in cash flow per year for Disney.
- LeBron James earned $72 million last year. He skipped college for the NBA.
- The boxer, Floyd Mayweather, earned $105 million last year. He dropped out of high school, making one wonder if education may be overrated (see the analysis of prediction 11 above).
- I paid over $100 for a pair of basketball shoes emblazoned with the name of some NBA player for a 10-year old, confirming that education is indeed overrated…

What's Changed in Fifteen Years?

Early 2000 marked the culmination of the great stock market bubble. From historic low valuations in July 1982, investors enjoyed compound annual returns of more than 17% per year. When we penned our fifteen-year predictions on January 1, 2000, we strongly believed the aggregate stock market would produce returns not only FAR BELOW those experienced over the prior 17 ½ years but also far below the magical 10.5% rate universally accepted as a birthright using sacrosanct Ibbotson data.

The S&P 500 closed 1999 at a price of 1469.25, 30.5 times trailing reported earnings of $48.17 and 2.1 times trailing sales. After tax profit margins were at a high level, only once exceeded in 1929. Stocks had never been more expensive in the U.S., not at the 1929 peak, not at the 1966 peak, and not in 1987. NEVER.

We also determined that earnings were overstated by a sizable margin, accounting for proper expense recognition for stock option compensation, recognition of a portion of write-offs and write-downs as otherwise operating expenses and normalization of aggressive pension accounting assumptions. Our calculation of "normalized" earnings were $37.05 for the S&P 500, 23% below the reported number and even further below operating earnings (which ignore write-offs and write-downs) and far below Wall Street's guru strategists who were looking for operating earnings pushing $60 per share in 2000. Not until 2004 and 2005, respectively, did operating and reported earnings hit $60.

Using our more conservative normalized earnings estimate of $37.05, the index was trading for 40.4 times earnings, resulting in an earnings yield of only 2.5% (earnings yield is simply in inverse of the P/E multiple). We have always said the earnings yield is, in our opinion, the best baseline predictor of future returns over a long period of time. Using earnings yield as a proxy for expected future returns, we believed the index would provide an annual return of roughly 2.5% per year over a fifteen year stretch. Even using reported earnings and a 30.5 multiple to earnings, the earnings yield indicated investors in the index could expect an earnings yield and expected return of only 3.3%.

So how did the index do? The index produced a total return of 4.2% per year, a far cry from the previous 17 ½ years' experience of over 17% per year. It did not even approximate the 10.5% rate that the Ibbotson gold standard promised. Considering the 4.2% is before expenses and taxes, most earned far less, and that's for those who stayed in the game. Many investors sold stocks at lows, quitting the game or allocating away from it in the wake of the 2000-2002 decline of 50% and the 2008-2009 washout of 66%.

While we expected the index to do far worse than it did, investors in technology and in the darlings of the internet bubble era were clobbered. Take the NASDAQ Composite, a good proxy for tech, especially at the peak. Since January 1, 2000 the index finally made it into the black in November 2013 and produced a whopping annual total return of 1.02% for the full fifteen years. Of course, some may view this as a huge success in light of the NASDAQ's 242 multiple to earnings at the outset, which equated to an earnings yield of 0.41%. Call it a 61 basis point annual smackdown!

We were fortunate at Semper. We took advantage of the two-tiered market that had developed in the late 1990's and owned a portfolio of good businesses at good prices. While the index traded at 40.4x in early 2000, we had a portfolio trading at 15.9x and an earnings yield of 6.3%. We expected to at least earn our earnings yield of 6.3% per year for the long haul, but also believed we would see our portfolio stocks accrete to fair value eventually from a discount of 83 cents on the dollar. If the process was repeatable we would also reasonably earn an additional premium over time.

For the fifteen years beginning January 1, 2000, our stocks produced a total return including dividends of 280%, which is a compound 9.3% per year. We indeed earned the combination of our initial earnings yield plus a closing of the discount plus the repeatability of the process. Even with varying amounts of cash and fixed-income securities in client portfolios, our composite total returns produced a 5.7% annual return after fees, 1.5% per year more than the index total return.

To see how things have evolved over fifteen years, consider the then and now of the following yardsticks:

	January 1, 2000	January 1, 2015	gain	annual
S&P 500 price	1469.25	2058.90	40.1%	2.3% ^
S&P 500 sales	700	1160 (est.)	65.7	3.4
Earnings (reported)	48.26	106.5 (est.)	121.7	5.4
Margins (reported)	6.9	9.2	33.3	nm
P/E	30.4x	19.3x	-36.5	nm
P/S	2.1x	1.8x	-14.3	nm
GDP nominal	$9.3 T	$17.6 T (est.)	89.3	4.3
Total fed credit	$618 B #	$4.5 T	628.2	14.2
Credit Market Debt	$25.4t	$58.3 T (est.)	129.5	5.7
Gold Spot/oz	$291	$1176	304.1	9.8
30-year UST	6.48%	2.75%	245.3 @	8.6@
3-month T-Bill	5.72%	0.04%	30.6	1.8

^ S&P 500 total return (includes dividends) annualized is 4.2% per year.
# Nearly $100 billion higher y/y due to increase in repos in advance of the Y2K fear.
@ The total return for the 30-year constant UST combines a rebalanced coupon with the price gain of the index. As yields fall the price of the bond increases and vice versa.

The best investment vehicle for the last fifteen years, from the table, would have been an investment in the Federal Reserve! With its printing press, the central bank inflated its balance sheet from $618 billion to $4.5 trillion, a staggering annual rate of growth of 14.2% over fifteen years. Note: the rate of change since the 2008-2009 crisis pops up to 30% per year. Since we all know, with the exception of the current President and the editorial writers at the New York Times, that you can't invest in the Fed and its magic press, the next best thing would have been to buy gold, a 9.8% annual gainer. Unfortunately, shares in gold mining enterprises have woefully failed to keep pace, with many of the majors actually trading below 2000 prices.

Surprising to many, long dated bonds not only beat the U.S. stock market but provided returns far in excess of what most would have expected. As the yield on the 30-year U.S. Treasury bond plunged from 6.48% to 2.75% over fifteen years, the corresponding increase in price, when added to cumulative coupon payments, produced an annual gain of 8.61%. A similar result will be *impossible* to achieve by the owner of the 30-year at today's 2.75%, unless of course the bond trades at a significantly negative rate of interest! Don't laugh.

While the S&P 500 produced a relatively and absolutely inferior result over fifteen years, we didn't think it would be even as good as it was for the averages. We are frankly somewhat surprised to be writing this letter with the market trading at new highs, thinking the index would be at about the same place as when it began 2000, thus providing only a dividend return. As it turned out, investors' good fortune to have earned all of 4.2% annually can be attributed to the massive money printing operations and government intervention in the economy since the 2008-2009 crisis. The balance sheet of the Federal Reserve has exploded by $3.65 trillion since 2007, an amount greater than growth in nominal GDP.

Investors were hurting for the bulk of the fifteen-year stretch until only recently. The index fell as low as 666.79 on March 6, 2009, down 55% over nine years. Even at September 30, 2011 the index had still produced a negative total return since the start of 2000.

Of course, in late 2011 the Federal Reserve was soon to unveil its third iteration of QE money printing and the markets haven't looked back since, suffering not a single 10% correction for over the most recent three years. Rapidly rising markets aren't generally great for our relative results.

Despite beating the index by a wide margin for fifteen years, we have significantly underperformed the S&P 500 by more than half since October 2011. The Fed and other Central Banks of the industrialized world are fueling a bonfire under financial assets, igniting speculation and again producing excesses. We suppose we are fortunate to have seen our stocks advance at more than a 9% annual clip for the past three years, outpacing not only our earnings yield but also the underlying growth in our businesses. Our net composite return including cash and fixed-income securities averaged just under 8% per year for the past three years. By comparison, the index has produced a three year cumulative return of 74.6%, an unbelievable 20.4% per year return. We say unbelievable as sales for the index have compounded at 3.1% per year for the past three years and nominal GDP has only grown by 12.2% cumulatively, only 3.9% per year.

We find the stock market again in bubble territory, thanks to the globe's central bankers having gone off the reservation. Stocks are now more overvalued than in 2007 and not far fundamentally from the excesses seen in 2000. Total debt in the system is at more excessive levels than in 2000. The combination of equity market excesses with unmanageable debt levels leads to the core of our predictions for the next fifteen years:

Predictions for the Next Fifteen Years

The last time we did this we were much younger and thus more perspicacious…

Fifteen years on we are less young and far less convinced about our ability to foresee the future. With age and experience comes humility, which the markets are very good at teaching. With that, we still believe looking out fifteen years is probably easier than looking out for a year or for any short period of time. Extrapolation often works over time but can produce disastrous results when the landscape shifts. Getting a trend change right in the long term, however, can produce a foundation on which investment reward may be better than average, perhaps far better. We were fortunate to have successfully reasoned how much of the big picture would unfold over the past decade and a half, getting several long-term trend changes right. Many who relied on simple extrapolation of seemingly long-term trends paid a handsome price.

Trying to envision how the landscape will look fifteen years out from today's starting line is far more unknowing than it was in early 2000. Out of control Keynesian Central Banking has so affected the workings of capital that how the future shakes out is anybody's guess. The millennium came in with a backdrop of excesses that needed to be worked off, and we based many of our predictions on a rational unwinding of those excesses. With money printing operations ongoing globally, debt levels are even higher today and bubbles have again developed in many asset classes. Having confidence in predictive ability is almost impossible. Getting a handle on the now fat tails in the "flation" probability curve will be tantamount to not only investment success but also survival. The globe is battling deflation with inflationary policy. We are certain the future won't be without pain.

From an investment standpoint, the things that matter to us don't change over time. We invest in well-capitalized businesses earning sufficiently high returns on invested and reinvested capital. The three variables which drive investment returns all look to be headwinds to broad stock market returns from today's lofty perch: The price paid for profits is high; profit margins have never been higher; and top-line growth in sales is de minimis. We own a portfolio of stocks with sizable embedded advantages versus the market. Our advantages are invariably the greatest at market peaks…

As with our predictions from fifteen years ago, we'll save the elaboration for 2030. We wish all of our clients and friends a Happy New Fifteen-Year! Here we go:

1. Real GDP per capita in the U.S. will not grow from year-end 2014 levels. The two-century long trend line growth rate of this measure is about 2% per year. Looked at over a shorter but still long horizon, inflation adjusted output per capita grew fivefold from 1929 to 2014; we are actually just now back to 2007 levels. We envision the same fivefold growth in the hundred years from 1929 to 2029, meaning no growth in the next fifteen.
2. Japan will be the first in a queue of industrialized nations to restructure its government debt. Sovereign nations with printing presses seldom default on their debts, but there is a good chance that we will see the yen replaced with a new yen. Holders of JGB's, mostly internal to Japan, will be forced to take a massive haircut in exchange for equity in partially state-owned companies.
3. The 28-member state European Union will dissolve, unwinding the Euro which had been created under 1992's Maastricht Treaty. The dissolution and reintroduction of sovereign currencies by the nineteen nations utilizing the Euro may be part of a modern day Plaza Accord, the 1985 coordinated attempt to devalue the U.S. Dollar. Germany will vote to withdraw from the EU and push for reintroduction of the mark.
4. The valuation of the U.S. stock market will again fall to between 30% and 60% of GDP at some point in the next fifteen years. We made the same prediction last time on January 1, 2000 when the market was valued at twice GDP. Today's valuation is 135% of GDP.
5. Both after-tax profit margins and price-to-earnings multiples will both broadly decline from current levels. After-tax operating margins for the companies in the S&P 500 were an all-time high 10.1% in the third quarter of 2014. That level won't be seen again. At a closing price of 2058.90, the multiple on $115.82 in estimated trailing operating profits is 17.8x, an absurdly high multiple on the highest margin structure ever. Our forecast for nascent economic growth will drive multiples below the long-term norm of 15 times earnings. The combination of lower margins, lower multiples and slower growth is the basis for prediction #4 above (market cap-to-GDP).
6. The Federal Reserve will attempt to raise the Fed Funds rate only to take their target back to 0% to 0.25% at least one to three times. The only way short-term interest rates would be raised above the Fed's 2% inflation target would be to defend the currency. Concerning the Fed's vast holdings of Treasuries, we expect their holdings to rise in subsequent rounds of quantitative easing. We believe the Fed's Treasury holdings will ultimately (perhaps beyond fifteen years) be substantially erased from the Fed balance sheet as the Fed "forgives" the Treasury that portion of outstanding federal debt.
7. The yield on the 10-year U.S. Treasury will trade below 0.75% and the 30-year yield will fall below 1.50%.
8. Gold will trade at a substantial premium to today's price. With no scientific logic or basis, we'll say $3,000 per ounce sounds reasonable. We'll see import restrictions throughout the globe, much like those in India from August 2013 to November 2014, as governments try to deal with current account deficits.
9. The last of the baby boom generation, those born between 1946 and 1964, will have turned 65 fifteen years from now. The youngest of the millennials, born between 1981 and 1997, are now wrapping up high school and entering the workforce. The millennials have now passed the boomers in size due to increasing mortality and immigration and are replacing high wage boomer jobs with lower wage jobs and increased productivity. The unfunded social cost of caring for the boomers will exact a massive demographic tax on society. The U.S. dependency ratio will increase from 52% to 64% and benefits to the elderly will climb from 12% of GDP to 17% by 2030. Look for a materially higher tax burden on working families and on capital. Look also for means testing to qualify for social security and healthcare benefits, an extension of the retirement age and Medicare benefit age, and surely a decline in the allowed level and quality of health benefits and treatment. Bleak.

10. The U.S. budget deficit will balloon from 2014's 2.8% of GDP to more than 10% at some point in the next fifteen years. The enormous $1.4 trillion deficit in crisis-plagued 2009 amounted to 9.8% of GDP, a peacetime record. The peak deficits were marked during WWI at 17% in 1919 and during WWII at 24% in 1945. Our 10% prediction is based on a peacetime environment and another Keynesian "solution" to a financial crisis.
11. Chinese GDP will **not** surpass the U.S. during the next 15 years. If the Chinese economy merely grows 3.8% per year faster, then our prediction will be wrong. In local currency terms, not purchasing power parity, Chinese GDP will total roughly $10 trillion for 2014, while U.S. GDP should total around $17.5 trillion. Remember, our forecast for U.S. GDP growth involves some grim stagnancy.
12. We're not dumb enough to again predict a decline in the commercial nature of sport. Our sports forecasts are thus more concrete:
    - Jack Nicklaus' record of 18 major championships will remain intact. Jack obviously won't add to his tally and Tiger turns 54 on New Year's Eve, 2029, the day before our next prediction letter. Incidentally, Tiger and Lindsey will part ways, not with a 9-iron to the cranium as a parting shot, but this time perhaps with a ski pole…insert your own prepositional phrase here…
    - We got a playoff this year. The NCAA will subsequently expand the football playoff field to eight teams.
    - The Chicago Cubs will still be searching for their first World Series win since 1908.
13. Charlie Munger will celebrate his 106th birthday on January 1, 2030 when we release our next fifteen-year prediction letter. Of course, Warren Buffett will have just turned 99 that August. There will be a big to-do in the financial media about Berkshire Hathaway becoming the first $1 trillion market cap company in the world. It will have surpassed Microsoft's record market cap (our previous January 1 prediction literally marked the all-time high for MSFT) sometime during the coming fifteen years and will close in on the $1 trillion mark as we approach Mr. Buffett's 100th. CNBC won't air anything about Mr. Munger turning 106, Mr. Buffett turning 99, or Berkshire surpassing the $1 trillion mark, as it will have ceased broadcasting due to lack of viewership.

You will note we added a bonus lucky #13 for good measure! We'll close with this…Chris and Chad will be in their 60's (the younger technically not for nine more days), undoubtedly even more battle-scarred and humbled by not only the markets but also by life.

The oldest of our children will be the same age fifteen years out as we were when we founded Semper Augustus, which is simply hard to fathom, and harder to take. We are humbled by not only the markets but by the relationships we have been fortunate to have developed with all of you over the years. It is a privilege to work with you, and we thank you, as always, for your confidence and trust.

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