HARVEST CAPITAL ADVISORS INC.

A FINANCIAL ADVOCACY FIRM

Helping you to grow and harvest your life's work

Market Outlook – May 2016

A Proactive Strategy to invest in the stocks of publicly owned businesses.

To begin this discussion, there are certain givens that must be recognized:

- This is a long newsletter.
- You do not have to read it.
- We would appreciate it if you do.

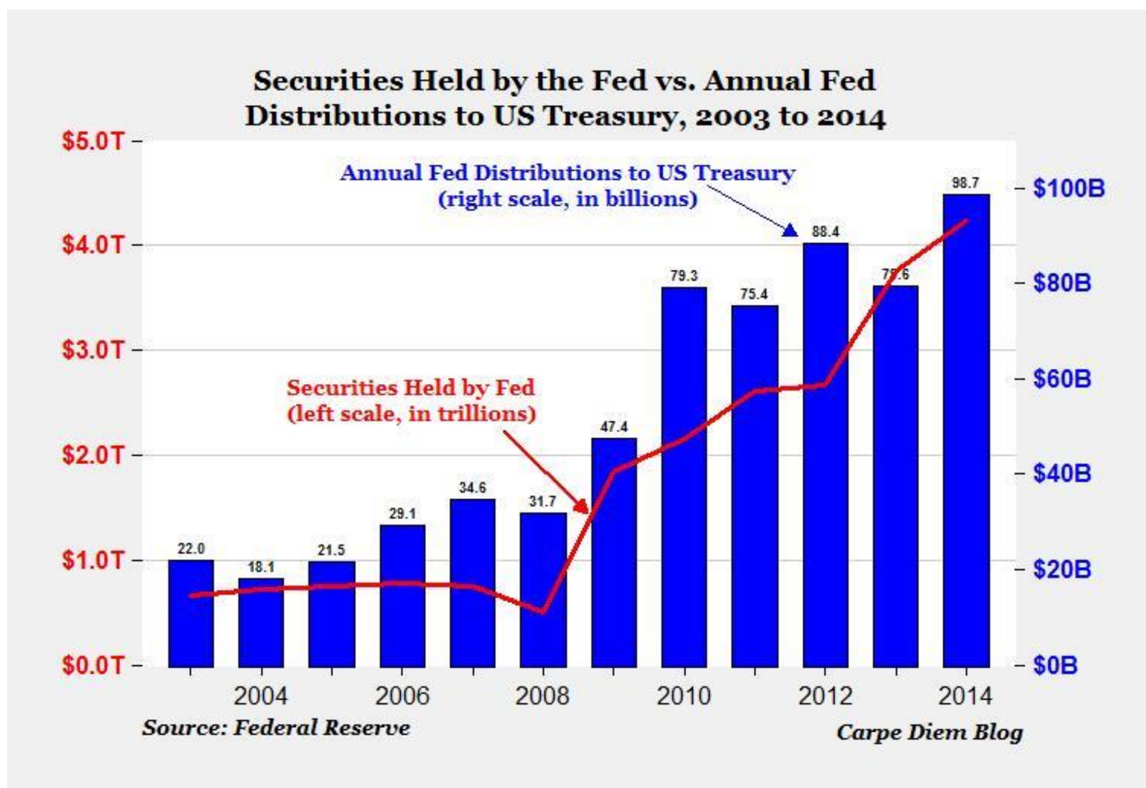
In any transaction involving shares of stock, one of the parties – the buyer or the seller is wrong, unless the seller has overwhelming pressure for other needs!

Who sold their 5% Treasury bonds in the open market and shortly thereafter found they could only buy 2% bonds? Who sold Microsoft in 1999? "Wicked smaaht" say our New England clients. Who bought the NASDAQ Index fund in 1999 -- **-77%** from 3/2000 to October of 2002, and **-54%** from 11/02/2007 to 3/06/2009. Sorry, but the NASDAQ index is still 5.5% below its 2000 high!

In times of deep distress (2008-2010), governmental agencies feel an obligation to "fix it". Their strategies were and continue to be:

1. Offering banks a borrowing rate of 0.25%. That removes the banks' need to sell CDs at anything much higher than that (their normal source of funds). This leaves savers high and dry, which Ben Bernanke (Fed Chairman at the time) admitted to the Senate Banking Committee. "We are attempting to repair the economy… at the expense of our retirees and savers".
2. Buying back over $4 Trillion in US Treasury bonds and Federally insured mortgages – creating a flood of money into the marketplace. See the chart on the next page. (This one was finished as of October, 2014.)

3. As a reaction to the slowed economies, US corporations have attempted to enhance their earnings per share by buying back shares, resulting in a higher earnings per share at the expense of not investing those earnings to grow the company's products and services and market share. Ask about IBM and Hewlett Packard.
4. Other negative impacts:
    a. Pension plans, public and private, cannot earn a high enough yield to meet their commitments. At some point in the not-too-distant future, tax hikes will be necessary and/or cut benefits.
    b. Endowments for charities and universities have as much as a 50% reduction in investment income. Who pays that price?



These events are not to be applied against the stocks of all companies, but enough of them to create a distorted value to both those companies and the overall market indices, such as the Dow Jones Industrial Average (30 companies), the Standard & Poor's (S&P 500) (500 companies), and the NASDAQ index (3,100 plus – includes many of the companies too small for either of the DOW or the S&P 500 – or your portfolio! Why? Sketchy data: nothing long-term. Buying Starbucks is an investment. Buying Groupon is a wager; some work, some don't.

The stock market, as a whole, is currently overpriced. Really. That means that the current aggregate price of its companies is more than the present value of all the

companies' future earnings over the next ten years. We cannot pick up an article from Barron's, the Financial Times, ValueLine, and a score of other responsible sources and not read about this fact.

At the end of this month Wylie and I will embark on a pilgrimage to Dallas for three days and 22 speakers addressing domestic and global economics and investment risks and opportunities. It will be my sixth year and Wylie's first.

The result of the demand for income has been a major factor in driving up stock prices. Utility stocks are the poster child of this need. In 2006 – 10 years ago – Pacific Gas & Electric (PG&E) paid a $2.76 dividend at an average price of $37.00, for a yield of 7.4%. Today, PG&E sells for $59.58 and pays a dividend of $2.75 (maybe). That represents a yield of 4.50%. Same dividend, but a 60% higher price to buy it. Those who owned it did well. Those who need income today are paying a much higher price for the same income, to the point where we have sold almost all of your utility stocks, specifically because prices WILL fall as interest rates inevitably begin edging higher.

All of these issues are direct results of the Federal Reserve Board's best intentions of lending money to banks for just 0.25% in an attempt to jumpstart the economy. Google was able to borrow $1 billion for virtually the same rate as the government borrows by issuing Treasury notes. When asked why they borrowed the money, the response was "It was such a great price, who wouldn't?"

As a last point of frustration, a qualified dividend of, say 4.5% avoids Federal income tax for singles with <u>taxable</u> income below $37,650 and married couples below $75,300. That's certainly more attractive than the 1.75% yield on a 10 year Treasury and a whole lot better than the yield of 2.6% on a 30 year note. AND, which is all taxed as ordinary income. Hmmmm!

To project the future value of a company, we need to determine what the future income per share will be. How do we know what future earnings will be?

1. Value of the business: by studying companies' long term history and evaluating their current offerings to their current markets, we can get an estimate of their growth rate. Is the company a leader, or a "hanger-on"?
2. The price to own the shares: by looking at it as Warren Buffett would…
    a. If I buy all of the shares of this company at $50/share, and the earnings are $1.00/share, my year-end check will amount to 2% return on my investment.
    b. If the shares sell at $10.00/share, that creates a 10% return on my investment. You have our attention.

3. How do we get to buy at the $5.00 price? First, look at the history of the stock price and the overall stock market price index. What we know is that in 1999-2003 and in 2007-2009, the markets dropped about 50%. In other words, I (and you) WAIT for it!

Since 2004, corporations have bought back $7.5 Trillion of their own shares!

Some percentage of this has been reinvested by the sellers into new companies that have emerged, such as Facebook. The point is: all of that money has had to look for a new investment, and THAT has had a huge effect on market prices. What happens when the strategy ends?

Here is a commentary from the group that manages the assets at Grantham, Mayer, & Otterloo, which manages $150 Billion for retirement plans and charitable and education endowment funds, and whom I quote ad nauseum! It is part of a 23 page quarterly report released this morning.

From GMO's 1st quarter newsletter:

"The past five years have been challenging for long-term value-based asset allocation. We do not believe this constitutes a paradigm shift, dooming such strategies in the future. The basic driver for long-term value working historically has been the excessive volatility of asset prices relative to their underlying fundamental cash flows, and recent history does not show any evidence of that changing. Outperforming the markets given that pattern requires either betting that the excessive swings will reverse over time or accurately predicting what those excessive swings will be. The former strategy amounts to long-term value-based investing, while the latter requires out predicting others as to both what surprises will hit the markets and how the markets will react to them. Our strong preference is to focus on long-term value, despite the inevitable periods of tough performance that strategy will entail.

It's no secret that the last half decade has been a rough one for value-based asset allocation. With central bankers pushing interest rates down to unimagined lows, ongoing disappointment from the emerging markets that have looked cheaper than the rest of the world, and the continuing outperformance from the U.S. stock market and growth stocks generally, it's enough to cause even committed long-term value investors to question their faith. Over the past several years, we at GMO have questioned a lot of things, including assumptions that we had held without much question for decades, but we have not wavered in our belief that taking the long-term view in investing is the right path and that in the long run no factor is as important to investment returns as valuations. In this letter, I'm going to talk about some of the reasons we continue to believe this so strongly.

Perhaps the first point to make on why we continue to stick to our beliefs is that this is far from the first period in which the patience of long-term value managers has been tested. A decade ago, we were all told that the great moderation had changed the rules of investing, making it safe to invest in risky assets without the margin of safety that used to be required. Less than a decade before that, we were all told that the internet had changed the rules even more profoundly, making anyone who was prepared to put money into boring REITs or TIPS in return for paltry mid to high single-digit real returns a fool for foregoing the hugely greater potential returns from investing in the loss-making companies that were someday soon to become massively profitable. As GMO's portfolios were positioned for the opposite in both cases, we got plenty of complaints from clients that we just didn't get it. But the periodic struggles of long-term value investors far pre-date GMO's founding. You can hear the frustration evident in John Maynard Keynes's quote from the General Theory back in 1936: "It is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism." I can't tell you exactly what was going on in Keynes's head when he wrote that, but to me it has all the hallmarks of someone who has just come back from a particularly trying investment committee meeting.

So this is certainly not the first period that has tested the faith of long-term value investors, but the fact that a style of investing has seen problems before is far from a guarantee that it will succeed in the end. While our faith is helped by the fact that this is not our first experience with misbehaving markets, the reason for our belief comes much more from a systematic study of history and the fundamental drivers of asset returns. The evidence is clear that asset prices are much more volatile than can be justified by the underlying fundamentals. This is the basic driver of the long-term returns to value-based asset allocation, and recent history, as painful as it has been for some of our bets, shows every bit as much excess volatility as the more distant past did. A world in which value-based mean reversion will not work in the long run is a low volatility world in which asset prices do not deviate from the slow-moving fundamentals that power financial markets. It is extremely hard for us to justify the last several years of market behavior through that lens, which leaves us confident that our strategy will work in the end.

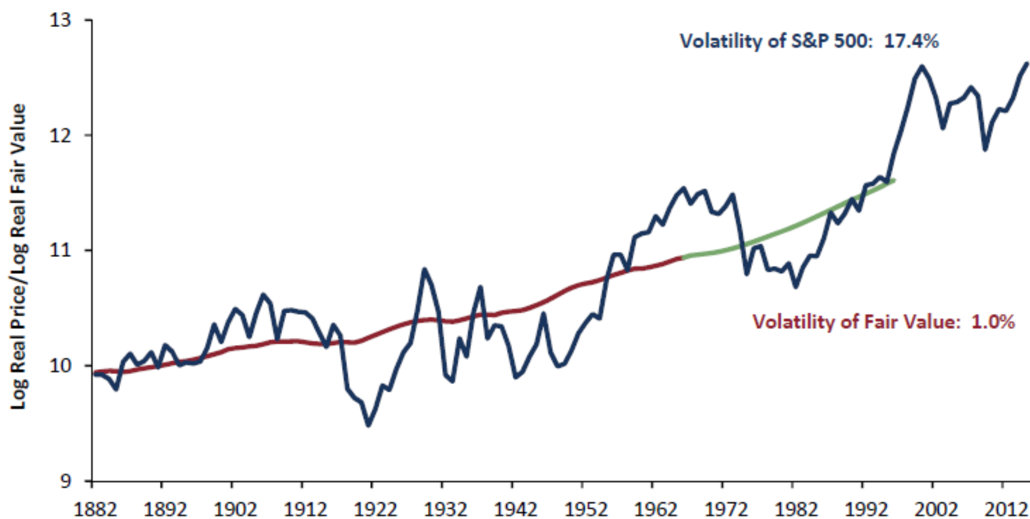
Value has always been a risky strategy, particularly for those trying to run an investment business. The drivers of mean reversion are not hugely powerful at any given time, meaning asset prices and even the underlying fundamentals can move in unexpected ways for disappointingly long periods. It is a little glib to say that without this risk, it would be difficult for asset prices to get meaningfully out of line in the first place, but the reality is that the only way you can get really exciting opportunities for mean reversion is to have misvalued assets become even more misvalued before they revert to fair value. This is the catch-22 of value-driven investing. Your best opportunities will almost always come just at the time your clients are least interested in hearing from you, and might possibly come at the times when you are most likely to be doubting yourself.

"Asset prices are too volatile"

So, why do we believe that asset prices are more volatile than they should be? Robert Shiller, the Nobel Prize winning Yale economist who is the source of so much common sense wisdom on financial markets, did a simple but powerful test of this almost 30 years ago in a paper for Science magazine. Shiller noted that while we cannot know the future with any degree of certainty, we have no such limitation when it comes to the past. He looked at U.S. stock market prices and dividends back to the 19th century and came up with a "clairvoyant" fair value estimate for the market based on the actual dividends that were paid over the next 50 years. This analysis, which is reproduced and updated in Exhibit 1, made the following important point.

The volatility of U.S. stocks since 1881 has been a little over 17% per year. The volatility of the underlying fair value of the market has been a little over 1% per year. Well over 90% of the volatility of the stock market cannot be explained as a rational response to the changing value of the stream of dividends it embodies. This means that the volatility is due to some combination of changing discount rates applied to those cash flows, and changes to expectations of future dividends that turned out to be incorrect. It is difficult to determine exactly which has been the driver at any given time, but there doesn't seem to be a lot of evidence for changing discount rates having been a major force. Even in the most extreme overvaluation in U.S. stock market history, the 1999-2000 internet bubble, none of the investors we heard explaining why the stock market was rational to have risen to such giddy heights explained it on the basis that future returns should be lower than history.

Exhibit 1: S&P Composite Real Price and Clairvoyant Fair Value



Source: Robert Shiller, GMO; Data from 1900-2016

Conclusion

So, why should anyone keep the faith as a long-term value investor? It is not enough to say that the alternatives are worse, because one possible alternative is to go passive and stop playing the game. We hold fast to our faith because, while the performance of value has been lousy over the last few years, there is little or no evidence that this is due to the markets somehow becoming more efficient. The performance of risk assets in the first quarter of the year, with global stocks falling 11% in the first six weeks only to turn around to rise 13% in the next six, has all of the hallmarks of a market obsessed with short-term surprises, not efficiently discounting the pretty stable stream of cash flows that most asset classes actually give. Efficient markets would show little volatility because the underlying fundamentals are stable. Today's markets, whatever else they may be, are clearly not efficient in that sense. Hyperactive central bankers and jumpy investors unable to decide between reaching for yield or running for safety may be a significant annoyance for long-term value investors, but we should not forget that their actions also create the very opportunities that such investors need to outperform in the long run.

Back to Harvest for a last thought.

If you read all of this, WOW! Thank you. If you understood every bit of it, there's a position waiting for you here.

The recitation of pieces of GMO's letters are intended to inform you that the investment staff at Harvest does not make up what we do. Starting in 1966, Rob has been investing in individual stocks and select mutual funds, both for his personal holdings and, beginning in May of 1974, for clients.

During the ensuing 42 years, Rob, and since 1994, his colleagues, have been committed to learning and maintaining competency. And it has paid off. Our primary rules are:

1. Don't lose money.
2. Invest in companies with a proven record of earnings growth, the opportunity to continue meaningful and predictable earnings growth, and wise management of debt.
3. Challenge our every decision, every day.

We are not even close to being always right. That said, we have been successful in our mission to preserve principal, even if it is sometimes at the cost of a higher rate of return.

As an example, this newsletter has taken over a month to prepare. Each time we thought we had everything covered, new thoughts, new information, new concerns crept in. We have begun to accept that this note can only represent this moment in time, and that tomorrow will offer new insights and challenges. And that's what keeps us here.

Thank you for being our clients. We have always insisted on serving "nice" people, and so coming to the office every day is always a pleasure, even when the markets precipitate stomach aches.

This is your money, and knowing each and every one of you makes it a responsibility to which we unfailingly adhere.

Gratefully,

The Investment Team

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