CAZ Investments
Quarterly Letter

An October Surprise

What is it about October? Memories of 1929, 1987, 1989, 2008... and many others flash through our minds as we approach the end of what has been a horrific (Halloween pun intended...) October. The reality is that September has actually been the worst month of the year, on average, for the stock market. But, it is October that has created so many of the headlines. October 2018 will not likely have the major news captions associated with prior sharp selloffs, but it may be as important as any of those events. No one can ever say until after the fact, but this selloff may be the start of something new.

Earlier today the S&P 500 officially entered "correction" territory for the second time this year when it surpassed a peak to trough decline of 10%. Large-Cap, Mid-Cap and Small-Cap stock indices are now all negative for the year and many international indices are down 10-15% year to date. We have talked for several quarters about our concerns with market valuations and have been a "1" on the CAZ Scale. As we have mentioned several times, the Scale is not a market timing mechanism. We attempt to quantify the risk/reward environment so that investors can amend/adjust their asset allocations to keep them within their risk profile. The adage we use regularly and have stated repeatedly in the last two years is to always remember that stocks go down a LOT faster than they go up, so sell when you can, not when you have to. The last several weeks have illustrated that point yet again, so now what should investors do?

The challenge investors face right now is the incongruence that we see between market action and the strength of the economy. To be clear, the economy is firing on nearly all cylinders with the most growth we have seen in more than a decade. The combination of fiscal and monetary stimulus has resulted in record low unemployment, solid wage growth and a shortage of workers in some areas of our economy. Businesses are investing in the future and hiring at a brisk pace. Thereby, it is hard for investors to understand what would cause a selloff of this magnitude with such a strong economic backdrop. Could it be rising interest rates, tariffs, geo-political uncertainty, wage push inflation etc...? In a word, "yes", it could be all of those things, and it might be none of those things. We could spend page after page unpacking each of those issues and how much they do concern us, but we really don't think you will want to read that much analysis.

This bull market is now almost a decade old. Our industry is significantly made up of investment professionals under the age of 35. Very few of them were even in the business when we last experienced a bear market. We wonder how those professionals will react when we actually have one... Every bull market ends for different reasons, and rarely is it one reason. We very likely have put in a material top in the market and started a new phase that will consist of lower lows and lower highs. On the other hand the bull market may not be over, and we could build you a case that it is not over but that this is just a healthy correction. If that is the case, we are likely to see another leg up and possibly a "blow-off top" that many have been calling for. With those intentionally conflicting potential results, we ask again, so now what should investors do?

Up to this point we have talked about what we don't know and the conflicting signals in the world. Let's talk about what we do know and where there is no conflict, just facts and statistics. Here are a few absolutes:

1. Valuations have gotten markedly better in the last few months. This is from a combination of falling stock prices and growing earnings. The market is flat for the year, yet earnings have risen sharply, and analysts expect earnings to grow sharply again next year. (Key word... "expect")

2. Interest rates have risen significantly, albeit from artificially low levels, and we now have a 10-year U.S. Treasury that seems determined to stay above 3%.

3. The Fed has forecast that they are likely to raise rates again this year, on top of the four times they have increased the Fed Funds Rate in the last 12 months, and have led us to believe they will probably increase rates even more in 2019.

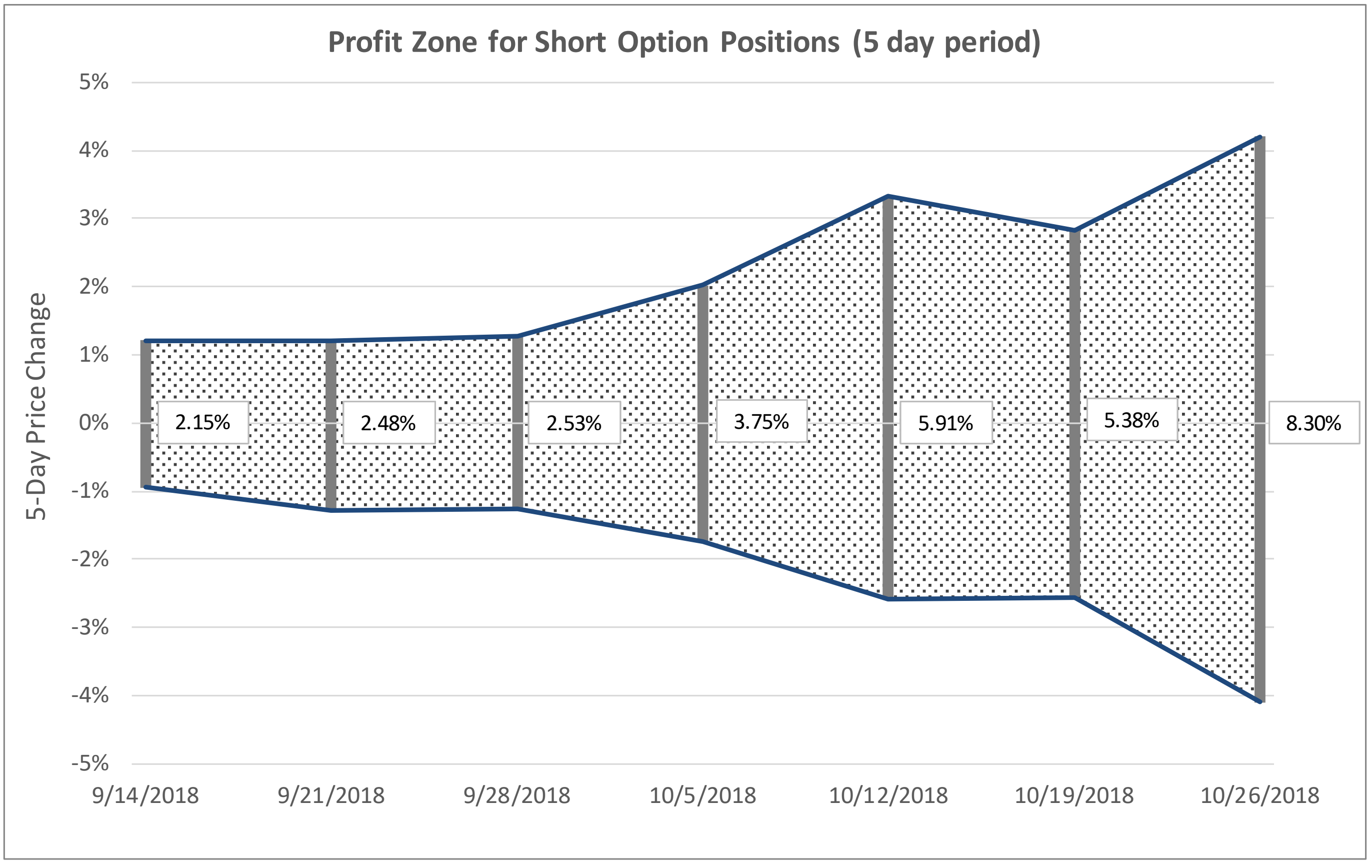
4. Market Volatility has returned with a vengeance and many of the most popular stocks have been hit the absolute hardest, with declines of 20-50% in some names. The VIX index (market volatility measure) has increased from nearly 10 in early August to more than 29.

Those facts are helpful and important to understand but ultimately investors really just care about the question above, which is what they should do now. One of our Firm's Guiding Principles is to "Find What is Important - See the Forest not the Trees." Right now, there are a lot of trees, and the information above provides a brief glimpse of how hard it is to find what is important. Therefore, when we look at all of this information we see as cloudy a picture as anyone else does, but there is an obvious absolute buried in the trees. That is that volatility has returned and it is unlikely to dissipate quickly. **<u>Where there is volatility, there is significant opportunity.</u>**

Toward the end of last year, when the VIX was trading below 9 we created a strategy that was designed, and built, to profit from the return of volatility whenever it would finally occur. We more or less "kept it on the shelf" waiting for the right time to invite partners to allocate capital. If there is anything we can say at this point in the market cycle, it is that volatility is likely here to stay for a while. That provides us with an opportunity to profit from something that is "obvious" and likely to persist. More importantly, this spike in volatility and fear has now created an extremely favorable risk/reward scenario for us to take advantage of. With volatility at these elevated levels, we believe strongly that short volatility strategies are superior to owning equities outright.

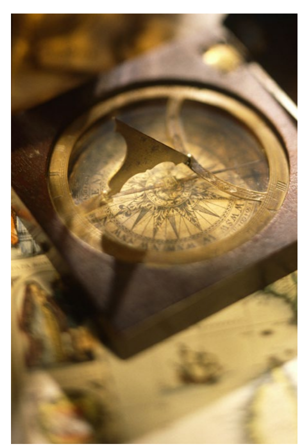
I asked Matt Lindholm, Co-Portfolio Manager of the Fund, to illustrate how much better the environment is today for selling volatility, compared to even just a few weeks ago. His answer is here:

When volatility increases, speculators and hedgers pay substantially more for short-term options. As sellers of those options, this does two things for us. First, it increases our return opportunity because we are simply selling the options for a higher price. Second, the increased volatility level priced by the market offers us a larger cushion from the current price, or what we call the "profit zone." As long as the S&P 500 closing price 5 days later is within this band, the options we have sold are profitable. Consider the chart below, which shows graphically that our profit zone has increased by approximately 4x over the last 6 weeks:



In mid-September, our profit zone was approximately 2.16% of price movement over a 5-day period. Last Friday, 10/26/18, our profit zone for a 5-day period was a whopping 8.30%, with 4.20% of cushion to the upside and 4.10% of cushion to the downside. Over any historical timeframe you look at, 5-day price moves of this magnitude are rare. Over the last 30 years, for example, weekly moves of this size have occurred just ~6% of the time. Said another way, approximately 94% of the time over the last 30 years, the S&P 500 weekly price change has not exceeded our current profit zone in either direction. Further, we got paid option premiums that annualize to 49.4% per year!

So, now let's answer the question above which is what should investors be doing now? Now is not a time to be a gun slinger. The markets are getting cheaper and some stocks are becoming more attractive, but the uncertainties around the market will likely persist. Thereby, we would strongly recommend working towards reducing your correlation to the stock market by allocating to investments that will not zig and zag as much with the market. Focus on investments that will generate significant cash flow without interest rate risk, that also provide growth of cash flow and the opportunity for capital gains appreciation. For those that invest with us in private equity, you should be aware of what we are doing in that area with our personal capital. There are not many places in this environment where we can earn mid-teen annual cash flows without interest rate risk or market correlation.



In closing, we see new opportunities and we reiterate some warnings that we stated in past letters. We are happy to give you feedback on your portfolio allocations so please let us know if we can be helpful in that regard.

Your statements will arrive via email on approximately November 15th and you will notice some new upgrades and improvements. We hope you like them and would appreciate any feedback you have as to how we can make them even easier to use. Our team continues to grow, and we look forward to introducing you to the new members of our family at our annual CAZ Casino Party, this Saturday night. If you have not already let us know whether or not you can join us for the event, please email events@cazinvestments.com as soon as you can so we can get an accurate headcount. It is an incredibly fun event and we hope you can join us.

All our very best and we look forward to seeing you soon.

The team at CAZ Investments