

CAZ Investments
Quarterly Letter

The Trampoline and the opportunity...

We hope that you and yours are persevering through these times and staying healthy in these truly unprecedented times. That word seems to be used more than it should, but it really is the most fitting. We are living through a historical event that will be talked about for generations. If you are not journaling during this time, it is something that you may want to consider so that the memories don't fade over time.

In that spirit of not wanting to forget where we have been, and what has transpired, we need to look backwards to start this letter. Dwelling on the past is not necessarily a good thing, and our Team is taught that we should focus on what we are doing and going to do, not what we have done. However, as the famous quote goes, *"Those who fail to learn from history are doomed to repeat it."* We must look at recent history and learn from it, especially to appreciate the action steps that should be taken based on our **rating change of the CAZ Scale. We are lowering our rating on the scale from "3" to a "2"**. The reasons will be listed below, but that context is important as we look back over the last few months. As a reminder for anyone not familiar with the CAZ Scale, it is not designed to be a market timing tool, but it is designed to articulate how we view the environment for risk assets, and how we believe investors should manage their risk exposure levels. The ratings range from a 1 – 5, with 1 being the least attractive risk/reward and a 5 being the most attractive risk/reward.

The velocity of the bear market, and subsequent rally, has been so vicious in both directions that we don't have to travel back in time very far to see where we were. Let's start with a direct quote from the letter that we delivered to our Partners on Tuesday February 18th:

2020 has seen a continued march higher in the market despite the Coronavirus, concerns about worldwide economic growth, and relatively mediocre earnings announcements. Now, as we write this, markets are again at all-time highs. So, where does that leave us? It leaves with an outstanding "tape" where stocks seem to shake off any signs of negative news and charge higher, but very expensive valuations when compared to any historical standard. Indeed, as the price-to-sales chart above shows, according to that metric, we are now more expensive than any time in modern history.

We reiterate that expensive valuations don't mean that stocks must fall, however they do make it harder and harder to predict higher prices. And it means that downside risk is significantly higher than it has been, simply because there is farther to fall if valuations begin to revert to any rational mean. Therefore, we will maintain our rating on the **CAZ Scale of a 1**.

There are potentially serious storms that we see brewing on the horizon, including the economic impact of the virus and the increasing possibility of an openly Socialist candidate representing the Democratic party in the November



election. How these matters settle out are challenging, at the least, to predict but it is safe to say that the mindset of investors could be influenced significantly by these factors, as well as several others. To reiterate what we stated last quarter, *the hardest part about valuation driven rallies is that they are typically based on psychology, and that can reverse on a dime. One wrong news headline, or tweet, can change the psychology of the markets which makes it very difficult to predict. That said, we are very aware of the adage “don’t fight the tape,” and the tape is actually acting quite well. Our caution for investors is to be sure that your allocation to stocks has not grown to a larger % of your target allocation than it should be. Sell when you can, into strength like this, not when you have to.*

It is hard to imagine how much has occurred in less than 10 weeks since that letter was delivered. To summarize our actions over this period, these are the changes we made to the CAZ Scale:

- On February 28th with the S&P 500 at ~2900, we increased our rating on the Scale from a 1 to a 2. We did this because the risk reward was better after a ~13% decline in stock prices from the all-time highs of ~3400 reached on February 19th, just 8 trading days earlier.
- On March 18th, with the S&P 500 at ~2300, we increased our rating on the Scale from a 2 to a 3. We did this because of the prevalence of mass liquidations and “panic” that was transpiring in the markets as a result of the more than 32% drop in stock prices in just 30 days.
- The market put in the low for the move just three days later, on March 23rd, at ~2238.
- The furious rally that has occurred in the last 30 days has driven the S&P 500 all the way back to ~2850, an increase of more than 27%. This is the level at which we are lowering our rating on the CAZ Scale from a 3 to a 2.

Plenty of other correspondence that we have delivered goes into the many reasons for these amazing market gyrations, and our changes to the Scale. That communication delivers our thoughts on the shutdown of the global economy, the dramatic surge in unemployment, and the numerous actions taken by governments/central banks around the world to stem the tidal wave of economic disaster caused by policies adapted to slow the progress of the pandemic. If you have not read/listened to those market updates, we would encourage you to visit the Media and Insights page on our website by clicking [HERE](#).

The lessons we must, and we emphasize must, learn from history is that when it is time to act, we must do so and not be complacent. Risk thrives in an environment of contentment, and those who allow themselves to be “lulled to sleep” by ever increasing risk assets will inevitably feel the full force and effect of the declines that occur. So many investors believed stocks, and other risk assets, would just continue to climb in an uninterrupted fashion and they did not adjust their portfolio allocations or stress test their positions to see how they would be impacted by a market move away from risk. There are three adages that anyone who has followed our work over the years has heard used repeatedly:

1. Asset prices always go down faster than they go up, because Fear is a much more powerful motivator than Greed.
2. The market will often find a way to inflict the greatest level of pain on the largest number of people.



3. Sell when you can, not when you have to.

As we look forward, let none of us forget those market absolutes that have been proven out over every market cycle, so we are not doomed to repeat any mistakes that have been made.

History Lesson Complete - Now What?

Now that we have seen where we have been, let us utilize the experience to inform our decisions as we look forward. Normally at this point we will talk about what we know and what we don't know. In this extraordinary time, what we know is quite limited and what we don't know is nearly endless. Therefore, this list will be very brief, and we will readily acknowledge there are numerous other factors where we simply don't know what we don't know...

What we know, or at least believe we know:

- The Governments/Central Banks have clearly stated that they intend to rescue the economy, with money as no object and they will spend whatever amount is needed, in whatever form it is needed, including issuing checks directly to consumers and buying bonds/debt directly from companies.
- The economy around the world is going to open gradually over the next 30 – 60 days, with varying levels of restrictions depending on locale and density of virus cases.
- Company profits are going to be decimated from the shut down and even the strongest of balance sheets will be stressed because of the drastic drop in revenues.
- The number of unemployed will peak at levels historically unprecedented, with more than 1 out of 5 people out of work, and we could possibly end up at higher levels than even seen during the great depression.
- The number of virus cases and deaths are expected to drop sharply from the normally seasonal impact, along with much greater social awareness and precautions.

What we don't know:

- How will consumer behavior change after the self-quarantine restrictions have been lifted? (add everything one can imagine here related to business travel, vacation travel, football season, school openings, will we order nearly everything online, etc. etc. etc....)
- When will companies feel safe to resume normal capital expenditures and hiring practices?
- Will remote employees become more mainstream and what is that impact on commercial real estate?
- How/When will the Governments around the world repay all this debt they are taking on?
- Will industries/sectors see a mass purge of “zombie” businesses that should have gone bankrupt a long time ago, finally resetting the supply/demand balance in those areas?
- How will companies view their supply chains, and their vulnerability to further pandemics and/or transportation restrictions?



- Will we have a therapeutic medication/treatment that changes expected mortality rates, impacting behavioral patterns?
- When will we have a vaccine for this strand of virus?
- How will the world react when we have a second wave of virus outbreaks, which is more or less inevitable until a vaccine is found, and how bad will that wave really be?
- Is herd immunity our ultimate solution, if there is data that clearly demonstrates that individuals cannot be impacted more than once from the virus?
- Here is where you add all the other questions that we don't know the answer to, which is a lengthy list...

Where does all that leave us? Interestingly, it leaves us right back at the beginning. For everyone who has attended any of our annual Themes events, you have heard us say repeatedly, “Math matters, valuations drive prices, always...” That is just as true today as ever. But, just like any other time, valuations drive prices over time but psychology and expectations drive prices over the short run. Thus, the massive rally in prices we have experienced, with no measurable corresponding improvement in fundamentals.

Once it became clear that we were not going to fall off the economic cliff, the safety net provided by the governments/central banks became a trampoline and we sprung higher. Stay with us for the trampoline analogy, as it is very applicable to historical market moves of this sort. If you visualize a person of significant weight jumping off a roof onto a trampoline, you can easily envision the way that canvas is going to be stretched and strained, getting lower and lower, until the springs are able to overcome the descending weight. From there, the person is projected significantly into the air, and as they decline with less momentum, so the bottom gyrations are reduced, which limits the amount of rebound that the person subsequently experiences. This ebb and flow of the person bouncing on the trampoline is markedly similar to the way risk assets perform after a shock. The analogy is not perfect, but the visual allows investors to see a common response of markets to a significant unexpected event. Sometimes markets do reverse and go straight higher, never to look back again, but that is certainly the anomaly and not something that people should expect. We could put a bevy of charts here to illustrate this, but suffice it to say if one were to look back at any shock to the market, the trampoline effect was on full display, whether it be the Crash of 1929, the start of World War II, the multiple events that caused the 1973-1974 bear market, the Crash of 1987, September 11, 2001, Lehman's collapse etc...

The trampoline effect makes it easier to understand the torrential rally we have seen in the last month. We can talk about all the “springs” that stopped the descent and propelled prices higher, but we have already covered most of them above. Now we need to focus on how we should respond to this rally, and what adjustments should be considered for your asset allocation.

Make no mistake, this huge rally is a gift! And it is a gift that should be appreciated and cherished, more than most market rallies. Place yourself back in time, just a month ago, when the S&P 500 was at ~2300. How did you feel? Were you:



1. Excited about your portfolio and the opportunities being provided by the sell off?
2. Calm and comfortable that your asset allocation was proper, and you had a clear plan of how you were going to reposition your assets based on price changes?
3. Feeling like you were going to be sick and didn't know what to do?

Only you can honestly know how you felt that day. Well, in a rare market twist, everyone has a “do over.” The market rally has provided us with a window of opportunity to do a complete portfolio review and decide if we are truly comfortable with our allocation methodology, the manner in which we are investing across that allocation, with whom we are investing, and what our risk profile really is. We are not saying that stock prices are going to go back to the March lows, but we absolutely are saying it is possible and every investor should have a clear plan in place that would allow them to resemble the investor described in #2 above.

As explained at the beginning, we are lowering our rating on the CAZ Scale from a 3 to a 2. We are doing this because the risk/reward is much lower than it was at ~2400 when we increased our rating from 2 to 3. We hope that markets continue to rally, but we have grave concerns about whether or not they have risen faster than they should. Earnings are clearly going to plummet, and it is almost impossible to project what company cash flows will be for 2020 and 2021. This means that markets are going up based on “hope” that the economy is going to snap back. We have talked before about how “hope” is not a sound investment strategy. Based on what we know at this point, with reasonable assumptions, markets appear to be very expensive relative to where sales, book values and cash flows will be at the end of 2021. Nothing would make us happier than for stocks to continue to charge higher, but we also want to be sure that our investors use this rally to reduce risk and take very seriously the portfolio review advised above. We are happy to be a resource and do a full analysis with you.

It is quite important that investors don't misinterpret this letter to think that we are hyper-negative on risk assets. Quite the contrary, we are seeing some of the best opportunities we have seen since the global financial crisis. We just want to be sure that investors know where the risk is, and isn't, in their portfolio and that they be sure that they are prepared for whatever may happen from here. It is unlikely that plain vanilla stocks and bonds will deliver outsized returns from these levels. However, there are ways to participate where dislocations have occurred and methods available to us to take advantage of the enormous volatility we have experienced. We continue to find outstanding places to invest our personal capital and we welcome you to co-invest with us.

Thank you for being our partner and we look forward to being able to see you very soon, preferably in person, as opposed to over a video screen! All our very best to you and yours and please let us know if there is anything we can do for you.

All our very best!

The CAZ Investments Team

