4th Quarter 2020

CAZ Investments
Quarterly Letter

Déjà vu

We could not help starting out this letter with that title. We thought it would be an interesting experiment to just republish our letter from February 18th, 2020 to see if anyone would notice. We decided to not do that, but if you feel like it is a bit of Déjà vu when you read this, that is because there are SO many similarities.

Even more disconcerting is how much this current environment feels like the tech bubble of 1999. We are already hearing from the "informed crowd" that "it is different this time." If you are over the age of 50, just hearing that statement is likely to make your skin crawl. Ladies and Gentlemen, it is always "different" but universal rules of investing do not just disappear. Like 1999 there is no way to know when this party will end, so we can "Party like it's 1999" for now, but the party will end and when it does there will likely be a bad hangover for many investors… To get to the punch line right away, it is a time for caution, it is a time to be fearful while others are greedy, it is a time to assess your asset allocation and be certain that you can be comfortable with the impact a material correction would have on your portfolio.

After increasing our rating on the CAZ Scale in March from a 1 to a 2 and then up to a 3, we reduced our rating in the summer to a 2 and then in the fall lowered it to a 1, our lowest level. We believe the risk/reward in the market is as bad as it gets from these levels.

To summarize what we think, which is virtually the same as 12 months ago, here is a copy of what we sent investors last February 18th, the literal day before the market topped and right before a 35% decline in the stock market in less than 35 days:

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 shows, according to that metric, we are now more expensive than any time in modern history.

We reiterate that expensive valuations do not 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**.

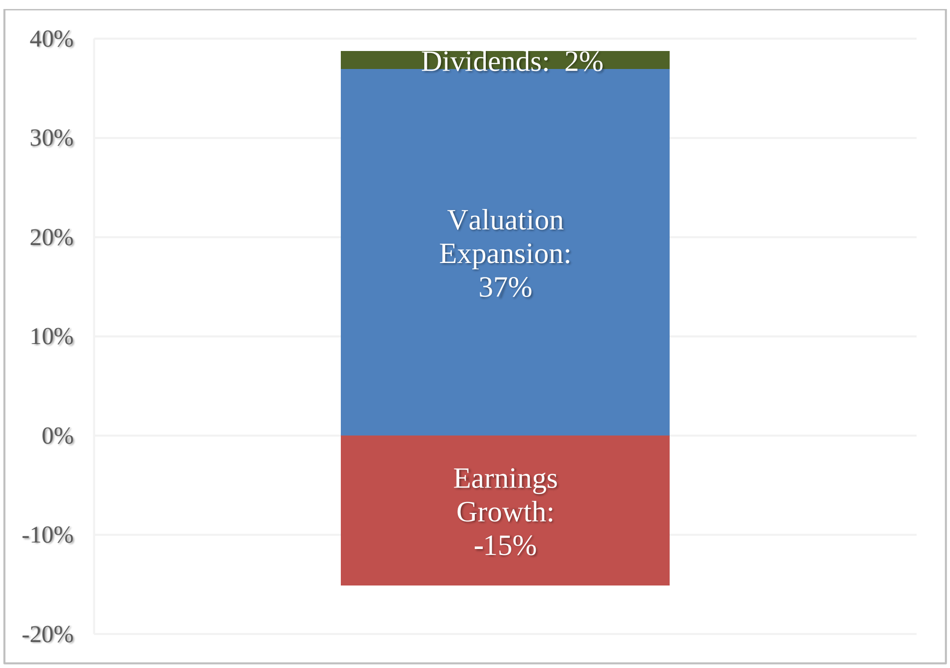
There are potentially serious storms that we see brewing on the horizon, including the economic impact of the virus and the increasing possibility of an openly Socialist candidate representing the Democratic party in the November election. How these matters settle out are challenging, at the least, to 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.*

If you do not remember anything from this letter, remember that last sentence, **"Sell when you can, into strength like this, not when you have to."** May no one repeat the mistake that so many made last year at this time when "TINA = There is no alternative" and "Don't fight the Fed" were the names of the game and investors simply ignored valuations. Valuations DO matter over the long run. "In the short run the market is a voting machine and in the long run the market is a weighing machine" is just another one of many wise quotes that can be attributed to some of the best investors of all times. It would be a shame for anyone to ignore such sensible counsel.

Our February 18th, 2020 letter sums up exactly the way we feel today. There are places to allocate capital that are extremely attractive but plain vanilla stocks/bonds are likely to provide a lot of heartache for investors over the next decade. (Not to mention the pain that could be in store for those that decide they want to trade the Reddit board stocks to create a fast fortune… we could write an entire letter on that phenomena and what it could mean for liquidity, regulation, price discovery and free markets…)

With that, let us look at what is definitive and the key charts that paint the picture that we should be focused on. One of our core Principles is "See the Forest, not the Trees." That tenant is incredibly valuable today, so let us see what is happening at the Forest level:

- Although it was an excellent year for equities, the S&P 500 return for 2020 was driven more than 100% by valuation expansion, not from growth in earnings or from dividends.



Source: Bloomberg

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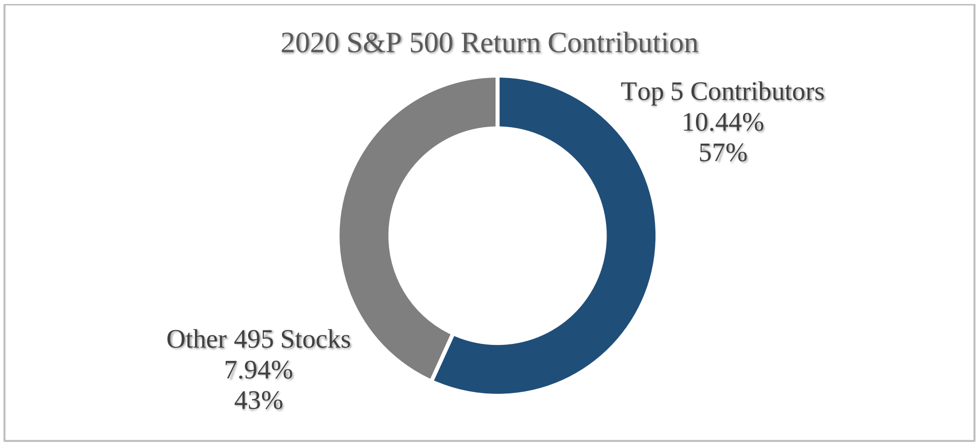
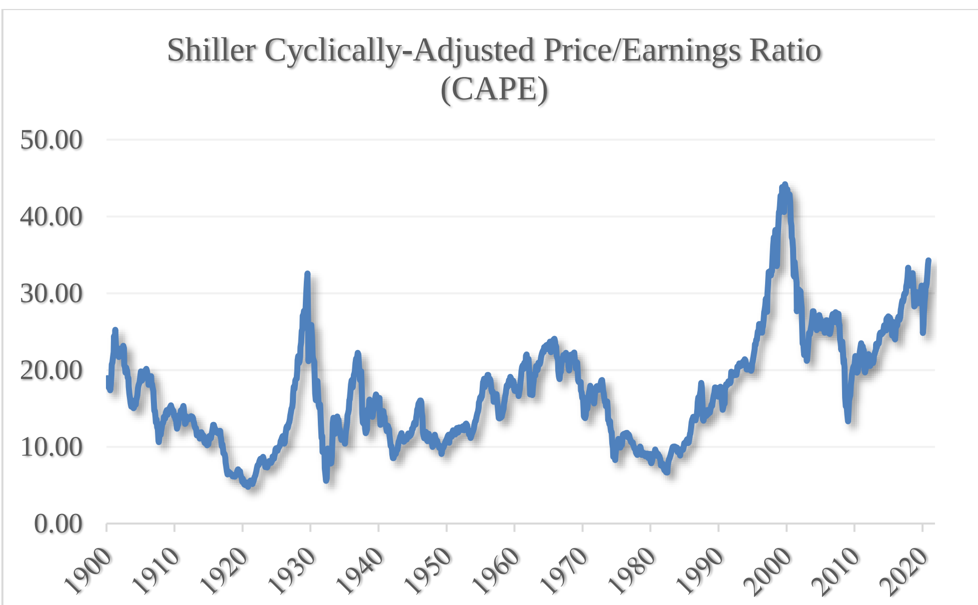
- Of similar importance, the breadth of positive contribution to the S&P 500 return for 2020 was extremely narrow. As shown below, the top 5 contributors to the index represented more than half of the return and therefore exceeded the other 495 stocks combined.

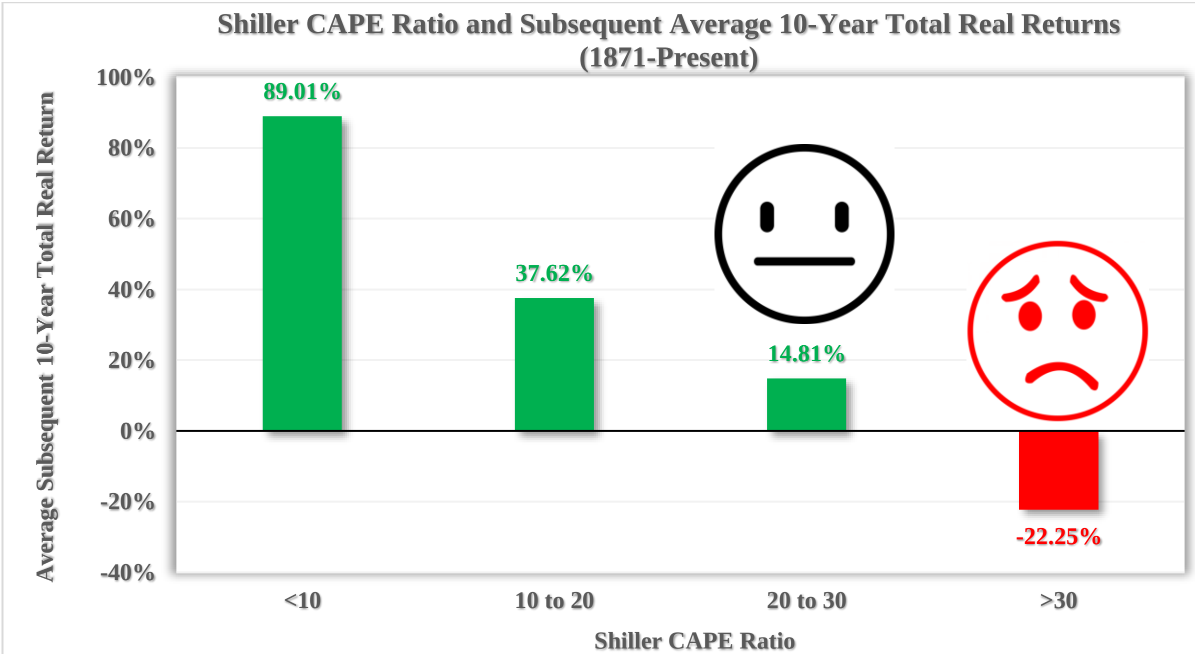


Source: Bloomberg

- As discussed at our previous Themes events, the Shiller CAPE Ratio has been a valuable indicator of future S&P 500 real returns. As the chart below shows, the ratio has risen to levels only exceeded by the Tech Bubble of the late 1990's. As a result of the valuation expansion that took place in 2019 and 2020, the CAPE Ratio is above 34. A CAPE Ratio above 30 has historically led to strongly negative 10-year real returns, as shown in the second chart below.

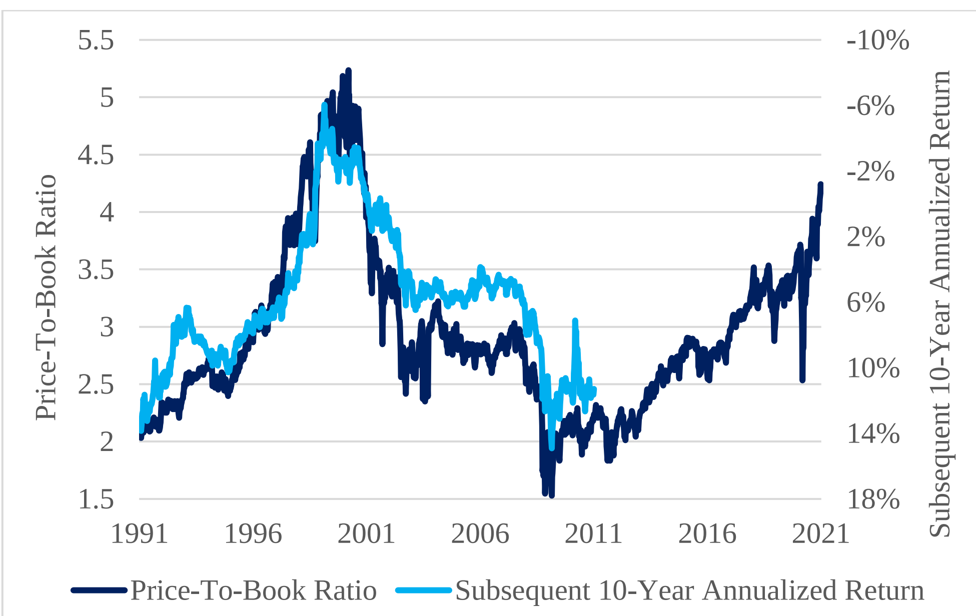


S&P 500 as of 1/15/21; Sources: www.multpl.com, http://www.econ.yale.edu/~shiller/data.htm



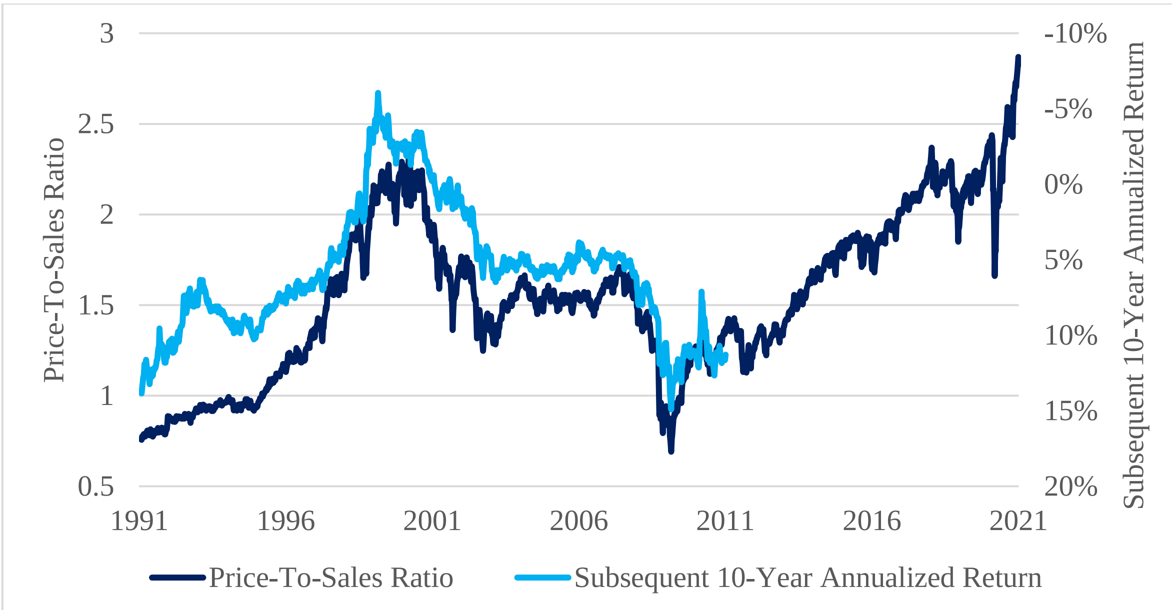
All data reference the S&P 500. Sources: www.multpl.com, http://www.econ.yale.edu/~shiller/data.htm

- Further, the Price-To-Book Value Ratio has been remarkably predictive of subsequent 10-year annualized returns. With the ratio above 4, forward returns have historically been negative.



S&P 500 as of 1/15/21. Source: Bloomberg

- Additionally, the Price-To-Sales Ratio has been an accurate leading indicator of subsequent 10-year annualized returns. With the ratio materially approaching 3, and **now the highest in modern history**, forward returns have historically been significantly negative. We are now in uncharted territory, even surpassing the Tech bubble.



S&P 500 as of 1/15/21. Source: Bloomberg

We are more than happy to have conversations with you about your asset allocation and be helpful any way we can. Further, we will continue to let you know what we are doing with our personal capital to generate consistent returns with very little correlation to the overall markets. There are several things that we have in final diligence and we will advise if those opportunities become a reality.

We do not intend to be "raining on anyone's parade," but it is our responsibility to tell you what we believe and how we are allocating our personal capital. From there, everyone can decide what is best for their personal portfolio. Have a plan, be disciplined in following that plan and, more than anything else, do not let good judgement be clouded by others greed. We are more than happy to answer any questions you have. Please remember to access the private page on our website with the videos that contain individual vehicle updates. There is a significant amount of valuable information in those videos and they are worth the time to watch them. All our very best to a healthy and prosperous 2021!