MOI GLOBAL

Business as Usual

This post is excerpted from a letter by Jim Roumell, partner and portfolio manager of Roumell Asset Management.

Our 2017 composite returns were accomplished with an average of roughly 40% in cash and cash equivalents. The Roumell Opportunistic Value Fund, RAMSX, returned 18.32% in 2017, building upon the 18.02% gained in 2016. The Fund's past two years' returns were also accomplished with an average of about 40% cash and cash equivalents, indicating the strength and meaningful portfolio weightings of our individual security selections. Separately managed account clients should contact us about transferring their accounts into RAMSX given the fund's generally higher portfolio weightings and its access to certain foreign markets.

We cannot recall a time when we were asked the following question more often, "Why does the market keep going up?" Specifically, we're often asked why the market doesn't seem more concerned about the following: a possible nuclear war with North Korea, possible trade wars, the dramatic increase in Federal debt estimated by the CBO as a result of the recently passed tax cut (60% of publicly held US debt matures within the next four years), and the potential implications of the Russian investigation? Add to those concerns an overall stock market level that is quite high by any rational measuring stick. For example, Crescat Capital, using Bloomberg data, recently put together a presentation noting that the following S&P 500 market ratios are now at all-time highs—Median Price to Sales, Median Price to Book Value, Median Debt to Total Assets, Enterprise Value to EBITDA and Enterprise Value to Free Cash Flow.

Many investors point to the potential positive effects of the recent tax cuts passed by Congress and signed by the President. The ultimate effects of the tax cuts will be known over the next several years. Will the tax cuts unleash growth (which would go a long way in financing them) through massive investment by the private sector that wouldn't otherwise happen? Or, will the reinvestment in productive assets be minimal while our country is left with another $1.5 trillion in debt at a time when financing costs are rising, thus making it more difficult for our government to finance needed infrastructure, research and safety net expenditures? Independent research firm Moody's believes the tax cuts will have a limited effect on the economy. According to Moody's analysts, led by Rebecca Karnovitz, "We do not expect a meaningful boost to business investment because U.S. nonfinancial companies will likely prioritize share buybacks, M&A and paying down existing debt. Much of the tax cut for individuals will go to high earners, who are less likely to spend it on current consumption." We'll see.

Regardless of how the economy performs over the next several years, we always come back to valuation, valuation, and valuation. We concur with Howard Marks, who recently noted in a letter to his shareholders that in relation to the general market, not specific securities, "Most valuation parameters are either the richest ever…or among the highest in history…thus a decision to invest today has to rely on the belief that 'it's different this time.'"

Market bulls seem buoyed by some version of Jana hedge fund manager Barry Rosenstein's recent remark, "The economy is growing. Earnings are growing. Rates are at all-time lows. It just seems like the market [rally] is going to continue for a while." Rosenstein goes onto to say, "In fact, we are more invested today than we've ever been."

Highlighting causality between economic data and market returns is a curious view, in our minds, because there are so many instances where the two events decidedly diverge. For example, in January 2001, economic data was strong: the economy's growth rate was about 3%, the unemployment rate was below 4% and the country had its first budget surplus in decades. And, it was a terrible time to invest in the stock market—the S&P 500 dropped 31% over the following 24 months. Conversely, in January 2009, economic data was weak: the economy's growth rate was -2%, the unemployment rate hit 10% and the nation's deficit soared to 10% of GDP (above $1 trillion). And, it was a fabulous time to invest—the S&P 500 rose by 25% in the following 24 months. The point is that valuation (what you're paying to own something) is ultimately more important than general overall economic data points. Investing is not economic forecasting; which is underscored by the fact that there are few wealthy economists.

Nonetheless, investors like Rosenstein, and many others, muse about economic data as if it's predictive of market returns and evidently provides them some measure of comfort. Predicting GDP growth rates (U.S. and or worldwide), the strength and direction of interest rates changes, or commodity prices is simply not what we do. We try to be modest in any attempted forecasting. We choose to rest our investment theses in deeply undervalued securities not overly dependent on the expectation that a rising tide will lift all boats.

What we do is bottom-up fundamental security analysis; despite living in an age that seems increasingly drawn to passive and/or algorithmic investment styles. We will continue to focus our efforts in finding significantly mispriced securities that are conservatively financed, independent of the weather "out there." We will continue to spend little time trying to predict macro events, and for good reason: it can't really be done with sufficient regularity to be bankable. This fact was underscored recently when Barron's reported the results from its 2017 forecasting challenge with over 3,000 entries (a group comprised of highly-educated professional investors and do-it-yourselfers). When asked, "What will the Dow Jones Industrials return in 2017, including dividends?" a mere 3% selected the right answer even after being given four choices from which to choose. Predicting interest rates turned out to be just as hard. Only 6% of respondents correctly chose the box (out of four) indicating that the US 30-year Treasury yield will end the year under 3%. It's a good thing we're not prognosticators because we also would have missed the right answers by a long shot.

Thus, it's business as usual for us, answering the question: Would we take this company private in a heartbeat? The three securities highlighted below, two pieces of debt and one common stock, perfectly underscore RAM's investment approach.