

## What We Mean by Opportunistic, Absolute Return Investing

*This article by Jim Roumell is excerpted from a letter of [Roumell Asset Management](#).*

We have long described RAM's investment approach as being opportunistic. We've defined opportunistic investing as a willingness to do nothing in the absence of a compelling investment idea. With a cash balance of roughly 40% of our assets under management, it is worth digging a little deeper into this central investment issue.

The crux of opportunistic investing lies in the Hippocratic oath to "First, do no harm." For RAM, doing no harm means doing nothing — in terms of actual capital commitments — when we are unable to source high-conviction investment ideas, possessing strong balance sheets, and meaningful discounts to our calculations of intrinsic value. Period. Full stop. We are not in the business of buying simple market exposure. Our view is that the temporary opportunity cost of low-yielding cash returns will be more than financed by patiently waiting for the risk/reward dynamic embedded in great ideas.

At this stage in the game, we believe we have a material advantage over many of our Wall Street peers — the ability to think independently and to allocate capital as we please. It's not so for large portions of the industrial money management complex. Currently, Wall Street strategists (the chief macro-economic investment gurus of Wall Street's leading brokerage and asset management firms), see the S&P 500 rallying 5% before the end of the year. A stunning 87% of strategists responding to a recent CNBC survey said they believed the S&P will finish the fourth quarter higher. So quaint — just "higher" for the quarter. Bernie Madoff was also smart enough not to promise big returns, just consistently good ones, lest he appear to be a charlatan.

In fact, Wall Street strategists always love stocks. In December 2007, Wall Street's top strategists, in aggregate, predicted that the S&P 500 would rise 8% in 2008. Modest predictions can't be confused with blind industry self-interest to sell the stock market 24/7 irrespective of valuations and market cycles. Goldman's Abby Joseph Cohen estimated that the S&P 500 would end 2008 at 1,675. The S&P 500 dropped 37% in 2008 and on December 31, 2008 the index stood at 903. Wall Street's individual stock analysts, often possessing deep industry knowledge, are also well aware of who pays the bills. According to FactSet, of the 11,257 ratings that analysts have on S&P 500 stocks, 49% are "buy" ratings, 45% are "neutral" and only 6% are "sell" ratings. Objective advice?

In 1998 Goldman Sachs Capital Partners, the bank's private equity arm, raised \$2.8 billion in a new fund targeting...internet stocks. The timing of launching such a fund was bad. How bad? The S&P 500 Information Technology Index closed in June of this year at 992, seventeen years after the fund's launch, reaching the all-time high set back in March of 2000.

To be fair, Morgan Stanley did go very bearish on March 13, 2009 predicting a drop of as much as 25% in the S&P 500 index over the following few months. March 13th turned out to be just days before the market hit rock bottom and then proceeded to rise more than 25% that year.

Of course, Morgan Stanley and Goldman Sachs could write a letter noting some of RAM's individual, bottom-up, company specific, mistakes. Fair enough. However, we would note that we've never witnessed wealth creation that resulted from the advice of Wall Street market strategists. On the other hand, we are surrounded by investors who have built stores of wealth from savvy individual security selection. Wall Street is a selling machine domiciled in a city "that doesn't sleep" and its market

strategists are the chief cheerleaders.

An integral part of the industrial money management complex are the journals and news sites that sweetly whisper the 24/7 chorus to own the stock market. In its opening January 2006 edition, BusinessWeek informed investors that there was a clear blue sky, waters were calm and that there was nothing of substance for investors to worry about. The environment, according to BusinessWeek, was picture perfect. After dismissing concerns about the past year's negative savings rate (consumers spending more than their incomes), BusinessWeek noted, "Record wealth also helps explain why large increases in debt relative to income remain manageable...Delinquency rates on both mortgages and other types of loans to households remain at very low levels...In 2006, balance sheets should stay strong. Borrowing will slow as interest rates rise, cooling the growth in liabilities. And even if home prices stop rising, assets should benefit from stock market and other gains." Man plans, God laughs.

Yes, over time, often much time, the stock market goes up and this fact should not be ignored. Perennial bears have paid a dear price for being too intransigent in their investment views and there are few investors who have consistently made money shorting the overall market and/or individual stocks. In fact, perennial market optimists have done much better than perennial bears because the U.S. economy, despite an abundance of headwinds, grows over time and the odds are high that it will be bigger and stronger still in the years to come.

However, there is a reality beneath the stock market's hood that investors should appreciate. "Over the long haul" includes long periods of drought, loss, volatility and misery. It took fifteen years for the Nasdaq to recover from the dot-com bubble bursting; the Dow Jones Industrial Average was flat from 1966 to 1982 and in the past 20 years the market has dropped 50% twice which resulted in very costly investor responses (selling at lows and buying back in after the recovery). Moreover, going back to January 1, 1926 and looking at every rolling ten-year period for the S&P 500 beginning each month (over 1,000 ten-year periods), shows that in over 50% of those ten-year periods, the market (with dividends) failed to generate an 8% annualized return. Thus, locking in a near 8% yield, without the roller coaster of the stock market, is a pretty good return that would likely satisfy most investors. That is why we've been willing to allocate a portion of our assets to business development company (BDC) debt paying 6.5% to 7.75%, (see Great Elm Capital discussion later in this letter and TICC Capital in our second quarter letter).

Despite the slew of conflicts inherent in the financial services industry, Wall Street is a financing mechanism that appears to have done its job well, in aggregate, over the past several decades. Beating up on Wall Street doesn't take much courage these days as Wall Street now seems to be out of favor with people of all political stripes. Businesses have long accessed equity and debt capital from Wall Street and our capital markets are the envy of the world. Capital is the elixir that enables companies to begin, grow and mature and we don't see financing mechanisms superior to our own anywhere in the world. Investors simply need to be mindful of the nature of the business, the myriad conflicts embedded in this great financing system and the perverse incentives often found after peeling back the onion. As in all societal endeavors promulgated by governments or private entities, the actors are human.

Notwithstanding Wall Street's conflicts, there is a serious debate about relative versus absolute value. There is a worthwhile discussion about the role interest rates play in assessing relative value among asset classes. After all, investors have to do something with their money and opportunities are viewed in the context of what's available. Thus, many argue that in a world in which a 10-year Treasury bond pays 2.5%, buying a company's stock at 20x earnings is a bargain. To wit, 20x earnings is a 5% return, i.e.  $\$1/\$20 = 5\%$ . Thus, in this analysis one is doubling the current risk-free rate of return even at a 20x multiple. Not bad? Remember, a portion of earnings must be reinvested to just maintain current earnings, so they're not really "owner operator" earnings.

In our minds, the problem with an interest rate, relative-value informed view is that companies' earnings are in no way assured. This fact is particularly true today as technological change is gaining steam and business models and industries are facing disruption in materially new ways. An October 2017 Bloomberg headline like the this one is commonplace, "Amazon spooks UPS, FedEx investors over fears that the retail giant will start making its own deliveries." Indeed, disruption appears to be accelerating. Therefore, the expected return to own equities should be greater than normal, not smaller, in our view. Further, we are not so certain, as many others seem to be, that if interest rates remain low that equities will continue to perform positively. Japan's Nikkei peaked at 37,000 in 1990 and sits under 21,000 today despite decades of falling interest rates.

Moreover, accounting for a typical business cycle makes the cyclically adjusted price to earnings ratio (CAPE), created by Yale economist Robert Shiller, far more meaningful in our view than a simple forward-earnings multiple (Wall Street's preferred measuring stick). Who would buy a mature business off of current earnings? Doesn't it make far more sense to smooth out a company's earnings over a business cycle to arrive at a cyclically adjusted earnings number? Based on the current CAPE ratio of roughly 30x (the third highest ratio on record), stocks are yielding not 5% but rather 3.3%, i.e.,  $\$1/\$30 = 3.3\%$ . Some may criticize the CAPE ratio on the margin, but the fact remains that the ratio's signal does not suggest a market with a plethora of cheap securities.

It should be understood that the S&P 500 is not some interesting start-up with big upside, rather it's "the market," which at day's end is tethered to GDP growth. The OECD is targeting a 2.1% U.S. economic expansion this year and 2.4% in 2018. So, 30x to live with a more competitive and a rapidly changing business environment, coupled with sub-3% growth? We're not taking the bait. There are plenty of things to worry about and none other than recent Nobel Prize winner Richard Thaler, an American economist and Professor of Behavioral Science and Economics at the University of Chicago Booth School of Business (Craig's alma mater), recently mused, "We seem to be living in the riskiest moment of our lives, and yet the stock market seems to be napping. I admit to not understanding it. It's certainly puzzling." Richard has company.

To sum, RAM does not look at investments in relative value asset contexts. Rather, we determine whether the absolute return warrants the risk. If interest rates were to stay down for many years to come, it is quite possible that the stock market could continue to be "the cleanest dirty shirt" in the asset-class closet. Historically, we have not paid a price — compared to major stock market indexes — for possessing a high cash position. Nonetheless, investors ought to think through how much capital they want allocated to an opportunistic, absolute value investment style that may have elevated cash levels for the foreseeable future. To be clear, we have a robust "on-deck" list wherein the work has been done and we're simply waiting for the price(s) that we're willing to pay.

RAM will continue to source investment ideas on a case by case basis. We believe the best way to manage overall economic or market risk is to simply remain highly price conscious at the point of purchase. The three securities described below all easily meet our north star threshold, i.e., would we take the company private in a heartbeat? It's hard to find new ideas, but it's not impossible because investors over react enough times to misprice a number of securities (or ignore all together), even in an overall expensive market. Of course, no investment strategy can be separated from individual temperament. We believe our analytical and research strengths are anchored by mental toughness and conservative judgment. Finally, RAM is committed to maintaining a modest level of assets under management that allows us to optimally execute our strategy, focusing as it does on micro and small cap securities.