

3rd Quarter Commentary

October 2019

A Sober Look at Your Market and Economic Risk Exposures

A number of clients have inquired about oil prices. Of course. Because oil prices are down and many of our energy related holdings are down. But all questions are good questions, so this review will cover the energy sector. As to what is being said about energy and energy stocks, there is so much commentary and agreement on the topic, that it is time for one of our periodic Bunk/Debunk exercises. But energy is only part of the job. We'll also cover other sectors that are down, why that is so, which sectors we choose to own and which we choose to **not** own. Because our choices are all very much the opposite of how other investors – the entire stock market, in fact – are positioned.

That's a lot to cover, making it dangerous territory, what with my tendency to favor words and analogies – the more, the better, is my vice. So, I'll make heavy use of the work of one of our very able analysts, James Davolos, who tends to favor tables and graphs – the more, the better, is his vice.

Before delving into any one sector, we'll begin with a depiction of how the great majority of investors are currently invested. This is easy to determine nowadays. Not so very long ago, you had to subscribe to an expensive database service that collected such data from private sources. Now you need simply look at the ETFs with the greatest amount of assets. It's all been made very easy.

For orientation, we have this blank chart. One axis is for GDP, which can either expand upward, above the X-axis, or contract downward below the X-axis. The other is for inflation, with prices either increasing, to the right of the Y-axis, or decreasing, to the left. The X and Y axes intersect at their respective zeros, which is how we're accustomed to seeing Cartesian coordinate graphs. We're starting with this because the real chart below uses (2%, 2%) as the intersection of the X and Y axes, which people are not accustomed to seeing.

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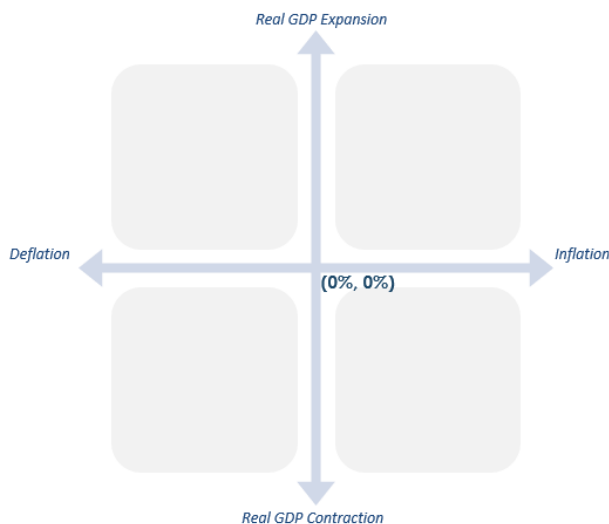
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Today, the asset classes and economic sectors to which most investors are allocated are dependent upon a continuation of the current status quo of the U.S. financial system: moderate 2% GDP growth and moderate 2% inflation as well as record-low 2% interest rates. This 'normal' is the basis upon which mainstream – which means index-centric – equities and bonds have been priced, and upon which investors expect to earn a certain level of return. But this condition is transient. Guaranteed.

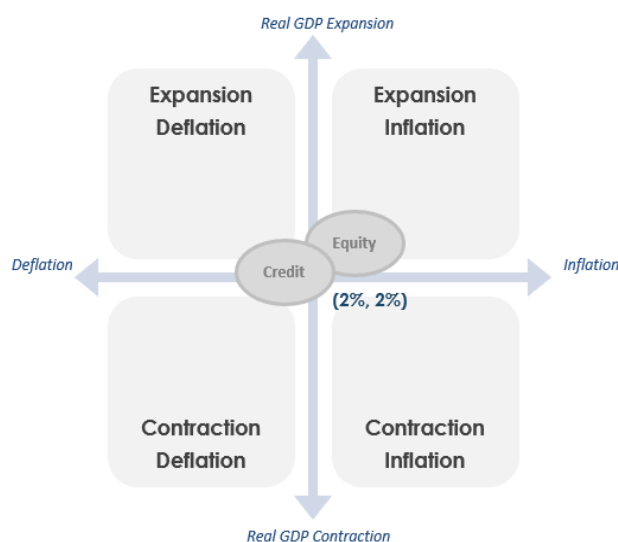
Therefore, it is not just a return expectations chart. It is also a risk exposure chart. It depicts the risks faced if either condition – GDP growth or inflation (or interest rates) – changes. And based upon actual exposures, people are very poorly prepared for any slide away from that 2%, 2% balancing point.

Risk in the Upper-Right Inflation Quadrant:

What if inflation or interest rates rise, even if the economy is still expanding?

Equities and the Interest Rate Valuation Risk

For stocks, the conventional allocation now is to the very largest companies in existence. For clarity, people are invested pretty much only in the top quarter or third of the S&P 500 or Russell 1000. The top 100 of the 500 S&P companies account for 67% of its market value. And any major subset of those indexes is no different. These would include the likes of the iShares S&P 500 Value ETF (IVE), iShares MSCI Edge Minimum Volatility USA ETF (USMA), iShares S&P 500 Growth ETF (IVW) or the iShares Russell 1000 Value ETF (IWD). Just these four so-called style or factor ETFs have over \$110 billion of assets. You can buy a dozen different indexes with markedly different descriptions and categorizations, yet the odds are that you just own mostly the same companies over and over, as you'll see in the section after this one.



One of the common systemic risks of the mainstream index funds is that their future returns are quite dependent on maintaining the high P/E ratios of these dominant companies. Those unsustainably high valuations come in two flavors. One is made up of companies that are still growing rapidly, such as Visa, Facebook and Amazon. They trade at 30 years' worth of earnings or more. The other flavor is the former-growth-now-mature companies, like Procter & Gamble, Coca-Cola and McDonald's. They trade at a P/E of 25x or so, yet their revenues during the past several years are either stagnant or have actually declined; in that sense, they might be even more expensive than the growth stocks.

	Visa	Facebook	Amazon	Procter & Gamble	Coca-Cola	McDonald's
Rev. Growth Rate, 3 Yrs.	13.9%	31.2%	22.8%	1.2%	-7.8%	-5.4%
P/E, Est. 2019 Earnings	32.5x	29.6x	74.7x	24.2x	25.9x	26.0x

Source: Company filings

The mature-company P/E ratios are particularly dependent on continued low interest rates. Investors 10 or 20 years ago were certainly willing to pay 25x earnings for a growth company, like Coca-Cola was back then. But never for a mature company with declining revenues like Coca-Cola is right now. Even during periods of euphoric risk-blindness, they could see the risk/return mismatch in a non-growth or negative-growth company, because it couldn't hold out a plausible lottery-ticket possibility. But what changed between then and now? Why the loss of valuation sobriety? No choice.

What's changed is that in the past, if all comparable companies were expensive, investors could default to a safe store-of-value instrument. In 2006, before the financial crisis unfolded, you could get 5% from a 10-year U.S. Treasury, but less than 2% from the S&P 500. You had a choice. In 1999, at the inception of the ETF wave, you could get 6% from a 10-Year Treasury, but only about 1.3% from the S&P 500. You had alternatives. Your no-credit-risk interest rate was 2 ½ to 3x higher than the stock market dividend yield.

Don't like today's stock valuations? You only get 1.7% in a 10-year Treasury. Can't retire on that yield, even with \$1 million. But, 1.9% is available at the S&P 500. Even better, Coca-Cola, Procter & Gamble, and McDonald's pay 2.2% to 2.9%. Better, still, is an ETF that holds all three, the Vanguard High Dividend ETF. It has \$35 billion of AUM, obviously very popular, and yields 3.3%. That's 2x the 10-year Treasury yield. That is a historically important reversal. An awful lot of money is in stocks that probably doesn't really want to be there, that was manipulated into that risk position because the Federal Reserve's adherence to ultra-low rate policies has forced interest rates down to levels on which even people with substantial savings can't live.

You're So Over-Allocated Within Indexed Equities, You Don't Even Know

People who think they are diversified via their ETF choices are actually concentrated to a degree that they simply are unaware of. Herewith, a table depicting those above-mentioned ETFs – the mother ship itself, the S&P 500, and the Growth, Value, Minimum Volatility and Dividend Yield funds – along with their weightings in Coca-Cola, Procter & Gamble, and McDonald's. Well over \$300 billion is in just these six funds, yet with but one exception each of those three companies is in every single one of those ETFs.

		Numerical and Percentile Rank Within Each ETF		
	Cos. in			
	ETF	Coca-Cola	Procter & Gamble	McDonald's
iShares S&P 500 ETF	505	#24 = top 5%	#11 = top 2%	#32 = top 6%
iShares S&P 500 Value ETF	382	#19 = top 5%	#14 = top 4%	—
iShares S&P 500 Growth ETF	297	#32 = top 11%	#15 = top 5%	#17 = top 6%
iShares Russell 1000 Growth ETF	530	#15 = top 3%	#139 = top 26%	#100 = top 19%
iShares MSCI Edge Min USA Volatility ETF	212	#2 = top 1%	#17 = top 18%	#7 = top 3%
Vanguard High Dividend ETF	405	#11 = top 3%	#3 = top 1%	#17 = top 4%

Source: iShares and Vanguard as of October 21, 2019

Which means that each of Coca-Cola, Procter & Gamble, and McDonald's is officially defined by ETF organizers and asset allocators as simultaneously a Value stock, a Growth stock, a Low Volatility stock, and a High Dividend stock. Is that the real reason these companies are included in these and scores of

other variously described indexes? Or is it simply that the ETF manufacturers can't source enough companies with sufficient share trading liquidity to accommodate billions of dollars of money inflows? Because, in truth, there aren't that many. Some might say it's a bit misleading.

Moreover, these three stocks – which I chose semi-at-random, by the way, and they are but three among many – are for the most part within **the top 5%** of the holdings in each of those very differently described indexes.

An Interest Rate Sensitivity Test, An Unusual Offer, & Indexation Crosses the 50% Market-Share Threshold

There's another way to see the interest rate sensitivity in this high-valuation stock market. I trust you won't mind, but I've arranged for an informal test of sorts. A representative of a reputable financial institution that I will not yet name has agreed to join us on this call momentarily. A valid offer will be made to anyone on this call. It's not for the general public, or even for any clients who are not on this call, so in that sense it is an extremely limited offer. I'll preface this person's presentation in order to allow you a bit more time to consider what will be presented.

How many of you would, without too much soul searching, take some money today – the markets are closed right now, but I suppose you can send in an email with your name and level of interest after this call – and buy a 10-year Treasury at 6%, which this institution will agree to sell you? They also offer a municipal bond fund of AA credit quality, paying 6% tax-free. Would you take either one of those, or even both?

I think an awful lot of people would take it. If necessary, I think they'd sell some stock funds to do it. And if 6% tax-free sounds unrealistic, we can just return to year-end 1999, when Treasuries did yield 6%. At that time, the Nuveen Quality Municipal Income Fund (ticker NAD), paid a distribution yield of 7.3%. For a closed-end fund, NAD is pretty significant, since it has \$3.2¹ billion of assets. During these past 20 years, it has returned about 6.5% a year. The S&P 500 has returned 5.7% per year since year-end 1999. I think a lot of people, looking forward another 10 or more years, would take some of that 6%.

The point is, if you or someone you know would take that investment grade 6%, or even 5% or 4%, then stock valuations are highly sensitive to an interest rate increase, because – on the margin, at least – there will be some net selling of stocks. And that wouldn't be unusual; it would be historically normal.

But there is a deeper valuation risk that would *not* be historically normal, because of something that has never existed before in the history of the stock market. In a report published in June 2019, Morningstar Inc. measured that there are now more assets under management (AUM) in passive U.S. equity funds than in actively managed funds². Passing that 50% threshold means that the bucket of active equity AUM is now smaller than the bucket of indexed AUM. If, one day, 'allocated' investors desire to re-allocate just a bit from their passively held equities into additional cash or bonds, there isn't sufficient capability to buy it from them.

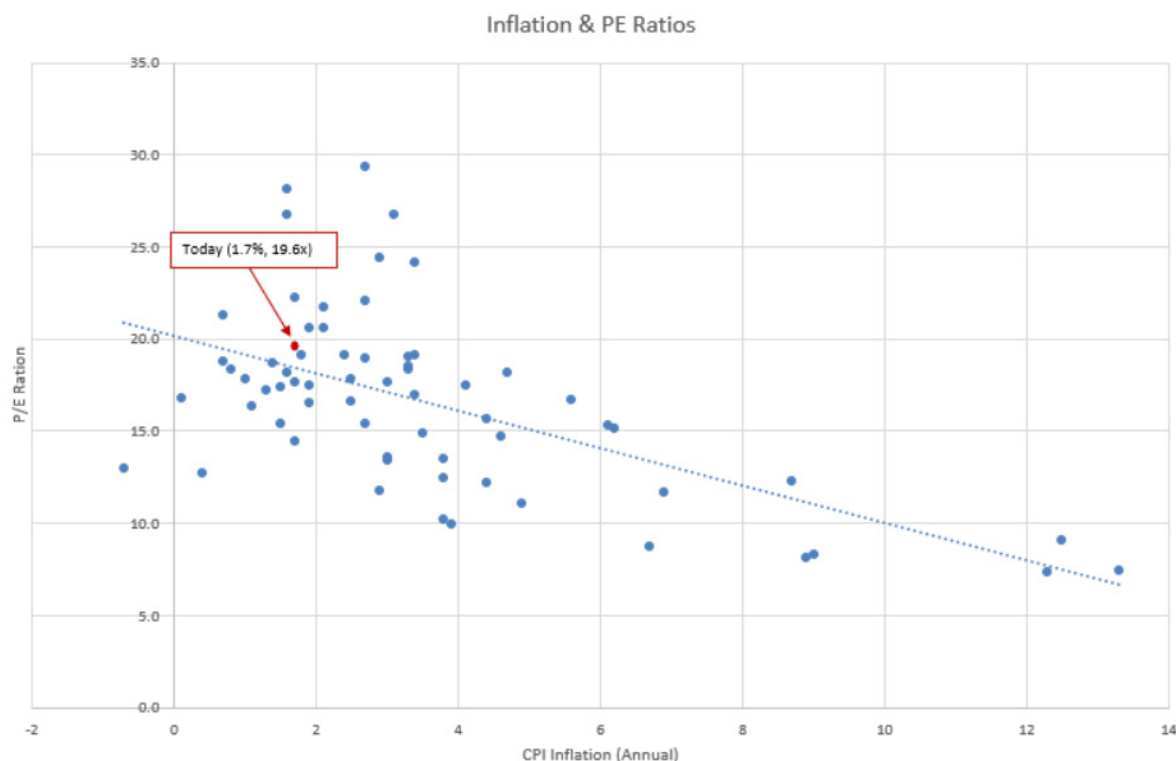
¹ Common net assets as of September 30, 2019

² <https://www.morningstar.com/blog/2019/06/12/asset-parity.html>

Even if active managers had sufficient assets – which by definition, they no longer do – and *were* willing to buy every share of for-sale passive stocks – which they wouldn't be, except at way lower prices – they still wouldn't have the *cash* to do so. To raise the cash, the active managers would first have to sell what they already own. To whom would active managers sell *their* stocks? In the meanwhile, since money continues to be withdrawn from active managers, the pool of theoretical active-management buying capacity will be getting even smaller relative to the indexed assets. If the \$200 billion of net inflows into indexed products this year through September continues at the same pace for 5 years, all else held equal, active funds will account for only one-third of the total. The whole process is one of increasing extremes.

The Absence of Inflation Optionality or Resilience in the S&P 500

Many people believe that higher inflation helps corporate earnings, since companies can charge higher prices. Inflation, though, particularly a marked increase, is associated with contracting P/E ratios. Therefore, any earnings increase can be overwhelmed by valuation contraction. In part, that's because people come to realize that future dollars, like next year's earnings, are worth less than current earnings. Here's another one of James's graphs. It suggests that inflation would not be a friend of today's market.



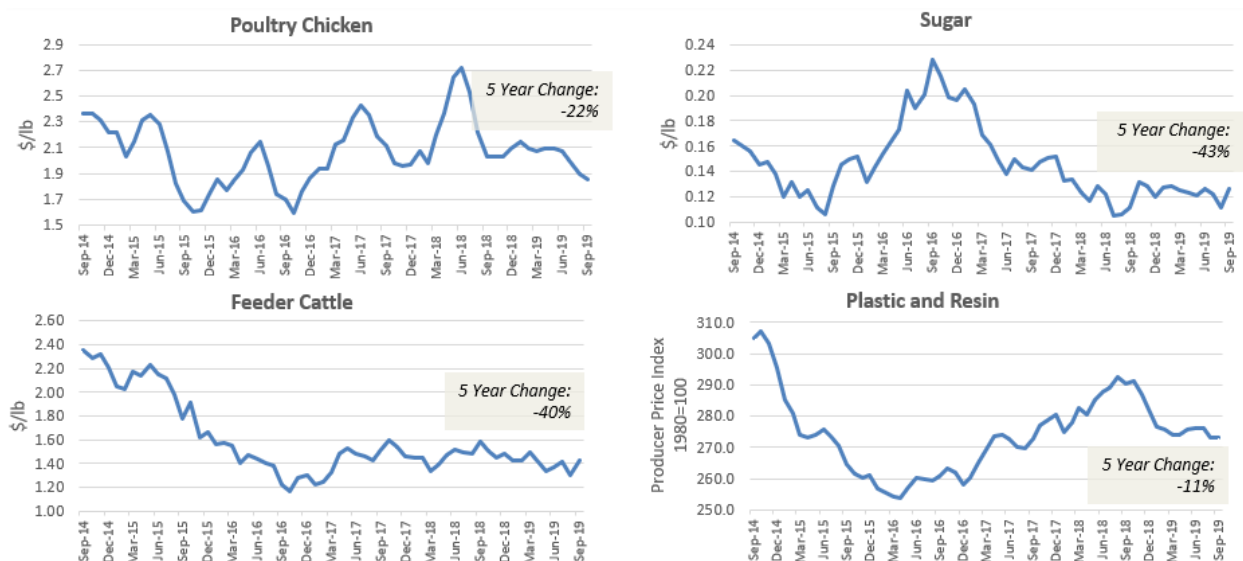
The inflation-helps-earnings idea ignores input costs, which rise as well. Our three former-growth-now-mature companies will continue to do service here. Recalling that their revenues have been flat or declining in recent years, somehow their operating income (before the complications of restructuring charges, tax changes and the like) is actually higher. Coca-Cola's operating income is 22% higher than three years ago, Procter & Gamble's 3% higher, and McDonald's is up 12%. How is that?

All three have been very fortunate beneficiaries of price declines in commodities that are critical ingredients of their products. Sugar is now 12¢ a pound. It was 34¢ at the end of 2010, and 23¢ in late 2016. It's down roughly 50% and 65% in the past 3 and 9 years. Can't make Coke without sugar.

	Coca-Cola	Procter & Gamble	McDonald's
Change in Revenue, 3 Yrs.	-21%	3.6%	-15%
Change in Operating Income, 3 Yrs.	22%	2.9%	12%

Feeder cattle are now \$1.44 per pound. In October 2014, they were \$2.42/pound, and in 2016 were \$1.63. Those are 40% and 12% price drops in the past five and three years. Wholesale chicken is now \$1.85 per pound. In September 2015, it was \$2.53, and in June 2016, \$2.16. So, chicken is 27% and 14% lower in just the past 4 and 3 years. *Beyond Meat* aside, can't make Big Macs and Chicken McNuggets without beef and chicken.

Procter & Gamble isn't into food, but just about every one of the hundreds or thousands of items they sell, from various forms of Pantene and Herbal Essences hair goo, to Old Spice and Safeguard deodorants, to Crest and Oral-B dental care products is packaged in plastic. No plastic, no Tide detergent. In the past 5 years, since October 2014, the Producer Price Index for plastics and resins manufacturing is down 11%.



Source: *indexmundi, Factset, St Louis Fed*

These index-multi-function Growth-Value-Low-Volatility-High-Dividend mega-cap companies have been able to maintain higher earnings in the face of flat or declining revenues with the help of sharply lower commodity input prices. This providentially occurred at the very time that their growth phase was ending as a natural consequence of market saturation for their products. Can you imagine the earnings damage that can be done to these and other industry sectors when there is a rebound in the prices of the commodities they require?

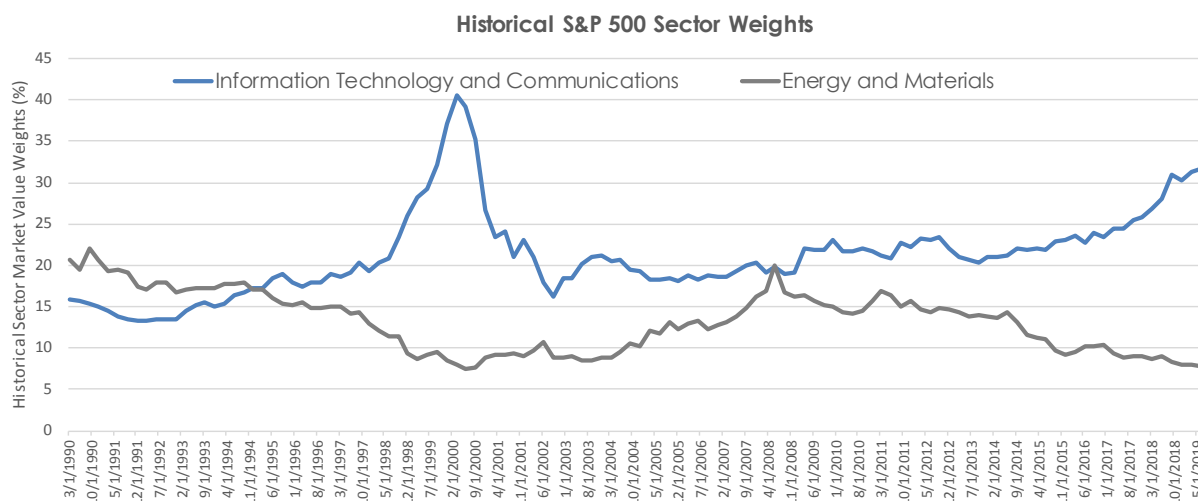
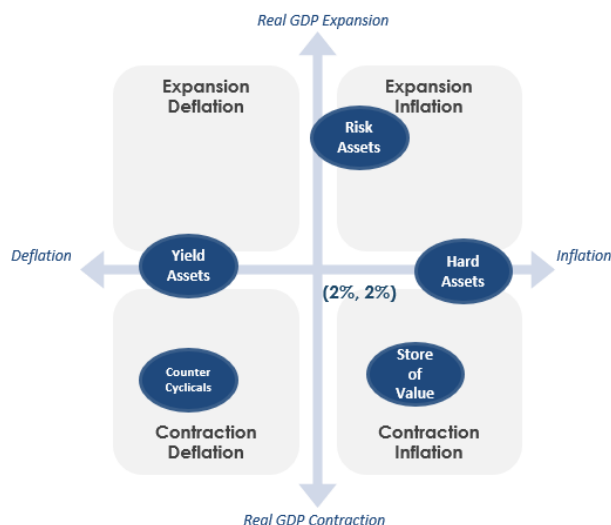
Separate from generic stocks, any index-based long-duration yield oriented strategy will be particularly vulnerable to rising interest rates or inflation, especially when the starting point is only 2%. That includes utilities and REITs, preferred stocks, and intermediate- and long-dated bonds.

But What Might Benefit, and Is It in the Index?

An inflationary environment with continued economic growth might benefit firms that own land and develop real estate. Or oil producers or other hard asset owners. Or marine shipping.

Unfortunately, energy is now only 4.5% of the S&P 500, the lowest weight on record. ExxonMobil, all by itself, used to be a larger weight than that only 10 years ago. Energy was 16.2% in 2008.

We'll talk more about the energy sector later, and **Texas Pacific Land Trust**. But for the moment, energy's ongoing de-emphasis in the index is plainly visible in the accompanying chart: as if the one drained investment funds from the other, one can see the rise of the Information Technology/Communications sector weighting as a mirror image of the decline of the energy sector. The Technology index weight is now surpassed only by its prior Internet Bubble peak at year-end 1999.



Real Estate is only 3.2% of the S&P 500, but even that doesn't count at all. The S&P's Real Estate sector is all in the form of REITs, and REITs are a way of packaging real estate that neutralizes its inflation benefits. They can suffer from inflation, rather than being beneficiaries. REITs typically have long average lease terms for their tenants, so that their ability to revise rents upwards can only happen gradually as leases expire. In the meanwhile, their operating costs, whether for electricity, wages, taxes or maintenance, can rise rapidly. Moreover, since they must distribute most of their cash flow as dividends, they cannot

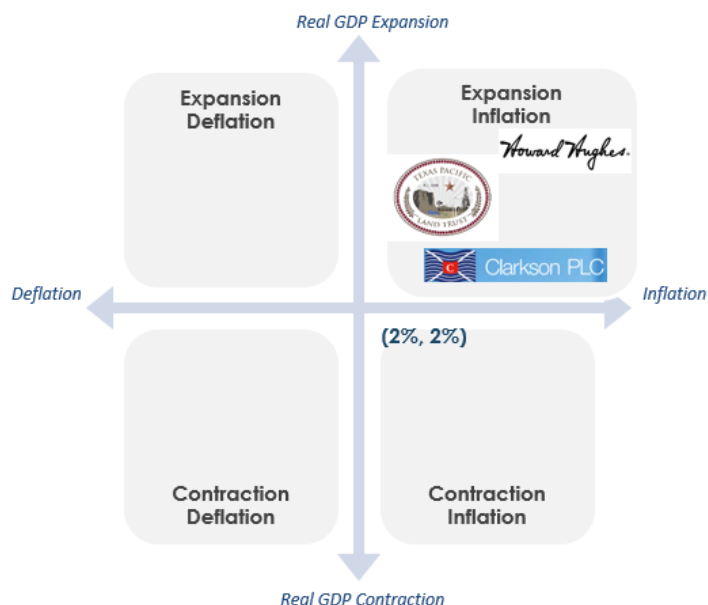
reinvest much of their earnings in additional properties. They could borrow to do so, but in an inflationary environment, the interest rates on such debt would be rising as well.

Land and real estate development embodied in a standard corporate structure is different. Lots held for development can appreciate sharply, and if a company is also a developer, it can meaningfully enhance the value of its land portfolio. There are no actual land or real estate development companies in the S&P 500. **Howard Hughes Corp.** is an example of this kind of company. While it is not in the S&P 500, it wouldn't even matter to the performance of the index if it were: the company has a \$5 billion stock market value, which would make it only about a 2/100^{ths} of 1% position.

As to marine shipping, there are S&P 500 companies with ships. But they are Royal Caribbean Cruises, Carnival Corp and Norwegian Cruise Lines. Those aren't the kind of ships we're talking about. Even if they were, all together they amount to 0.19% of the index. There are no marine shipping companies. Even though it is a major global industry. The World Shipping Council³ reports that marine shipping's direct GDP contribution to the U.S. was \$183 billion in 2017, with employee compensation of \$27 billion. As a rough point of reference, the combined revenues of Coca-Cola and Pepsi (only its soft-drink business) are roughly \$68 billion. Yet, Coca-Cola and Pepsi, just the two of them together, are 1.6% of the S&P 500.

Relative to portfolio resilience in an inflationary growth economy, marine shipping is about the most depressed industry in the world. Shipping rates for the dry bulk carriers that haul raw materials such as iron ore and coal are down more than 80% from a high 11 years ago⁴. Ergo, whenever prices recover, they can increase by multiples. Diversified participation in all the shipping sectors, from tankers to container ships, can be captured through a shipping broker like the 167-year old **Clarkson PLC**. For an inkling as to the information value of Clarkson's services, it provides data on over 135,000 vessels and 600 shipyards.

The inflation-expansion quadrant is well-represented in our equity strategies.



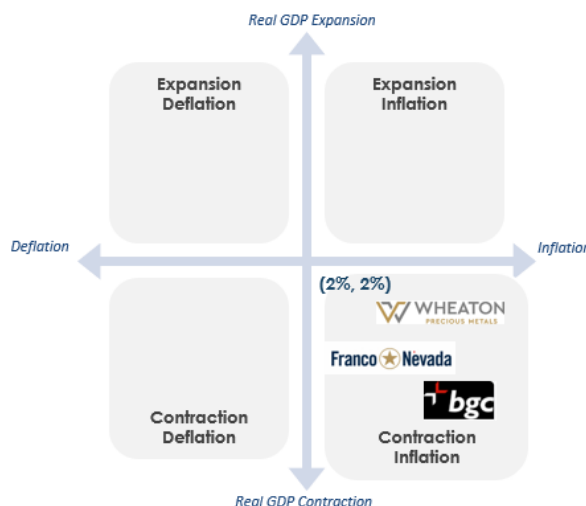
³ www.worldshipping.org

⁴ Baltic Exchange Dry Index

Risk in the Lower-Right Inflation Quadrant

Rising inflation accompanied by a slowing or contracting economy, particularly in a circumstance of record debt-to-GDP levels, expands the economic risk to credit deterioration. This can catalyze serious damage among low- and non-investment grade bonds, among private equity funds (or leveraged equity, as we prefer to call them), and the finance sector. Such uncertainty can also weaken the dollar.

That is just the sort of environment in which precious metals can be an important source of portfolio return. As far as the S&P 500 goes, though, its exposure to mining consists of one gold mining company (Newmont GoldCorp), which amounts to 0.13% of the market value of index. And one copper mining company, equal to 0.05% of the index. That's it: less than 20/100^{ths} of 1% between them.



Our portfolios make substantial use of an enhanced form of precious metals participation, via royalty companies like **Franco Nevada** and **Wheaton Precious Metals**, about which we've written extensively. They remain profitable even when mining companies are not. Without the need to support any meaningful amount of land, property or equipment, they can direct their cash earnings into new royalty agreements and thereby expand even when mining companies cannot. Therefore, while they are permanent call options on higher precious metals prices, they are also growth companies – which cannot be said about gold miners or gold bullion.

An entirely different way to try to benefit from an otherwise injurious equity environment is through a company like **BGC Partners**. This is an inter-dealer broker. Just as an individual investor engages Fidelity or Charles Schwab to buy and sell securities on his or her behalf, these broker-dealers require the services of a company like BGC Partners for certain types of trades. This would be for instruments that are less liquid due to a certain size or character, and for which BGC can add value by providing price discovery, market intelligence and, ultimately, match buyers and sellers.

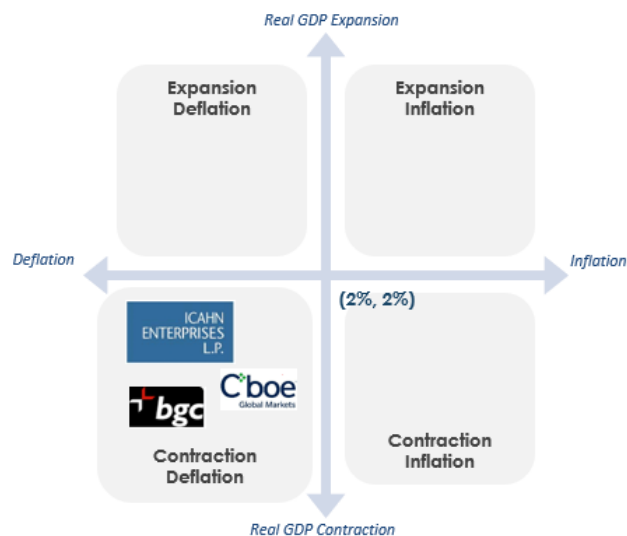
Here's an irony. This long period of declining interest rates and declining market volatility – which has brought us to the 2%, 2% condition – has been challenging for the company, whereas it has been a boon for the top of the S&P 500. The market conditions that benefit the company are more volatility and wider transaction spreads – which have been suppressed. Despite these unfavorable conditions, and unlike the Coca-Colas of the S&P 500, BGC Partners' revenue is up 22% in the last three years. To do even better, it can use some more credit defaults, interest rate spikes, currency exchange rate tumult, and the like.

It should be mentioned that BGC Partners pays a dividend yield of 9.8%. It is possible.

The Lower-Left Quadrant: A Recessionary Environment with Deflation

The composition of our equity portfolios is intended to avoid making their performance dependent on the continuation of the status quo. Some holdings are uniquely positioned to benefit from a divergence from the 2%, 2% low-growth, low-inflation balance point.

In this regard, **CBOE Global Markets** is much like BGC Partners in that it can thrive during periods of market volatility, including volatility sparked by shifts in interest rates and currency exchange rates. CBOE is a primary options exchange, including options on the VIX volatility index, the S&P 500, ETNs (ETFs based on futures) and stocks. It also trades futures, including futures on the VIX and on corporate bond indexes. It trades U.S. equities, European equities and Foreign Exchange products and derivatives. Whereas many of its products, which are used to hedge or lay off risk, are in lesser demand in today's low-volatility environment, one would expect options and VIX volumes to surge amidst some of the tumult that occurs during an economic contraction.



A couple of interesting statistics, since this discussion is all about diversification. This year through September, the daily price correlation of the following indexes with the S&P 500 were all between 0.86 and 0.98, meaning that their price behavior varied almost identically with the S&P 500: S&P 500 Growth ETF, the S&P 500 Value ETF, the Russell 2000 ETF of small-cap stocks, and the All Country World Index Ex-U.S. The greatest variance, among the major equity classifications was from the Emerging Markets ETF, and that fund mirrored the S&P 500 77% of the time.

By contrast, CBOE Global Markets, had a 0.15 correlation with the S&P 500. On a given day, if the stock market was down, you'd be hard put to know whether the CBOE shares would be up or down.

The Great Diversification Machine Daily Price Correlation with iShares S&P 500 ETF For the 9 Months to September 2019

IVW	iShares S&P 500 Growth ETF	0.98
IVE	iShares S&P 500 Value ETF	0.96
IWM	iShares Russell 2000 ETF	0.88
ACWX	iShares MSCI ACWI ex U.S. ETF	0.86
EEM	iShares MSCI Emerging Markets ETF	0.77
CBOE	CBOE Global Markets	0.15

Icahn Enterprises is a counter cyclical holding in that Mr. Icahn continues to run this activist portfolio with a net short position that is about 40% of asset value. It includes swaps that benefit from a decline in the stock market and from an deterioration in corporate credit quality. Additionally, he has raised liquidity over the past 24 months, monetizing successful multi-year investments in Federal Mogul, American Railcar and various real estate holdings. So, Icahn Enterprises is highly liquid and positioned against the market cycle. The current dividend yield is 11.8%.

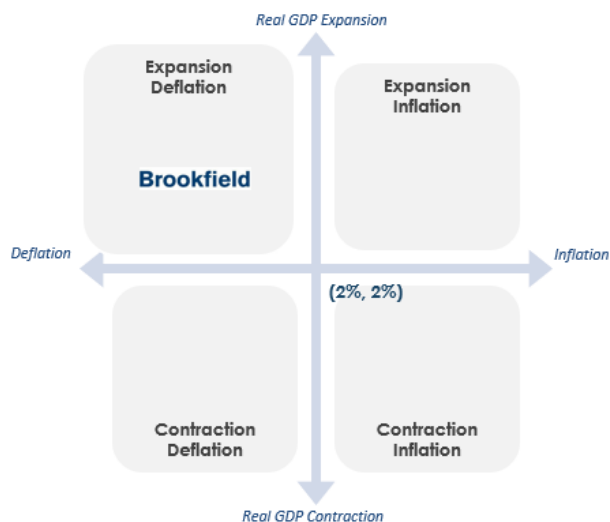
Even the Upper Left Quadrant

It is self-deceiving to presume that a specific company will perform in a predetermined manner in an imagined future economic scenario. This review is intended to be qualitatively suggestive. If this is a failing, it is of a kind with the indexation movement, which presumes statistical reliability where there is none. Neither is a true failing, so long as there is self-awareness of the limitations.

With that proviso, what type of business might succeed in an expanding economy that is deflationary, since that is the final quadrant in the chart we've been using? We're not economists, and I don't recall having read about such an economic cycle occurring, so I couldn't say if it is even a realistic scenario. But if it were to occur, it is possible that **Brookfield Asset Management** might fare well enough.

Brookfield is one of the largest so-called alternatives asset managers, with over \$160 billion of client capital. It earns over \$1 billion in asset-based fees, separate from incentive fees. Its portfolios are primarily allocated to commercial real estate, renewable power (hydro power, wind, etc.), and infrastructure (ranging from electricity transmission grids to toll roads and export terminals). A sustained expansion absent inflation is basically fuel for the company's "long-duration" asset base. Most of its assets have long-term contractual pricing embedded in them, and are likely to include price escalators, as would be the case for a leased office building or a power transmission grid.

These projects are financed in advance and backed by the assets themselves, so are non-recourse to Brookfield. When first set up, such properties produce a net current yield to Brookfield, perhaps low but which tend to rise over time with economic expansion, as for a toll road. In a deflationary environment, the yields on low-risk investments might decline even from current levels, which would enhance the valuations of the Brookfield-type properties. Like CBOE or BGC Partners, Brookfield can thrive in other quadrants of this scenario chart.



The Extraction-Based Industries – A Classic Buying Opportunity

Remarks on What Makes a Good Investment

By and large, investors measure what they should own by what's been doing well. That's always been the case. But the comparison used to be relative to that year's most successful individual fund manager. Even so, that manager might have taken too much risk – maybe a one-sector or too much volatility. If so, the excessive risk invalidated the excess return. Today, though, the comparison is to the index, and the index cannot be 'wrong' in that sense; it is defined as being the market.

Either way, investors tend to measure their satisfaction by how well they do relative to whatever has been 'driving the market', as it is phrased. Sometimes it's bio-tech-driven, sometimes it's Internet- and

technology-dominated. Lately, the stock market has been driven by indexation-centric mega-cap companies. It is paradoxical that people think this way even as they read admiringly about how successful, storied investors like Carl Icahn, Sam Zell or Warren Buffet operated. Paradoxical, because they did precisely the *opposite*.

That ilk didn't compete with everyone else for a given stock or sector. In fact, they scrupulously avoided competing, because they wanted an *advantageous* price. Despite what is propounded daily in the financial news, it is not the growth rate or the superior quality of a company that makes it a successful investment. It is the price. And that price 'doesn't make itself' – it is other human beings who make the price. They are responsible for the creation of a superior investment; although they don't know it.

Here are two investment choices; it's a test. You can buy only one. Remember, there are no wrong answers.

- The first is a simply terrific, large-cap, name-brand, debt-free company growing at 20% per year.
- The second is a newly bankrupt corporate bond with a 5% coupon.

Which do you choose?

If you've already made a choice or were about to, I'm sorry, but you fail the exam. Because you don't know the prices.

Here is the first price: the growth company trades at 35 years' worth of earnings, a P/E of 35x. It's highly improbable you'll get a satisfactory long-term return at that price; I'd rather hold cash. Perhaps this one would be the exception, but do you want the return on your capital to depend upon an ongoing series of exceptions to statistical probability?

Here is the second price: that bankrupt bond trades at 50¢ on the dollar and is expected to emerge from bankruptcy in 18 to 24 months. Because of its legal claims and standing in the credit hierarchy relative to observable balance sheet assets, it is quite probable that it will be paid off at 100. In which case, over the course of 2 years, the annualized return is 50%. If it takes 3 years to reach face value, the annualized return would be 33%. If the estimates turn out to way off, off by 50%, and the bonds are only worth 75, and even if the interest arrearages are not paid, then the 3-year rate of return is 14%.

In isolation, those two wildly different instruments – the blue-chip growth company and the junk bond – are neither good nor bad. It is *their prices, reflecting what other investors think those instruments are worth*, that determine whether they are good or bad investments. The index can't tell you that, because it is not concerned with valuation; it's just an inclusion/exclusion formula.

Those storied, much admired investors have an entirely different world view. They buy securities that have been priced BY OTHER PEOPLE to their satisfaction, companies that other investors have fled or simply abandoned. They bide their time. They don't try to earn steady returns most of the time with only short periods of volatile interruptions; they keep their capital safe most of the time, awaiting those volatile interruptions. It's a wholly different understanding of how the market works.

How to show this in a few pictures instead of a few thousand words?

Hard Assets: Precious Metals

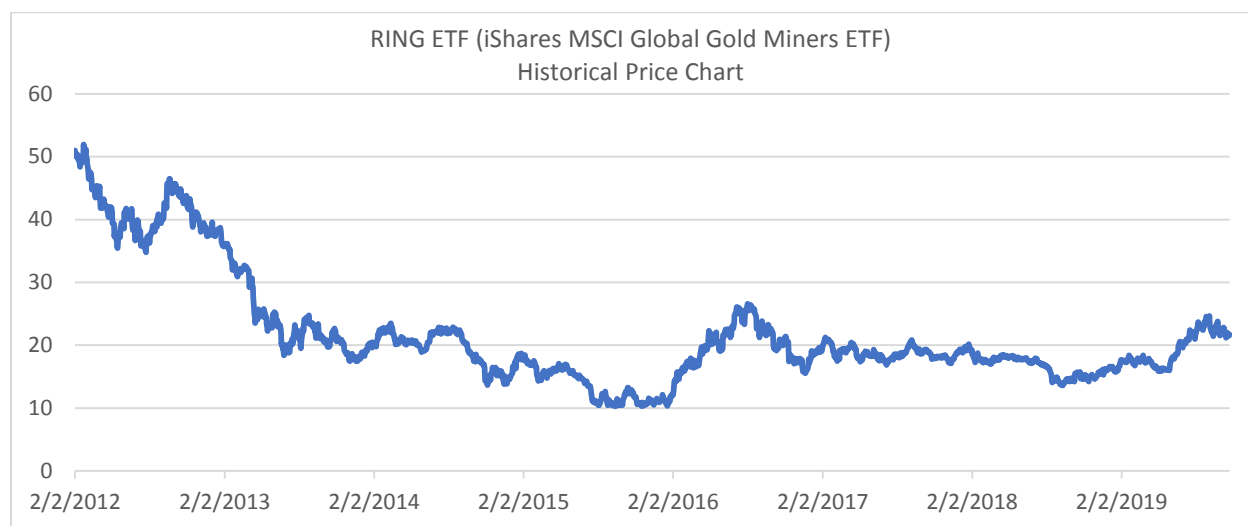
Gold prices peaked in 2011 at \$1,833 per ounce. Gold is now \$1,490, 18% lower than eight years ago. Silver is 60% lower since its peak in 2011. That's pretty severe. The major gold companies have been able to sharply curtail operating costs and either maintain a low level of profitability or avoid losing too much on the mines they are already operating. They have been able to maintain production levels.



Less obvious is that the production has been maintained only because the large development expenditures needed to establish those operating mines were made in the past when gold prices were higher. Gold has not been high enough for the miners to be able to earn a return developing new reserves. So, they have been reducing their capital expenditures for years, and their reserves have been declining.

Companies: Newmont Mining, Barrick Gold, Newcrest Mining, Agnico Eagle, Zijin Mining, AngloGold Ashanti, Kinross Gold, Gold Fields, Sibanye Gold, Yamana Gold, Harmony Gold, Goldcorp, Randgold*

This is the price chart, since inception in January 2012, of the iShares Global Gold Miners ETF (RING). It holds the largest gold companies in the world. It was created when gold prices had peaked. That must have been attractive to investors at the time, which clearly made it attractive to offer a gold mining ETF to the public. The price is down over 50% since then. For a portfolio today, that is not a bad thing.



So far, because gold production has not declined, there has been no impact on pricing. But the day will come when new supply declines sufficiently relative to ongoing demand, and the price of gold will rise toward some new impermanent equilibrium. According to ETFdb.com, there is about \$65 billion of AUM in U.S. gold ETFs and ETNs. That is 1.5% of the \$4.3 trillion now in indexed equity funds in the U.S. What could possibly happen to gold mining stocks if the roving attention of allocators or risk-adjusted return statistics turn in favor of this sector?

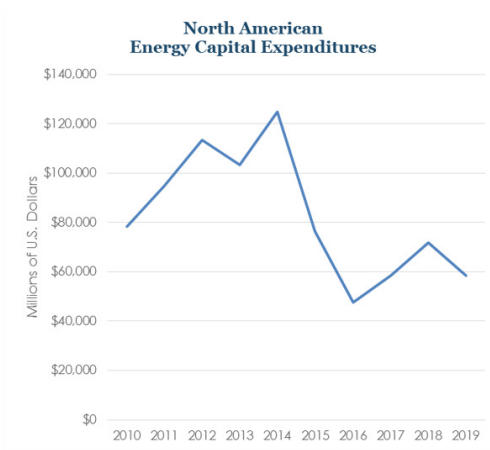
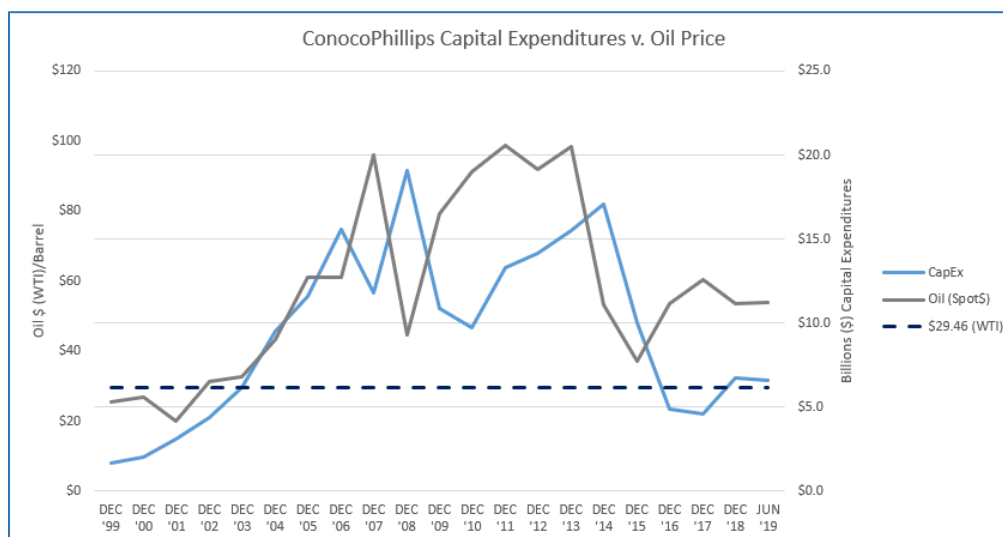
Hard Assets: The Energy Sector

The circumstance is very much the same. The price of the underlying commodity has declined for years and the oil production companies have had to curtail their capital spending.

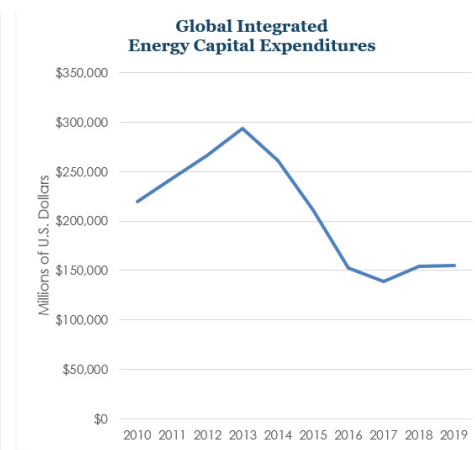
ConocoPhillips, the 3rd largest US oil company, is used for this chart, be-

cause it is exclusively a producer. ExxonMobil and Chevron have enormous refining and chemicals operations. Those operations accounted for 90% of ExxonMobil revenue last year and 40% of its earnings. The company might make less money on production when oil declines, but oil is a feedstock for its other operations, which can benefit mightily.

Oil today (West Texas Intermediate) is \$54 barrel, 50% lower than the \$110 it reached in 2013, over a half-decade ago. Capital expenditures at ConocoPhillips are now 60% lower. The last time its capital expenditures were this low, oil was about \$29



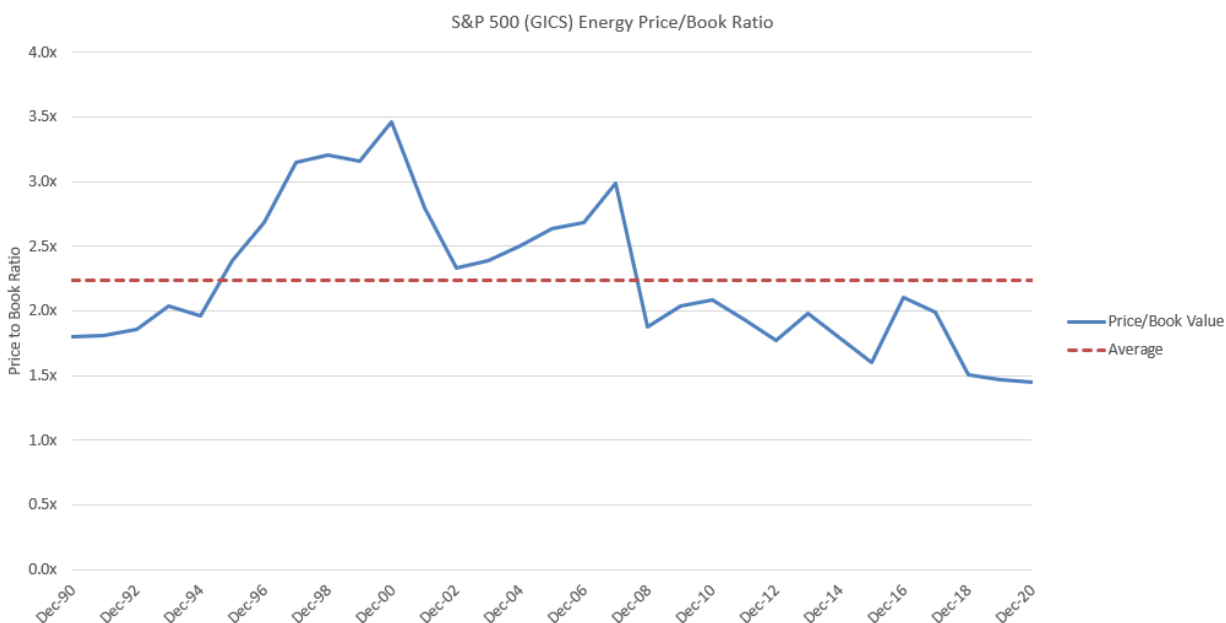
Companies: EOG Resources, ConocoPhillips, Occidental, Anadarko, Pioneer, Concho, Hess, Diamondback, Continental, Noble, Encana, Marathon, Apache, Chesapeake, Devon, EQT, Antero, Parsley, Cimarex, Murphy, WPX, Southwestern, SM Energy



Companies: Exxon Mobil, Royal Dutch Shell, Chevron, Total SA, BP PLC, Petrobras, Sinopec, Equiano (Statoil ASA), Eni SpA, Suncor, Repsol, Cenovus, Husky, YPF

per barrel. This phenomenon of decreased exploration expenditures has been occurring for years, both amongst U.S. companies and globally.

The share prices are down precipitously, they have been deemphasized in indexes, and the S&P 500 Energy Sector companies now trade at the lowest price/book value in at least 30 years. This does not happen in a vacuum. The fossil fuel divestment movement, in connection with efforts to protect our planet from global warming, has reached the institutional level. Among well over 1,000 entities that have sold holdings in such companies are foundations like the Rockefeller Brothers Fund, university endowments, including Stanford University and Johns Hopkins, and local governments and associated pension funds, such as New York City. These institutions hold trillions of dollars of investment assets. The impact on oil company prices is clear to see. The S&P Energy companies now trade at a lower price/book value than they did when oil was \$28 a barrel at year-end 1990.



There are discussions around whether it is even possible to reduce oil use in the foreseeable future and, separately, whether it is even desirable. As a singular example, China and India are primary buyers of liquified natural gas that is shipped from the U.S. That cleaner-burning fuel replaces coal, which is still a major source of energy in those regions. Although this is a complex topic in which every facet is less clear upon close examination, it is presumed by many (though, again, not settled consensus) that every unit of such coal/liquefied natural gas replacement is a net benefit environmentally, even if not ideal.

One impact of the sustained decline in the price of oil, just as in the case of gold prices for miners, is that reserves are not being sufficiently replaced. ExxonMobil produced an astounding 3.833 million barrels per day in 2018, but less than the 3.985 million in 2017, and 4.053 million the year before. Its total proved reserves in 2018 were listed as 24,293 million oil-equivalent barrels. In 2013, the figure was 25,216. That is not expansion. But global demand *is* expanding. Eventually, there will be a supply deficiency relative

to demand, and that imbalance will change the equilibrium price to a new, higher one. But no one will own the stocks at that point, only afterwards.

But that was not necessarily the real interest behind the energy sector question. The real interest was in **Texas Pacific Land Trust (TPL)**, partly because of a lower stock price recently and partly because of financial news stories about the lack of profitability amongst shale oil companies, the over-drilling of shale oil deposits and the early exhaustion of some of those fields. Stories that look like this; these happen to be from the Wall Street Journal. So, it's time to look at actual – you know -- information.

BUSINESS

Wall Street Tells Frackers to Stop Counting Barrels, Start Making Profits

The shale-oil revolution produces lots of oil but not enough upside for investors

By [Bradley Olson and Lynn Cook](#)

Updated Dec. 13, 2017 6:09 pm ET

MARKETS

Norway's Sovereign-Wealth Fund Boosts Renewable Energy, Divests Fossil Fuels

Parliament instructs fund built on oil profits to redirect investments in smaller firms

By [Dieter Holger](#)

June 12, 2019 12:38 pm ET

BUSINESS

Shareholders Have No Love for Shale Companies

Investors are down on fracking firms, even as the companies pump record volumes of oil and gas

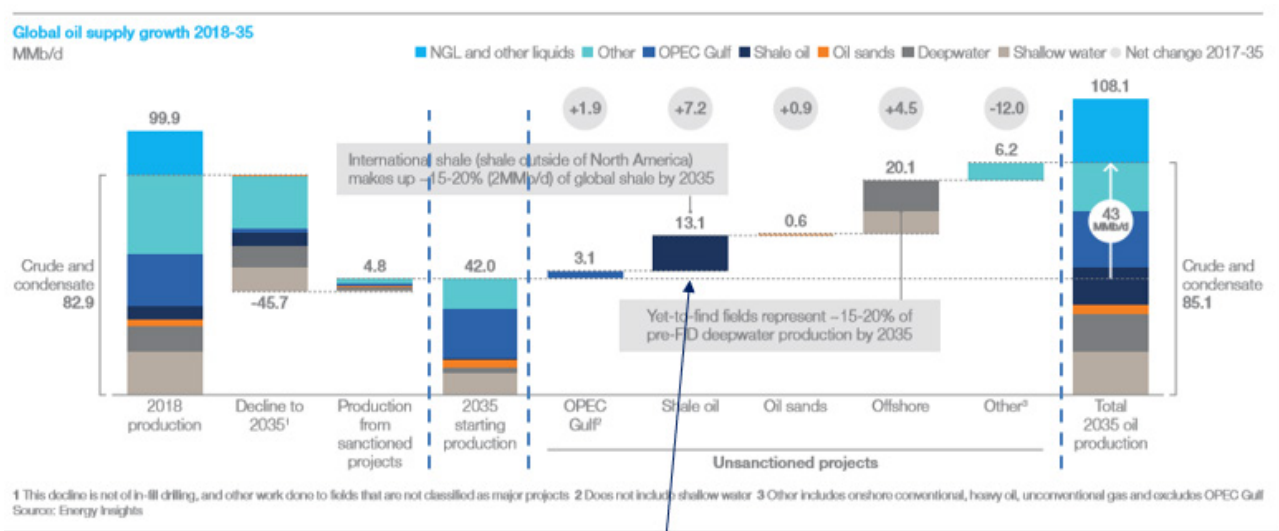
By [Rebecca Elliott](#)

Updated Aug. 13, 2019 7:22 pm ET

Bunk / De-Bunk, Assertions and Data

The world will use less fossil fuel over the next one to two decades.

A McKinsey Associates study, which obviously took place with awareness of the current trends in clean energy technology, climate-change politics and regulation, estimated the increase in global oil demand through 2035. It analyzed the growth in required supply, inclusive of both the decline in existing reserve sources and the compensating increase from the development of new sources. The study put the 17-year increase in supply at 8 million barrels per day, up from a current base of 100 million. There were only two significant contributors to that net increase of 8 million barrels: off-shore production (which is only economic at much higher prices); and shale oil. Shale oil was estimated to account for 13 million additional barrels. *Essentially, the global supply/demand balance will be largely contingent on U.S. shale, which will derive predominantly from the Permian Basin where Texas Pacific Land Trust's (TPL) land and mineral positions are located.*

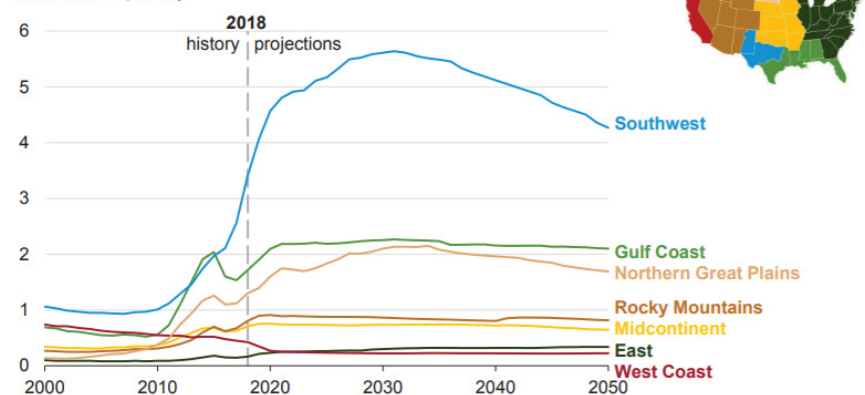


Global Supply/Demand Balance
Contingent on U.S. Shale

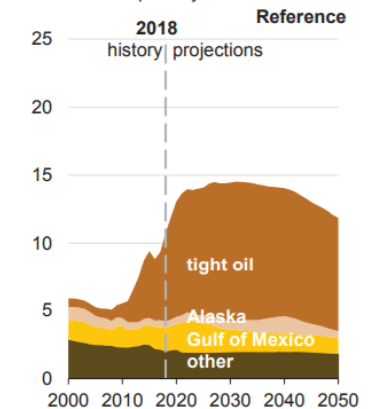
McKinsey is a private commercial consultancy. The U.S. Energy Information Administration is not. Its 165-page 2019 Annual Energy Outlook makes detailed projections about energy use and production through the year 2050. It takes account of all sources, from solar to nuclear. Its base case is for oil production to rise from about 10 million barrels/day presently, to about 14 million in the 2035 time frame.

A further level of detail is the EIA's determination of the regional sources of the increase in supply. According to EIA, the increase will come entirely from what they term the Southwest, but which their map makes clear is for the most part the Permian Basin.

Lower 48 onshore crude oil production by region (Reference case)
million barrels per day



Crude oil production
million barrels per day



U.S. Energy Information Administration

Real quote from a real e-mail: "I get it, now – the TPL share price simply tracks the price of oil."

This person observed that recently the price of TPL has varied with the prices of both oil and other oil companies. It is indeed true that on most days TPL shares are correlated oil. However, underlying economic value creation is occurring at TPL, which cannot occur with the commodity itself, and which might be called the long-term signal within the short-term noise. There are only a small number of days in any given year when that underlying value trend manifests in the stock price. On those days, TPL shares are not correlated with oil prices and it is to capture those few days that we own TPL.

This person did not observe that in the five years since October 2014, the price of oil is down 35% from its \$84/barrel price at the time, whereas the price of TPL is up 3.8x from its \$163 price.

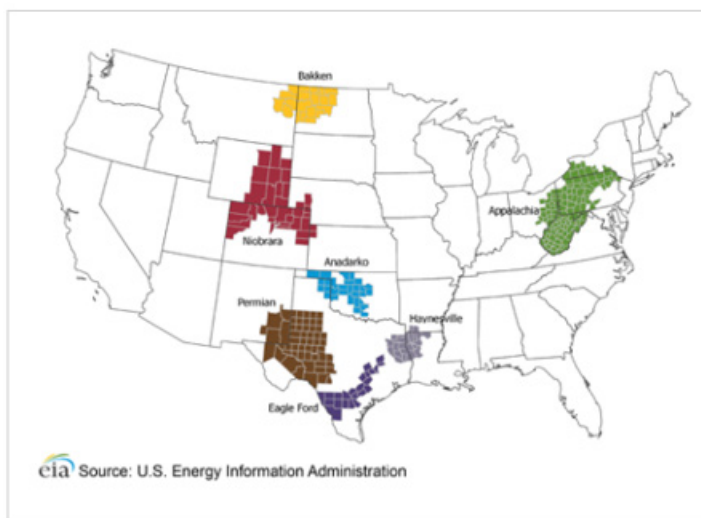
Shale oil fields are being over exploited. The reserve lives are declining more rapidly than forecast. Shale companies can't earn profits at current prices.

Here is a brief, highly abridged view of just what the Permian Basin and TPL's resource excitement is all about. Yes, drilling activity is down. The U.S. rig count is 851, which is down 50% from the 1,739 in early 2011. In the Permian Basin, the rig count is up 18%. The Permian now accounts for over 50% of U.S. oil and gas production.

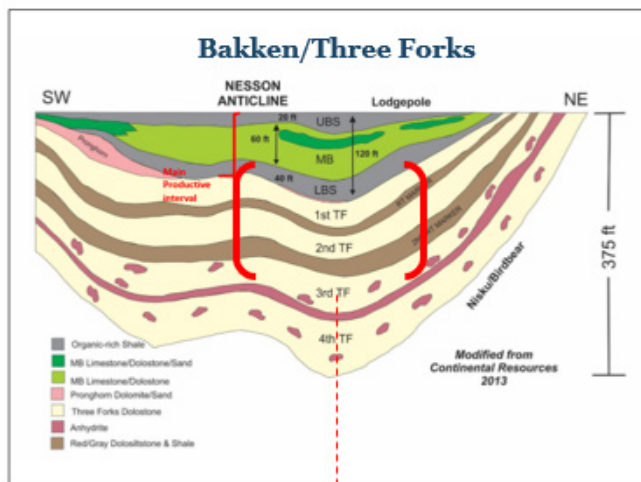
In the two other major shale-drilling areas of the U.S., the Bakken and Eagle Ford deposits, the depth of shale is roughly 400 feet, and the thickness of the productive layers within which the drilling is focused is roughly 200 feet.

In the western portion of the Permian Basin where TPL's property and mineral interests lie, known as the Delaware Trend, the depth of the shale is as great as 25,000 feet, and the interval thickness where drilling is focused can be over 4,000 feet. If one ponders that difference for a moment, and considers it in terms of three-dimensional volume, one can perhaps appreciate why the Dept. of Energy not too long ago determined that the Delaware Trend contains the world's largest oil and gas deposit outside of Saudi Arabia.

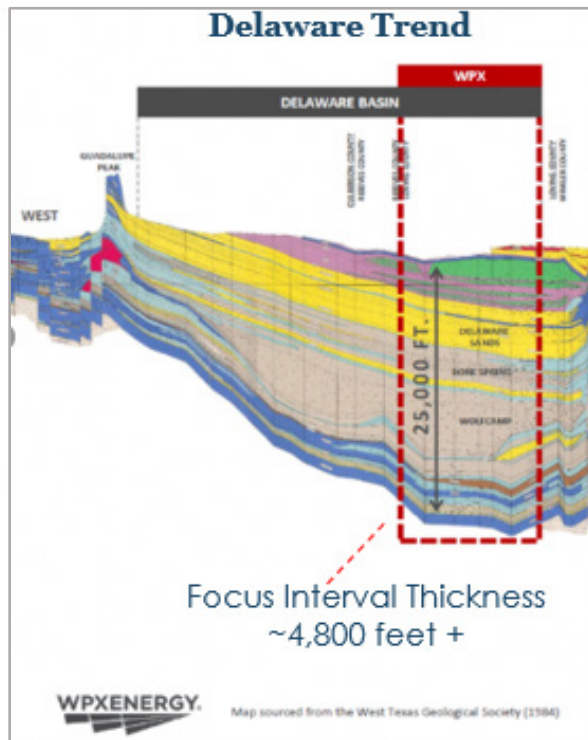
A look at the capital spending plans of drillers like Chevron and Apache Corp. will confirm that they will be expending the money to expand production for many, many years. We anticipate that production volumes will rise for well over a decade.



Basin	State(s)	BOE/D	%
Anadarko	OK	549	6.2%
Appalachia	PA/OH/WV	155	1.8%
Bakken	ND/MT	1,471	16.6%
Eagle Ford	TX	1,374	15.5%
Haynesville	TX/LA/AR	42	0.5%
Niobrara	CO/WY	767	8.7%
Permian	TX/NM	4,485	50.7%



Focus Interval Thickness ~200 feet



It's The Matrix – and We See the Code!

Algorithms Aren't Just for Your Life Savings, They've Invaded 'Research' and 'News Articles', Too

I came across an article on the Yahoo Finance website a week or so ago, authored by *Simply Wall St*. It seemed quite detailed, with specific information about insider selling at TPL. It explained how such activity can shed light on the alignment of management interests, and how differences between insider buying and selling patterns can also be revealing.

On a granular level, it noted how, during the past year, "the biggest insider sale was by the insider" Maurice Meyer. That's an odd way to phrase it – an "insider" sale by an "insider." Also odd because he was TPL's Chairman, but was referred to simply as Mr. Meyer. Particularly odd because it failed to mention that he was the *only* insider to sell shares.

The article noted that Mr. Meyer sold a total of 1,500 shares. It did not mention that his 73,000-share position, worth over \$40 million, was 365 times greater than the 200 held by the next-largest insider.

The author calculated that Mr. Meyer sold his shares below the current price. "As a general rule we consider it to be discouraging when insiders are selling below the current price." That rule of thumb with respect to such sellers, the author went on to write, is because it "suggests that they were happy with a lower valuation."

Here's the thing. If I hadn't wondered at the weird awkwardness of some of the wording, if I hadn't been particularly familiar with Texas Pacific Land Trust, I wouldn't have known that Maurice Meyer was gravely ill in November 2018, when that sale took place, that he resigned three months later in February, and died in March. I wouldn't have known that, because



The screenshot shows the Yahoo Finance homepage. At the top, there's a search bar with the text "Search for news, symbols or companies". Below the search bar, there are navigation links: "Finance Home", "Watchlists", "My Portfolio", "Screeners", "Premium", and "M". The main headline is "Trade Alert: The Of Texas Pacific Land Trust (NYSE:TPL), Allan Tessler, Has Just Spent US\$302k Buying Shares". Below the headline, it says "Simply Wall St" and "Simply Wall St. October 9, 2019".

Texas Pacific Land Trust Insider Transactions Over The Last Year

Over the last year, we can see that the biggest insider sale was by the insider, Maurice Meyer, for US\$573k worth of shares, at about US\$576 per share. That means that an insider was selling shares at slightly below the current price (US\$612). As a general rule we consider it to be discouraging when insiders are selling below the current price, because it suggests they were happy with a lower valuation. However, while insider selling is sometimes discouraging, it's only a weak signal. This single sale was just 1.4% of Maurice Meyer's stake. The only individual insider seller over the last year was Maurice Meyer.

Over the last year, we can see that insiders have bought 900 shares worth US\$548k. But they sold 1500 for US\$877k. Maurice Meyer sold a total of 1500 shares over the year at an average price of US\$584. You can see a visual depiction of insider transactions (by individuals) over the last 12 months, below. If you want to know exactly who sold, for how much, and when, simply click on the graph below!

If you like to buy stocks that insiders are buying, rather than selling, then you might just love this [free list of companies](#). (Hint: insiders have been buying them).

Insider Ownership of Texas Pacific Land Trust

Another way to test the alignment between the leaders of a company and other shareholders is to look at how many shares they own. Usually, the higher the insider ownership, the more likely it is that insiders will be incentivised to build the company for the long term. From our data, it seems that Texas Pacific Land Trust insiders own 0.2% of the company, worth about US\$9.8m. We do generally prefer see higher levels of insider ownership.

What Might The Insider Transactions At Texas Pacific Land Trust Tell Us?

The recent insider purchase is heartening. But we can't say the same for the transactions over the last 12 months. We're not thrilled with the relatively low insider ownership and the longer term transaction history. But we like the recent purchasing. I like to dive deeper into how a company has performed in the past. You can find [historic revenue and earnings in this detailed graph](#).

If you would prefer to check out another company -- one with potentially superior financials -- then [do not miss this free list of interesting companies, that have HIGH return on equity and low debt](#).

he was, sadly, putting his affairs in final order, there was absolutely no investment valuation content in that sale.

The only conclusion I can posit is that this article was written by a computer algorithm that collected the raw data from an SEC database, then sequenced the data according to a pre-determined format, and from some grab-bag digital folder then attached stock phrases and generic commentary to the various data points. Because any human being who so much as glanced at the filings themselves as well as at the exceedingly few TPL press releases at that time, which included notices of his resignation for health reasons and of his ultimate passing, would have understood all of this immediately.

Wait, there's more. "From our data, it seems that Texas Pacific Land Trust insiders own 0.2% of the company, worth about USD\$9.8 million. We do generally prefer see *[sic]* higher levels of insider ownership." OK, a couple of things...

- First, Maurice Meyers's 73,000 shares were 0.9% of the company, not 0.2%. The reason for the discrepancy in the article is ***because he died***, and is therefore no longer a reporting party.
- Second, any human being reporting on the company could not have failed to notice the avalanche of articles, press releases and SEC filings about the very colorful proxy battle between a group of long-term shareholders with a roughly 25% stake and the remaining two trustees. Whether one might consider such long-term shareholders, whose interest is arguably ideally and almost solipsistically aligned with, um, shareholders, to be akin to insiders or not (the Trustees referred to them as Dissident Shareholders), surely this would have been a front-and-center item in an article about insider buying and selling.

So here we have a machine – or software or app, as you like – presenting what appears to be a piece of public reporting investment research, yet which is not research, merely some statistics incorporated into paragraph form rather than a table.

It also purports to be written by an analyst or reporter, presumably to lend an air of expertise and judgment, fostered by first person wording like "We do generally prefer see *[sic]*..."

It also, after having demonstrated its investment value, invites the reader to "not miss this **free** list of interesting companies, that have HIGH return on equity and low debt."

Yes, that investment list of interesting companies appears to be free. What is it worth? Should you click on the link? In which case, what is the near-zero fee on a large-cap stock index worth? Clearly, nearly-free, algorithm-based investment funds are quite popular. Perhaps they offer the same value as algorithm-based research articles.

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Past performance is not indicative of future results. The information contained herein is subject to explanation during a presentation.

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