COLBERT
INVESTMENT
MANAGEMENT

Annual Letter 2018

*** As an update, please note that our stock portfolio composite is now beating the markets, up strongly in January 2019. Our bond portfolios are doing well too. ***

> *"I think once in a while the market needs a trip to the shrink (psychologist); in the real world things fluctuate between pretty good to not-so-hot. But in the (stock) market things go from flawless to hopeless. And in the fourth quarter, the people who were unworried for the first nine months of 2018 became petrified and now (in January) they're unworried again."*
> *—Howard Marks - January 31, 2019*

Why were financial markets so volatile in 2018?

Although the U.S. economy had been humming along, some concerns began creeping up, with suspicions that some of the growth in the 1st half of 2018 was due to companies buying substantial inventories before the Trump tariffs became effective. Secondly, the potential impact from the U.S administration's trade war posture translating into more actual action were weighing on markets. Thirdly, European economic growth was slowing to a trickle, while China had begun to reduce leverage (debt levels) in their system, thus slowing to fast economic growth (from *very* fast growth).

IMF forecast of GDP growth for 2019 (revised)

USA 2.5% (from 3%)
Euro area 1.6% (Italy 0.6%)
China 6.2% (from 6.6%)
World 3.5% (from 3.7%)

In addition, the Fed (U.S central bank) was keeping its promise of gradually raising interest rates to more normal levels <u>and</u> taking other hawkish (more conservative) actions. Markets also began worrying that after republicans' electoral losses in November 2018, Trump would increase his nostalgic economic rhetoric just to please his backers. The fact that widely respected and effective leading members of the Trump administration preferred leaving (rather than play along with what they viewed as bad policy for America) added to those worries. And when some big companies like FedEx started saying that there was a real slowing down in their businesses, all those worries and concerns coalesced into more people wanting to sell than to buy. As is often the case, selling begets selling, with fears of an imminent recession invading investors' minds.

There were some actual yellow flags of potential weakness ahead which might, in the wrong circumstances mentioned above, lead to a recession. However, the only *red* flag was the emotional reaction to the selling activity in markets, selling which was normal market action to start with, which lead to more investors selling just in case the worst might happen. Therefore, even though there was some change in economic conditions happening, in reality there was no need to panic (but many people did anyway).

> *"The market is not a weighing machine, on which the value of each issue is recorded by an exact and an impersonal mechanism, in accordance with its specific qualities. Rather should we say the market is a voting machine, whereon countless individuals register choices which are partly of reason and partly of emotion."*
> *—Graham & Dodd, Security Analysis*

Volatility is normal and expected in financial markets. Many good investments are made when downward volatility pushes prices to levels that not only reflect the current or prospective reality but to price levels that even exceed pessimistic scenarios. Many bad investments are made when everything is going well in markets because price levels reflect an ongoing positive environment and such prices levels thus exceed realistic scenarios or probabilities.

What is different this time is that financial markets have seen unusually low volatility in the last few years. So although it can be a little scary to see markets drop at a fast clip, it's actually normal during most years because human behavior drives us to view markets as from flawless to hopeless in a short period of time. That's what happened in 2018, smart optimistic people became anxious and sold, leading other smart people to be anxious and sell, repeat.

> ***Anxious*** *l adjective l Experiencing worry, unease, or nervousness, typically about an imminent event or something with an uncertain outcome.*

The US economy was doing very well indeed, and there was no sign of a pending recession at the time. Although markets were signaling worries that a recession may be happening soon, the most recent employment reports show the US economy created over 300,000 new jobs in the months of December 2018 and January 2019. In fact, since 2010, the economy has created 200,000 new jobs per month on average. Those millions of new jobs created means things have been going well for a long time.

While the markets may eventually be right that a recession may happen soon (nobody knows the future), the current economic situation is still positive overall. Many companies are doing much better than their current stock prices are indicating. Over time, stocks tend to reflect the underlying company's actual business performance.

The results of our stock portfolio have been disappointing, in two ways: the absolute results, and the results compared to the stock market in general. We had strong performance from some investments, but not enough of those. On the other hand, some investments cost us in performance.

With the underperformers, we have two categories:

1) Errors of analysis for example, where the intrinsic value of a company's assets has been gradually consumed or eroded by bad management exacerbating business losses over the years (Sears Holdings);

2) Cases where companies' stock prices declined *in spite of* appropriate management decisions, because profits did not meet expectations, or because the markets believe that immediate potential risks outweigh apparently improving business results.

We have more companies in the 2nd category than in the 1st category. This is important because in this 2nd group good business decisions have often been made, and are starting to show in operating results, but markets are not yet convinced that perceived risks have been removed or mitigated. For me, these business improvements over several quarters reinforce my confidence that the decline in price of these securities in particular shall be reversed in the short or medium term (Tenet Healthcare).

We also have a lot opportunity cost within a 3rd group of securities whose stock prices increased, but not as much as they deserve. In this group we have a great potential to continue gaining (GCI Liberty).

In the past we have had other negative periods, often when the stock market in general declined due to cyclicality, sometimes when other market indices were better performing than us. My approach to invest in stocks whose prices is lower than the intrinsic value of the company is called “value investing”. This implies that we don’t often invest in “sexy” companies, those with high growth, and whose share prices are quite high, stocks which usually are grouped under the heading of “growth investing”.

In the last two years, the companies falling under the category “growth” in general have gone up a lot, while those in the “value” category generally declined.

Recap

The past year did not go as expected in several ways. At this time last year, much of the world was in synchronized growth mode. It changed slightly in the summer of 2018 whereby growth was mostly good in the US and China, with Europe beginning to show slower growth. We finished the last quarter with investors asking how much is growth slowing around the world, and if we might even see a recession some time in 2018?

Note that lagging economic indicators still show quite positive momentum overall. It’s just that question are being asked about the year ahead, and the answers will only come slowly as we enter 2019.

In the months ahead many companies which have remained silent during the traditionally slow holiday period will be making commentaries about how their respective businesses are doing, and if their outlook for 2019 remains as previously expected, or has changed in any way.

As we get this feedback, we will be in better position to determine if these are just normal market volatility, or need to make more adjustments. At his point it’s too early to tell with certainty, but we will have more clarity as facts come through over the next few weeks.

In the meantime we have been making some adjustments to make advantage of the market volatility. When markets sold off with many stocks dumped indiscriminately, we used some of the cash we had strategically set aside before markets dropped to establish new positions in cloud-computer companies grabbing a larger share of business technology spending like Amazon, Microsoft, and Alphabet (Google). We also increased our holdings of Caesars Entertainment, Dish Network, Lions Gate Entertainment and Platform Specialty Products (renamed Element Solutions). These seven stocks gained an average of 15% in January compared to 8% for the S&P 500 Index.

Last year I highlighted Charter Communications, the 2nd largest cable TV/Internet provider in the U.S whose business was in the midst of a multi-year investments to modernize its recently acquired peers. My view was that Charter shares were cheap in early 2018, and when the markets would recognize how much their cash flow would increase in the years ahead because of lower normalized capital expenditures, we would be richly rewarded. We were not: Charter shares dropped 15% in price in 2018 (N.B.: Charter is in the 2nd category of underperformers described earlier).

On January 31, 2019 Charter announced that they were going to expend $7 billion in capital expenditures for 2019, almost $2 billion less than in 2018, pushing Charter’s stock price up 14% in one day! With this huge resulting boost to annual cash flows expectation, it appears the market has now turned the corner in appraising Charter. We are in position to be rewarded with our patient ownership of Charter.

Conclusion
Based on concrete business observations, I am confident that the investing cycle will come back in our favor, almost like trusting that gravity keeps our feet on the ground. I fully expect the return of prosperous years for our stock portfolios. Early results show promise with our stock portfolio composite now beating the markets, up strongly in January 2019. Our bond portfolios are doing well too.

Sincerely yours,

Karim Armand
President

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