Sankala Group

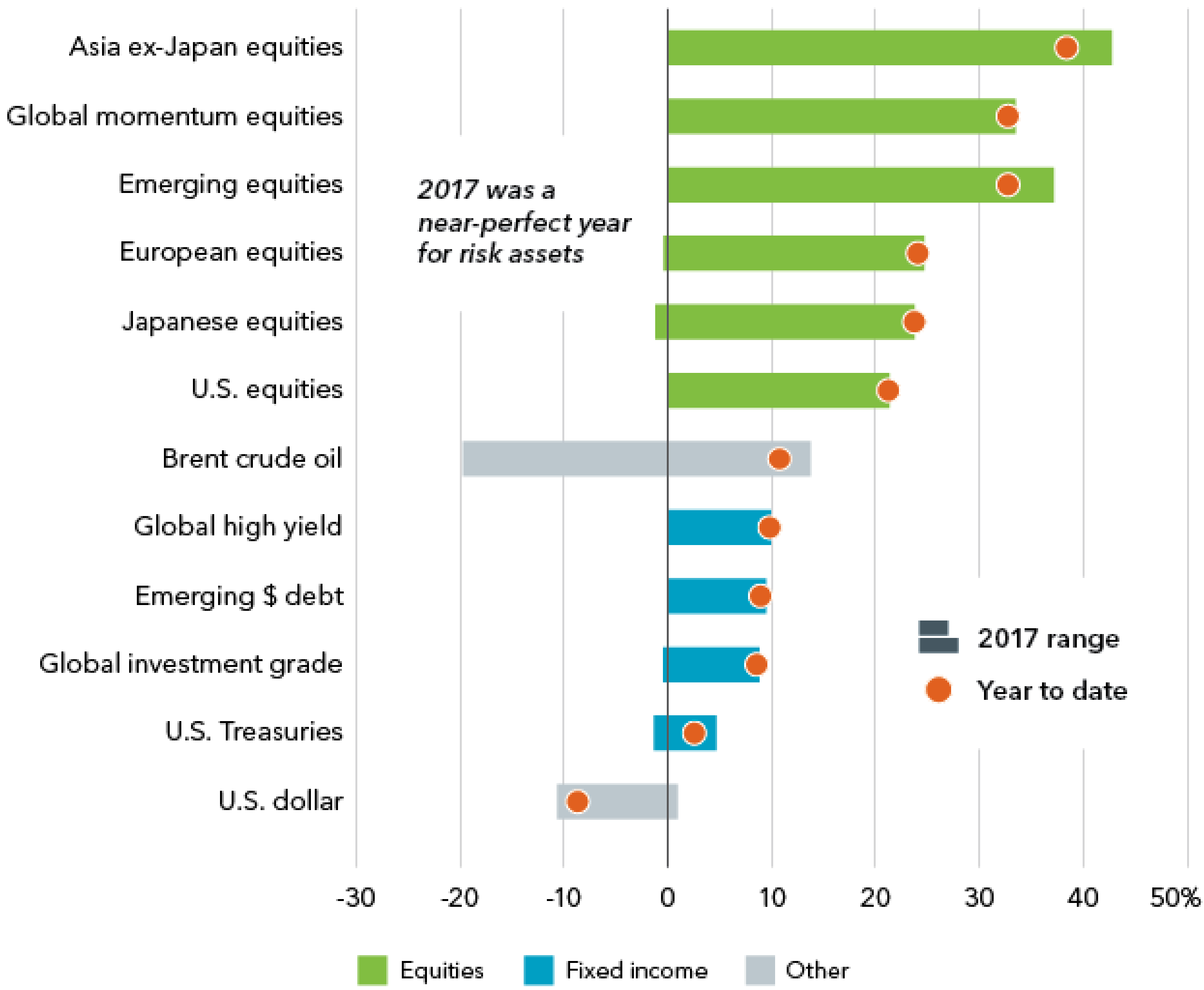
Real News

by Harold Hallstein

More than ever before, I'm finding solace reading financial news. That feeling isn't driven by the content itself, but through a sense that what I'm reading can actually be verified. Verification is uniquely comforting in 2018.

Finance is a remarkable field because we develop hypotheses using science, art and psychology—and then we get undeniable feedback from markets on the quality of our hypotheses. This process is deeply fulfilling because it demands constant improvement in many skill sets.

Below you will see real news in our field for 2017. It can't be denied; it can't be argued. In fact, everything you have read this year has been some form of spin on the development and evolution of these factual outcomes. Looking at it wholesale should help you un-spin it, and give you a clear view of how markets have changed.



Source: Bloomberg News

Asia and the emerging markets were at the center of the action, logging 35%+ gains. Amazingly, only two major asset classes made trips into negative returns during the year; crude oil and the U.S. dollar. Oil managed to recover and closed the year up, but the dollar didn't recover and closed the year down. Stocks in the United States, even while driven by corporate tax reform, notably lagged Japanese, European and emerging market equities.

Also interesting is that we start 2018 with nearly every asset class pinned near 52 week highs, with the exception of the dollar which is near lows, and emerging and Asian equities, which have undergone small recent corrections.

For all the media focus on the FANG stocks (Facebook, Amazon, Netflix, Google), the real story was developing in Chinese large-cap technology firms. Below you can see the FANGs in blue and the TABJs (Tencent, Alibaba, Baidu, JD.com) in red.

Every name on both lists outperformed the S&P 500 by a country mile, with Chinese firms Alibaba and Tencent particularly outperforming by two county miles, both more than doubling in price.

Tencent now comprises 9% of the Hong Kong stock index I prefer, and which I still think is undervalued. Sadly, we have not participated in Alibaba's performance due to the Hong Kong exchanges' ban on dual share class listings. While that ruling prevented us from participating directly in Alibaba, it is a case of us actually getting what we asked for when we decided to invest in China via Hong Kong. Hong Kong's exchange is highly disciplined and precludes the listing because cofounders Jack Ma and Joe Tsai carry privileged shares giving them management control without the same economic ownership. We don't like that in the same way that we don't like dual share classes in the United States.

When we buy ownership of a company we expect economic and voting interest in equal amounts, and we don't want to be complicit in giving license to technology firms to create privileged shares. It is simply bad for corporate governance and accountability—and a major factor in the disappointing behavior we are seeing in the "techbro" culture in Silicon Valley. I'm happy to leave a few bucks on the table over the issue, Quixotic or not. Perhaps the next funding crash for technology firms will more permanently rectify this misplaced entitlement.

Regardless of the individual stock details, our Hong Kong index fund was up 34.5% in 2017. Our dividend focused emerging index fund was up 25.7% and our newly selected fundamental value emerging markets index fund was up 26.7% for the year. Our Vietnam index fund (which we started selling and seeking a replacement for due to issues related to foreign ownership caps) recovered strongly throughout the year, rising 38.8%.

Those who have followed us for some time know that we have a special interest in Asian equities, which extends into general emerging market investment. We have been early to this trade, and we think it will ultimately be a massive shift in global capital. In 2017 the fundamentals really started to take shape. The dollar remains weak despite recent interest rate hikes from the Federal Reserve, and the valuation gap remains very large despite the strong performance. Buying into assets that are already up 30%+ may feel like chasing momentum, but in this case we are firmly grounded by the relative value of emerging markets compared to lofty valuations in the rest of the world.   We think we are looking at only the second of nine innings for emerging markets over the next decade.

Thomas has also articulated a convincing argument for why emerging markets are better prepared for an environment where inflation returns to the U.S. economy. Due to the lack of slack in the jobs market and Trump's decisions to unroll tax reform when the economy is already strong, we may see some inflation. The timing of the tax deal bothers the vast majority of economists who agree a better approach is *counter cyclicality*, which saves such measures for times when the economy actually needs stimulus. Emerging nations have dealt with higher rates of inflation for decades, and are less likely than the United States to see dramatic effects in funding conditions if interest rates keep trending higher.

One other area of the market I'm interested in is preferred stocks. Preferred stock, as a part of the capital structure of a company, is less secure than bonds but more secure than common stock. The preferred shareholder gets a higher tax-advantaged dividend payment which feels more like an interest payment due to its size and regularity. The company is not allowed to pay anything out in dividends to the common stockholder until 100% of the preferred dividend has been paid. Currently, a broad basket of preferred stocks pays ~5.5% in dividends.

While 5.5% is below our long-term requirements for general equity investment, we are in a unique environment of high valuations in the U.S. stock market. Specifically, the operating earnings yield in the S&P 500 was 4.75% in 2016 and will very likely be down closer to 4.5% for 2017 when all final numbers are submitted. In a simplistic analysis we should ask ourselves, "Why would I buy the higher risk of common stock to yield 4.5% (assuming the companies paid out all of what they are earning in their core business,) when I could buy more secure preferred shares which are paying 100bps (1%) more in dividends?" In principle, such an arrangement would allow preferred investors to collect an outsized share of the company's economic benefits during a period of weakness for corporate profit growth.

Those offering the counter-point to this view will say you just need to look at the crash in 2008 to see that with preferred stock you buy too much downside risk, while capping your upside. Statistically, they will show you that returns in preferred are low relative to their historical volatility, pointing to a measure of risk called the *Sharpe* ratio designed by Nobel Laureate William Sharpe.

I would respond by demonstrating that the data they are using is not a valid sample. It is too short and runs right through the banking crisis of 2007/2008. The majority of preferred stock is issued by banks, giving the results sector specific qualities. I don't think the next crisis will be centered on the banks the same way the last one was, so a material adjustment should be made for this bias in the sample.

I think we are seeing something in this market that other market participants haven't thought deeply enough about, and there may be safer and more plentiful return available here than available in the common stock market for the next couple of years. We want to own these assets before the rest of the world realizes they are not bad—just out of style and misunderstood.

Have a wonderful start to 2018, and thank you for your ongoing confidence. Keep us posted on anything and everything you see that is underappreciated!

Best,

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