
The following is an adaptation of a January investment letter Unio Capital sent its clients.

We believe we’re in a panic, not a bear market

As investors, our partners at Unio have experienced between us every correction, bear market, panic, and flash crash since 1982.

Our collective experience and market knowledge tell us that what has been happening since January 1st is a panic. Panics feed on fear and reverse once a contrary reality intervenes.

Panics, like flash crashes, start unexpectedly, decline in a vortex based on false premises, and upsurge suddenly and quickly. The upsurge following a panic occurs when reality disproves the false premise. But unlike flash crashes, panics tend to resolve more slowly (usually weeks) because it takes time for perceived problems to be tested against, and ultimately disproved by, a more-benign reality.

Bear markets are totally different. Bear markets typically decline in phases, not a vortex of sudden negativity. They typically involve complacent confidence being shattered by worse-than-feared realities. And bear markets typically take time to exhaust sellers and find a bottom (no sudden upsurge).

The vortex/upsurge and perceived problem/more benign reality patterns of panics are impossible to forecast before they happen. But once they do happen—as they did in January—the best policy is not to go in the direction of the panicked crowd when the facts don’t support it. The best policy is to do the opposite: take a deep breath, hold onto your investments, take advantage of the downturn to rebalance weightings in the portfolio, and put new money or additional capital to work.

Conviction investors

We are, and have always have been, conviction investors. As conviction investors, we make clear decisions based on experience and knowledge. We ground all our decisions, as we have for years, in a thorough understanding of the individual companies we invest in complemented by a systematic understanding of the macro environment. We avoid trends, fads, and the much more common tendency today of reducing every investment view to macro themes alone (themes not validated by on-the-ground knowledge of facts about companies and other economic data). Conviction investing has never let us down. In the end, the fundamental reality about companies and the economic and financial world always win.

Two stocks that show how panics work and reverse

Two stocks we own—Fastenal and McGraw-Hill—illustrate how panics unfold and reverse. In microcosm, they provide a template for how a portfolio as a whole can act as a panic vortex morphs into a post-panic upsurge. We cite them for illustrative purposes only not as recommendations.

Fastenal is a $4-billion-in-revenues world leader in the sale of industrial supplies like fasteners. In the first 20 days of January, it saw its stock price decline ~16%. This was based on fears that its earnings over the next year would be impaired by an industrial slowdown. When Fastenal dispelled these fears with an announcement that its January sales were healthy, the stock price went up +30% in the following 31 days. In one day alone (February 4th) the stock was up +14%.
Hedging in a panic is not a sound strategy

If you believe you are entering a prolonged bear market, increasing hedges significantly (or holding cash) makes sense. If however, you believe you are in a panic, hedging essentially is an exercise in timing the markets—something we believe is next to impossible to do consistently over the long term.

In both the case of Fastenal and McGraw-Hill, we have seen how quickly the panic mindset can reverse. Had one sold either stock, or hedged against its decline, one would have missed single-day rallies of +14% and +10% respectively followed by persistent appreciation in the prices of each stock.

Fastenal and McGraw-Hill are sobering examples of just how easy it is to lose money unwinding hedges after a sudden upsurge manifests itself (or reinvesting if one has sold the stocks and buys them back). By extension, the same costs can hit a portfolio as a whole, as excessive hedging or cash-raising with the well-intentioned idea of protecting against a panic can permanently cost that portfolio as hedges are unwound or cash is put back to work after a sharp upsurge.

The problems people are pointing to

But what about the big problems people are talking about?


To most of these questions, we have given answers in the past few written pieces, and we have investigated all of them. Our answers boil down to this: the world has had a set of serious problems for the past 9 years that it is working through and will continue to work through for the next couple of decades. But we don’t see any of these problems exploding into a crisis now or in the near future. About the only imminent conventional problem we’re flagging is a somewhat elevated wage inflation rate in the US that might accelerate the Fed’s interest rate increases. And the only unconventional threat we’re always flagging is a terrorist or cyber threat.

Fundamentals are actually ok

Almost all individual company, economic, currency, and financial data and news that has come out since January 1st and that we track validates what we’re seeing: problems in the world, yes; crises in the offing, no. Even the most negative investment commentators like J.P. Morgan’s trading desk are now changing their bearish tune.

In addition, the very high quality companies we own or have in inventory are going from strength to strength. We will repeat what we’ve said before: if the fundamentals change, we will change 180°. Factually, however, the big issues haven’t changed meaningfully one way or the other since the start of the year despite extreme pessimism.

The facts on China devaluation

One issue on the minds of many is the fear of Chinese devaluation. Despite massive short-selling by a number of hedge funds and lots of negative rumors being circulated, the Chinese Yuan has stabilized. The recent spread between the Yuan in Shanghai (6.5335 to the USD) and in Hong Kong (6.5359 to the USD) is very small—exactly the opposite of

Figure 2 – McGraw-Hill Stock Price (12/31/15 – 02/26/16)

Fastenal and McGraw-Hill are two of several stocks we own that have acted this way in January and February. The pattern is the same: a panicky decline in companies’ stock prices based on the false premise that their business results will be impaired. When that premise is dispelled by the reality of the companies’ results, the stocks reverse course. That’s the panic vortex/upsurge at work.

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what bearish hedge funds have predicted. Moreover, on February 13th, Governor Zhou of the People’s Bank of China made a rare and unequivocal commitment to currency stability that further stabilized the Yuan and settled world equity markets. Most important of all, weakening the Yuan significantly would undercut the restructuring policy China’s leadership is backing and, with lots of back and forth, is effecting. A lower Yuan would drive exports and lower rates in domestic China, putting more income into the hands of exporting and domestic business at the expense of the consumer. Yet the end-game of China’s restructuring program is to do the opposite: shift more of the GDP into consumption and less into business, especially capital investment.

The facts on US corporate earnings

There is a fear circulating that the US is headed for a corporate earnings recession. So far, in Q4 2015 earnings reports, over 80% of S&P companies beat earnings estimates. Ex-energy, Q4 EPS and revenue growth are each up +1%—better than expected. In Europe, ex-energy, revenue and earnings growth are up +4% and +7% respectively—better than expected.

We have participated so far this year in over 80 conference or management calls, mostly with companies we own or are otherwise follow. The vast majority met or beat expectations. 2016 outlooks were generally as we expected and, where they were not, the shortfall was modest.

But what about the fact being reported by Bloomberg that estimates are being reduced for the first quarter for many companies in the S&P at twice the pace of the past 5 years? Some of those cuts are about coming to terms with reality in stressed sectors like energy. Another part of the cuts is trimming revenues, and thereby profits, to account for the continued drag of a strong US dollar on the foreign business of US corporations. A third part relates to companies whose earnings are organically slower than expected.

Should any of this worry us? Of course it’s better to have earnings estimates going up. But the real question is: are any of these reduced estimates that sign of serious danger rather bumps in a road going to a good place?

Energy earnings are deeply cyclical and, in our view, the healthiest among them are at, or close to, a cyclical bottom. A few cuts in this sector are practically irrelevant after the big earnings damage that has already been done.

Cuts because of a strong dollar are also not a serious reason to be concerned. We’ve said before that the evidence points to the US dollar getting close to, or past, its peak in relation to many major currencies. The dollar drag is an old (and discounted) story. The next news will be the beginning of the reversal of the currency drag.

As to companies whose business is organically slower than expected, there definitely are some. In cases we’re familiar with, shortfalls are typically not changing the medium and longer-term case for the company, though because of hair-trigger psychology of this market, the slightest deviation from expectations can cause major stock damage.

All in all, the facts show that there is a pretty large subset of companies that is doing well and that, for rest, earnings sloppiness does not indicate a general malaise or a collapse just ahead. If we had to put a label on it, the earnings slowdown has the markings of a “pause that refreshes” rather than “the end of the line.”

On these and many of the other investor worries cited earlier, bearish interpretations tending toward the calamitous are simply not borne out by the facts.

Our interpretation of the pessimists’ views

Despite decent fundamentals, the bears really do believe that doom is around the corner. If they’re wrong, what accounts for the intensity of their convictions?

Global problems

One part of the answer is that there really are a collection of large problems in the world. In that we agree completely with the pessimists. One could argue, they are simply extrapolating those problems into full-blown crises waiting to happen. We, on the other hand, see these problems as contained and largely understood. We also give much more credit to the positive developments that are occurring alongside them.

Slowing bull market

A second part of the answer is that equity market returns really are slowing down. In that we also agree with the pessimists, but with a difference. The pessimists believe that an abrupt and major bear market right now will be part of what produces low returns. We see the equity bull market slowing but elongated. And we see no compelling evidence of, nor any reason for, an abrupt and major bear market now, just as all the world’s governments are pulling in the opposite direction to keep the business growth engine humming.
Along with many of the world’s top asset allocators, we do see fixed income and equities over the next decade entering a period of low returns, where a 60/40 equity/bond portfolio invested in standard indexes might earn +4% per year plus or minus 2%; and where an equity index like the S&P 500 might return +6% per year, plus or minus 2%. But low returns for the broad market are a far cry from a bear-market disaster.

In fact, for stock-pickers like ourselves, low returns ahead are paradise because we get rewarded for finding investments that stand out from the market averages and do much better. If pessimists should fear anything, they should fear bonds. We do. Bond prices and yields stand at 34-year highs and lows respectively.

Still fighting the last war
There is third part of the answer—the most important part in our view. Pessimists, we believe, are falling into the age-old trap of fighting the last war. By that we mean the fallout from the worldwide 2007–09 financial crisis and its antidote, 2008-to-the-present ultra-loose global monetary policy.

These past 9 years have taught pessimists two lessons: 1) get out of the way of massive hidden macro dangers related to overleverage (like the sub-prime crisis of 2007–09 in the US); and 2) look for the macro response from the authorities that will signal a time to buy and make money. The pessimists believe these lessons apply today all over again, with China’s and emerging markets’ overleverage taking the place of sub-prime debt.

In these letters to all of you, starting in 2012, we have warned about China and emerging markets. We have anticipated problems earlier than most. However, it’s the wrong lesson to conclude, as many pessimists do, that “here we go again”.

As close historians of the markets, we can say with a lot of conviction that people—and institutions—really do learn lessons. The evidence is pervasive that authorities (governments, centrals banks, supra-national agencies, etc.), as well as investors are so aware of out-of-left-field dangers, especially debt-related, that they are being preemptive in not letting problems like China’s debt or its unbalanced economy get out of control.

And we believe the pessimists are making another “lessons-of-history” mistake. Just because the 2007–09 crisis and 2009–15 antidote periods were big “macro moments” in the history of investing does not mean investing will be driven by more macro moments. The problems we cited earlier—China hard landing, US recession, European bank fragility, etc.—are all macro problems that pessimists are looking at as the triggers for a repeat of 2007–09. But, in all cases, we believe that the factual evidence does not support these problems as “about-to-explode” macro moments.

A stock-picker’s world to the foreground

In fact, the evidence we look at, plus our long experience as investors in all kinds of markets, suggests that macro issues are fading from the foreground to the background of what’s going on in markets. Taking their place is new importance on being able to distinguish between individual securities, i.e. stock picking.

The most critical piece of evidence we see in favor of this view is the increasingly greater differentiation in how companies are treated by investors. If they do well, their stock prices do very well. If they do badly, prices do very badly—a break from the trend of central bank easing lifting all boats. Positive company results have outsized positive impacts on stock prices as illustrated above by Fastenal and McGraw-Hill. Negative results have the opposite. This is happening not only in our funds but in the S&P 500, Germany’s DAX, Japan’s TOPIX, and other major indexes. In short, investment selection is having more and more impact relative to macro-moment identification.

Given the fact that so many investors now exclusively invest through ETFs and other packages of securities where the rationale for investing has to be some broad macro theme, there is a larger body of investors than ever that has no clue how to pick securities. Even if they wished to change, the experience, skill, and talent required to pick securities well is not easy to come by. It is a skill of the very few, not the many. As a result, if security-picking is becoming the foreground activity of investing in the coming decade, as we think it is, ETF investors are likely to find themselves very frustrated as they try to find macro themes to drive short or long positions. The panic we have written about here is an attempt to scour the world for just such themes.

We can’t tell you when and how the current panic will end. It will end though—more likely in weeks not months. Cool heads and patience is all we need.

What the chart below shows going back to 1987, is that when panics reverse direction, they do so sharply. Vortex becomes upsurge in a relative blink of an eye. And the biggest money is made (and hedging losses avoided) at the very beginning of the upsurge—which is why it pays to invest into a panic and stay invested through the whirlwind.
What owning stocks with intensive research behind it is telling us

A last, key point: our view that we’ve been going through a panic is grounded in a foundation of deep, company-specific research. We comb through our companies every day – those we own, those we’re investigating. We have proprietary valuation systems that take into account mountains of company data and our up-to-the-minute assumptions. We talk to managements, competitors, suppliers, service providers. We kick tires. In most portfolio companies, we have a long investment relationship, in many cases spanning two to three management generations. This company-specific intelligence adds enormously to our confidence in our macro and market views.

We are always adding to our research on these companies including all-important research into their business models and how these may be changing. We continuously compare them to alternatives we have in inventory. We also routinely re-examine these companies’ weightings in the portfolio. A company’s weight is a key to its portfolio contribution. We rebalance these weightings back to their targets whenever they go meaningfully above or below. The preponderance of our time is spent on these kinds of security-specific tasks.

We cite this investment work to make the point that at ground level we see no reason to panic. We feel incredibly positive about the quality and future cash-flow earning power of our companies. We feel very confident that we’re being conservative in how we value these companies.

And despite all the talk of overvaluation in the market generally, we also see no current impediments to finding the underappreciated, under-researched or misunderstood among these great companies—just as we did with Microsoft in 2012 when it was regarded (incorrectly) as a has-been growth company out of synch with the times, rather a company repositioning itself to return to its productivity-enhancing software roots. And we have other 2012-Microsofts under management and more under investigation.

So despite horrible market declines and one dire pronouncement after another, we see a panic that will reverse itself not an imminent bear market – whether we put on our top-down macro hat or our bottom-up stock-picking hat.

As Warren Buffett has said, you make money by looking at the players on the field, not at the scoreboard. One gets results on the scoreboard from what one does on the field—in our case, what our companies do, and what we do with our companies. Getting distracted by the scoreboard while it’s flashing “panic” announcements, takes one’s eyes off the very playing field that will change the score. Especially good advice to keep front and center today.

Sincerely yours,

John A. Allison
Chairman & CEO