HEARD FROM CLIENTS

ARE YOU WILLING TO WALK INTO A BURNING BUILDING AND WRITE A CHECK?

In general, we feel it's pretty rare for investors to have opportunities to make outsized returns. Doing so typically requires you to "walk into a burning building and write a check." We use that phrase with clients all the time because we think it captures the feeling of buying into a falling market quite well. When the market is crashing and people around you are panicking, it can feel like the craziest thing in the world to talk about pulling money from safe investments and investing in the very thing that is falling, but in many cases, that is exactly what you should do.

Warren Buffett once said that as an investor it is wise to be *"fearful when others are greedy and greedy when others are fearful."*

HOUSTON, 1987: A CASE STUDY

In 1987, the country was in the midst of the savings and loan crisis, and the Houston economy had plummeted. The apartment complex down the street from where I was living had been converted into condos and was more than half empty. Still, the owners of the complex were asking $80,000 for a 2-bedroom unit on the second floor with a view of the parking lot, and rumor had it that the developer had gone bust.

About a year later, a young woman moving to the area let me know she had bought one of the condos for $14,000 at a foreclosure sale. She laughed and added that she probably could have paid for it using her credit cards. Several thousand "credit-card condos" were sold at auction over the next few years. In fact, over the next five years, thousands of foreclosure sales were held all across the country.

Before all those auctions got rolling, however, a California real estate developer cobbled together funds from friends and bought as many half-empty apartment complexes and foreclosed condos in Houston as he could. His average purchase price was approximately two years of rental

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income. Other wealthy families and eventually larger institutions quickly caught wind of this opportunity and prices rebounded, but not before the developer had purchased some 40,000 units. He is a great example of someone who benefitted by walking into a burning building and writing a check.

When we think about Warren Buffet, the take-away from his famous statement is that **valuation matters**, and it matters more than you might think. This is true for most asset classes. Even though many investors are generally hard-wired to stay with the herd, we know that if valuations are high when compared to history, investors shouldn't expect relatively high returns in the future. Many investors rely on the good returns of the most recent few years to justify the prices they are willing to pay. And, many investors capitulate when valuations are lowest because they can't stomach the losses. But often, the best opportunities exist when valuations are lowest.

We teach our clients that you cannot successfully time the markets. That said, investors can often take advantage of mispriced assets.

So how do you know when to walk into the building? Start by adjusting your thinking, viewing market corrections as potential buying opportunities. As an example, we typically use March 2009. If you listened to any major news network around that time, you may have heard that the financial system was on the verge of collapse and that we all might be going back to the barter system at any moment. Although it wasn't clear that the worst days of the liquidity crisis were behind us, investors who had the confidence to remain in the market through the crisis fared well, and those who chose to invest at this point did very well.

We believe that there are two key ways to conquer fear of investing in times of a downturn. First, you need to look beyond the moment. Remember that we all still need food and places to live and that those key facts can provide excellent indicators of where to find returns. Second, invest the time to learn about the valuation drivers for each asset sub-class. There is nothing that dilutes fear as much as knowledge. Having the facts and data to make an informed decision gives you the confidence and conviction you need to enter into a distressed market.

Finally, remember that the next market crisis (or opportunity) will likely look very different from the previous ones. For example, if you're looking for an opportunity in high-yield credit because it performed well after the last downturn, you might miss an opportunity in bank loans or master limited partnerships ("MLPs"). Allow yourself the freedom to search for opportunities and react to what the market has to offer.

CASE IN POINT: EXAMPLES OF MISPRICED ASSETS

Master Limited Partnerships

From their lows in January 2009 through May 2014, oil prices had been rising, but in May 2014 they started to fall, and they fell quickly. As oil prices dropped, the price of midstream natural gas MLPs also began to fall. What does the price of oil have to do with the prices of pipelines that transport natural gas? Answer: not as much as the market seemed to think. Yet, prices for midstream MLPs continued to fall until January 2016, when the price of oil finally bottomed. This wasn't the first time that this mispricing had occurred. In June 2008, oil prices peaked at over $150 per barrel. As the price of oil fell to the mid-$50s per barrel by January 2009, the price of midstream MLPs dropped by more than 50%, despite the fact that most of the midstream MLPs were forecasting increased distributions in the coming year. In both of these instances, and in four other cases dating back to the mid-1990s when oil prices dropped significantly, the price of midstream MLPs followed. Yet, in each case, the prices of midstream MLPs recovered quickly because their earnings and distributions had less to do with the price of oil than many investors realized. Investors who understood that this was a case where MLPs were mispriced were able to reap the rewards by buying midstream MLPs in early 2009 and again in January of 2016.

High Yield Bonds

The option-adjusted spread on high-yield bonds reached 250 basis points ("bps") in June 2007, and by December 2008 it widened to almost 2,200 bps. In the dark days of the Great Recession, almost all forms of credit instruments were deeply discounted. Investors were spooked, and the Federal Reserve and U.S. Treasury were taking unprecedented steps to add liquidity to the banking system. Investors who were willing to take the risk of buying lower grade bonds were well rewarded for doing so. Spreads tightened by over 1,500 bps within the year. For a portfolio with an average duration of seven years, a 1,500 bps spread tightening equated to a gain of almost 100%. This phenomenon had occurred previously. In fact, when high yield spreads exceeded their U.S. Treasury equivalent by more than 650 bps, investors were generally well paid for the risk of this type of asset.

The bottom line is that there is plenty of opportunity to make outsized returns if you are aware that such opportunities exist and are on the lookout for them. Of course, we recommend you work with an independent advisor who can help guide you through these kinds of investments.

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