Published by SL Advisors, LLC

In Pursuit of Value

November, 2016

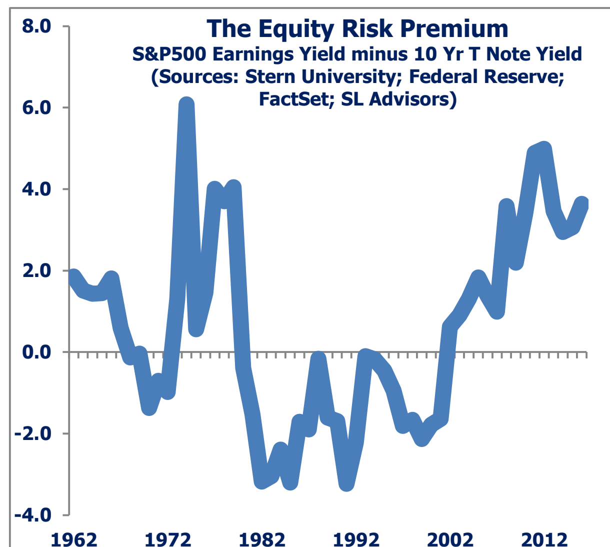
SL Advisors, LLC is a registered investment advisor offering separately managed accounts to individuals, family offices and institutions.

Bonds and Marshmallows

Many teachers are familiar with the Marshmallow Test, first implemented by Walter Mischel on pre-school students in California over fifty years ago. It measures self-control by presenting subjects with the choice between consuming one marshmallow now or two if they can wait fifteen minutes.

It's one of the most famous psychological tests ever created. Youtube has dozens of videos of young children wrestling with delayed gratification. Walter Mischel has come to be known as the "Marshmallow Man". It turns out that the ability to defer a reward predicts subsequent success in life. The spontaneous marshmallow grabbers grow up to be more frustrated, indecisive and disorganized than those who pass the test. Pre-school self-control predicts later self-confidence, self-restraint and scores up to 200 higher on the SAT.

Unsurprisingly, parents have been induced to test their young offspring and then fret over the consequences of failing the Marshmallow Test. Naturally, some schools now teach delayed self-gratification. Happily though, this doesn't merely assuage the fears of over-anxious parents; learning the skills to pass this test also develops qualities associated with the natural passers who didn't need coaching.



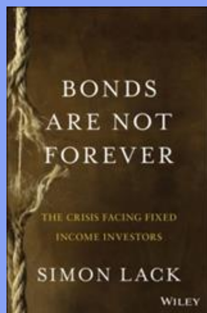
Investing is all about delayed gratification. Consumption today is deferred in exchange for more consumption in the future. As interest rates have sunk ever lower, bond investors are in effect being offered their second marshmallow with an ever greater delay. With the benefits of waiting deteriorating, today's buyers of bonds must increasingly be those who would have most easily passed the test in pre-school. In fact, fixed income investors have become so inured to insultingly low returns that in much of the developed world they not only deny themselves today's marshmallow but agree to give one away. Negative interest rates on German, Swiss and Japanese government bonds are cruelly exploiting the magnificent self-control these individuals evidently showed early in their lives.

Some are concluding that a contest they can't win must be rigged, and moving to stocks. They are abandoning the certainty of a sliver of marshmallow far in the future and seizing the probability of a better outcome even though it carries with it the possibility of a worse one.

We are a couple of weeks into earnings season, and FactSet is forecasting -0.3% year-on-year earnings growth for 3Q16 among S&P500 companies. For 2016 as a whole they are forecasting no growth. This is mainly because Energy sector earnings are -73%, without which 3Q16 would be +3.3%. Financials is the best performing sector with 7.8% earnings growth expected.

More importantly, Energy looks as if it will stop being a drag on S&P500 earnings starting next quarter, at which point a run of six consecutive quarters of lower earnings should end. Bottom up forecasts of S&P 500 earnings (i.e. based on adding together estimates for each of the 500 companies) tend to be more conservative than top-down ones which rely more on macro-economic forecasts. 2016 looks to be around $118 per share, the same as last year. This puts the S&P500 at a multiple of 18X. This multiple drops to 16X based on next year's (bottom-up) forecast of $133, a jump of over 12%.

SL Advisors, LLC focuses on investment strategies that provide income without relying on fixed income securities.



Depending on your interpretation of the Equity Risk Premium, stocks either look cheap on this basis, or not. Surprises are invariably what precede sharp falls in stocks. They're impossible to predict, but we do believe that the Federal Reserve will not provide a negative surprise on interest rates. Low rates are the solution to too much debt, as described in *Bonds Are Not Forever*. Regardless of the explanation, monetary policy is clearly being executed in a way that acknowledges such.

We receive so many warnings before the Federal Reserve ultimately doesn't raise rates that it's safe to assume they'll tell us when they're about to. And while it's possible inflation could one day surprise to the upside, leaving the Fed scrambling to catch up, we highly doubt they'll be surprisingly pre-emptive.

Ten year treasury yields are close to the 2% dividend yield on the S&P500. But dividends grow whereas interest payments don't, which is why we calculate that the return on $100 in ten year treasuries can be replicated with only $16 in stocks.[1] A barbell portfolio split 16/84 between stocks and cash would only lose 8% if the S&P500 lost half its value. It would take less than a 1% increase in rates to inflict a

[1] Assuming (1) 5% annual growth in dividends, the 50 year average, (2) unchanged Federal tax treatment of qualified dividends, capital gains and interest income, (3) unchanged yield on S&P500 in ten years, (4) unchanged short term interest rates

similar 8% loss on the bond investment. They're not equally likely to happen. This is the basic case for avoiding bonds in favor of higher returning assets combined with cash.

Interest rates continue to be the most important driver of investment decisions. The Equity Risk Premium reflects relative valuation. The recent drop in bond prices exposes how little valuation support yields provide. Those patient bond holders willing to wait ever longer for a marshmallow are finding there's nothing very sweet after all.