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A good framework for thinking is physics,
this sort of first principles reasoning.
What I mean by that is boil things down to their
fundamental truths and reason up from there.
- Elon Musk

During my career I have had the good fortune to work closely with and learn from individuals who have built large amounts of wealth. Serving as their financial advisor through ups and downs in the economy and booms and busts in the financial markets has allowed me to observe first-hand how successful wealth builders evaluate opportunities in good times and bad. These longtime clients have involved me in their investment decisions spanning a wide range of assets, from real estate and private businesses to stocks and bonds. One of those extraordinary people passed away earlier this year and since her death I have been thinking a lot about what she and other wealth builders have taught me during my twenty-three years in the investment business. The more I thought about the highly successful wealth builders I have worked with, the clearer it became to me that their approaches were founded on essentially the same principles. This struck me as fascinating given that they share virtually nothing in common except great wealth building success. Their backgrounds are different in terms of geography and education. Some were born into poor families, others into wealthy ones. One grew up in a small town and did not graduate from high school; another was raised in a major international city and earned an advanced degree from one of the world's most prestigious universities. Their attitudes differ, in some cases dramatically, about almost everything from politics to religion. In fact, they are profoundly different from one another in nearly every way except in how they make investment decisions.

Looking back, it is apparent to me that my work with successful wealth builders has influenced my thinking far more than my education in economics or my professional investment training. These clients have served as mentors and helped shape my personal philosophy on both investing and life. In thinking about the common elements of their approaches, I have identified five principles that I believe drive their decisions. As I share these principles, you will probably notice that they are, for the most part, common sense. Still, they are widely ignored by investors and somehow excluded from standard investment industry advice. In closing this letter I will attempt to apply a few of these principles to the current investment environment, highlighting several issues that I think investors should be concerned about today.

The first principle that I have learned from working with successful wealth builders is: capital is a precious resource and protecting financial strength is paramount. In my experience, wealth builders have a different attitude towards money. They do not feel the need to do what everyone else is doing. Their mindset is that money should be deployed thoughtfully with an eye to the future. Without exception, they abhor waste. They view money in much the same way a wise person views time— as a precious and limited resource. This mindset is a way of life rather than a sacrifice; successful wealth builders enjoy a sense of purpose in their frugality and derive more satisfaction from investing (and giving) than from consumption.

While speculators are often so confident in their vision of the future that they borrow and bet, wealth builders prefer to hold some cash back for a rainy day. They are more focused on preserving financial strength than making a big score. Financial institutions may promote low borrowing rates and easy terms but the wealth builder prefers to be his or her own bank. They understand that without capital set aside to weather tough times there is a risk of getting wiped out by the next big storm. In a recent conversation one wealth builder put it this way: “As an investor my capital is to me what a tool box is to a carpenter. Without it I’m out of business.”

The second principle that I have learned from these wealth builders is: invest in what you understand. This may seem obvious, but in my experience this precept is violated time and time again by the vast majority of investors. People invest in things they do not understand for many reasons, including deference to expert advice, diversification, reaching for yield, chasing performance, and good ole wishful thinking. All investments have downsides but they are not always easy to spot; this may explain why opportunities you know very little about are often more alluring than ones you know well. In my experience, successful wealth builders recognize that there is a lot they do not know and steer clear of situations where their knowledge or experience is lacking. They are especially quick to pass on the hot idea of the day, including high yielding investments that are complex or untested.

Wealth builders do not take comfort from diversifying across investments they do not understand. Standard industry advice is to allocate assets among many different investment categories— different company sizes (large cap and small cap); different investment styles (growth and value); different geographies (domestic and foreign). The successful wealth builders I know, however, are skeptical of the value of these labels and question the notion that safety can be achieved simply by spreading money around.

One especially successful wealth builder who has spent his life in the tire business has owned more than a dozen tire related companies. Another successful investor has accumulated more than 250 rental units in a single town— the town he has lived in most of his life. Understanding an investment to these wealth builders is primarily about understanding how the asset generates income and having a strong sense for the long-term sustainability and growth of that income.

This brings us to the third principle of wealth building: invest in assets that generate income. Income, from the perspective of the wealth builder, is the cash flow generated by an asset after expenses. This is often different from the amount distributed in the form of dividends or interest. They know that yield alone can be deceptive— a company earning 50 cents per share may distribute a dollar in dividends (double what it is actually making) or, at the other extreme, pay no dividend at all. The company paying out a dollar may be headed for trouble while the company paying out nothing may be reinvesting cash flow to fund expansion of its highly profitable business. Wealth builders know to look beyond payout and examine the sustainability and growth of the underlying asset's cash flow.

In my experience, the successful wealth builder understands the power of compounding and believes that the effective reinvestment of income is the surest path to building wealth. If they own shares in a profitable and growing chain of retail stores, they prefer that management use cash flow to open another store rather than pay a dividend. They will readily forgo 50 cents today if it means they are likely to collect a dollar in the future. To these wealth builders, investing is about accumulating assets that generate a sustainable and growing stream of income and wealth building is driven by the effective reinvestment of that income. I can recall a conversation I had many years ago with a client who amassed a small fortune investing in bank stocks. When I called him eager to share the news that one of his banks was being bought out for a 20% premium, he was clearly unimpressed by the jump in share price and focused instead on the fact that he was being forced to exchange shares that represented a dollar in earnings for shares in a new bank that represented only 75 cents in earnings. I was 24 years old at the time but I can still hear his voice: “Son, prices are fickle; income is what you need to keep your eye on.” The reinvestment of income harnesses the power of compounding— the mathematics behind wealth building.

Effective reinvestment of income is closely tied to the fourth principle of successful wealth builders: invest with an experienced and trustworthy partner. Wealth builders invest only when they have confidence in the person responsible for day-to-day operations. They buy farmland if and only if they can partner with an expert farmer who will manage the land productively. They are only interested in buying an apartment complex if they can bring in a trustworthy property manager. The wealth builders I know place more confidence in honest, hardworking people than in forecasts or sophisticated financial modeling. They steer clear of people with grand ideas and choose instead to partner with experienced individuals who sweat the small stuff.

Most professional investors have financial backgrounds and naturally put a premium on financial metrics—ratios, valuations, projections and the like. The wealth builder knows that those things mean little without the right people to drive results. Good partners have “skin in the game” and are typically diligent rather than brilliant. They discuss risks and problems frankly with a focus on solutions as opposed to blame. They approach problems with keen interest and energy— not as burdens, but as challenges to be expected and overcome. Good partners do not waste time dwelling on the past or prognosticating about the future; they are squarely focused on what needs to be done now. They project an almost palpable sense of accountability.

A client recently took me to meet the man who farms most of her crop acreage. The farmer showed me his equipment: some of it was new, some of it was old, but all of it was squeaky clean and ready to go. His son demonstrated the new technology that they use to maximize productivity during planting and harvesting. The farmer talked about different chemical applications they were experimenting with in an effort to overcome resistance that weeds had developed against older pesticides. The client owns the land, the farmer farms it and they split the harvest. They have a mutually beneficial partnership. The wealth builders that I know believe the person responsible for running an operation is critical to success whether they manage a farm, a five employee retail store or a publicly traded conglomerate. The right person and the right incentives are a powerful combination.

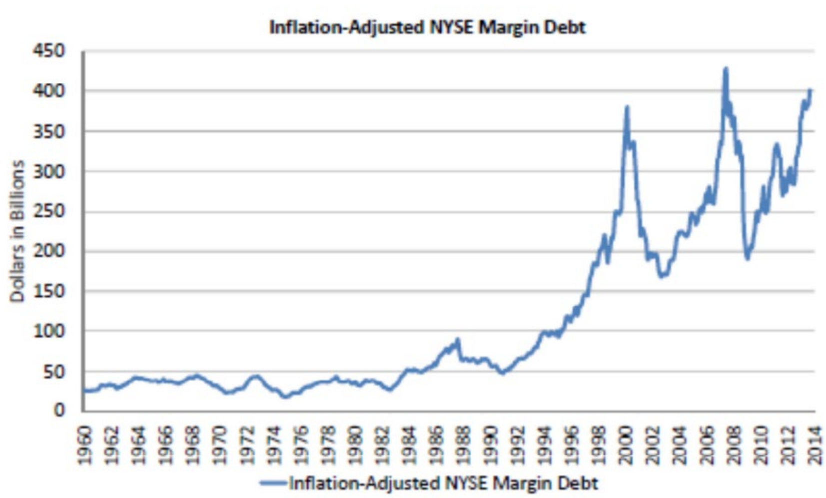
This leads us to the fifth principle of the successful wealth builder: bad times present great opportunities. Distressed selling by those who overbought in the last boom creates opportunities for those with capital when times are tough. The successful wealth builder is just as skeptical of predictions of permanent doom in bad times as he is of forecasts for eternal prosperity in good times. The successful investor understands that while economies and markets are cyclical, progress marches on over the long haul. The wealth builder takes the time to "do the math," comparing price to reasonable income expectations and is a selective buyer after market crashes and during economic recessions and depressions.

My grandfather (also my first client) made his first major investment in 1937 when he and two friends each put in $1,500 cash to buy property near the Ohio River. It was an especially difficult time. The great depression was dragging on and the river had risen to its 1,000-year flood stage only months before. Buying property along the river probably seemed extremely risky and optimistic to most people in town at the time. Fifteen years later, the three friends sold the property for more than $90,000. Another client acquired a ranch in Texas after it was foreclosed on during the savings and loan crisis and real estate bust of the late 1980s. Today that ranch is worth many times his initial investment. The wealth builder with over 250 rental units in his home town acquired more than 100 of them after the 2008 mortgage crisis forced overextended developers and troubled banks to liquidate properties at fire sale prices. In the depths of a crisis the media tends to sensationalize the risks and dangers while pundits debate what went wrong and who should be blamed. The wealth builder, focused on opportunities and recognizing that the crisis is unlikely to last forever, acquires assets that he believes will produce attractive levels of income for many years to come.

My experience in working closely with successful wealth builders over the past two decades has led me to believe that the five principles discussed in this letter are crucial to making sound decisions regarding all types of investments. I also think these principles can be useful in assessing the attractiveness of the overall investment environment. Surveying the current landscape with these principles in mind brings an increasing number of risks to light.

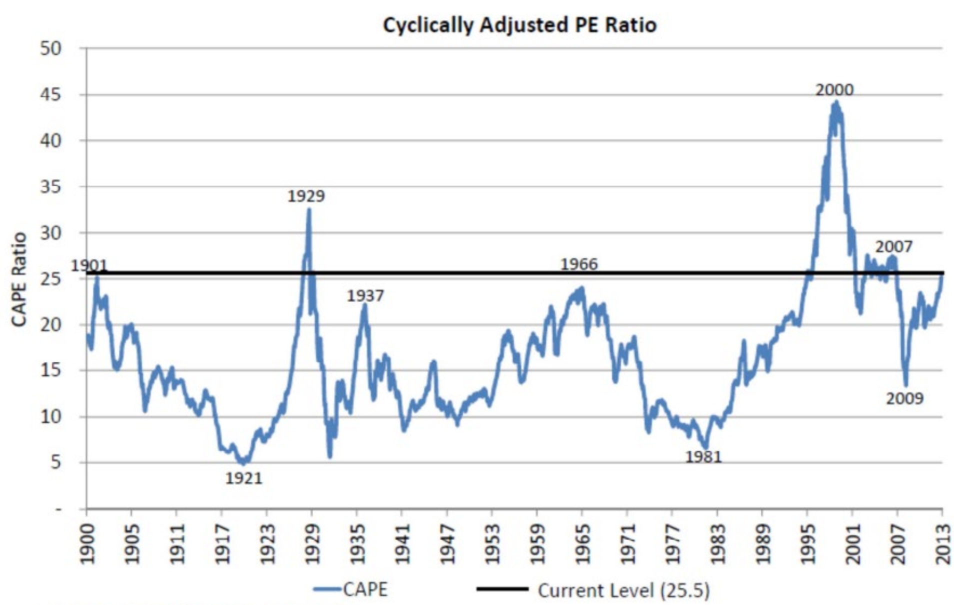
It is clear the market environment has changed dramatically since the Federal Reserve's easy money program began in 2008. The Fed initiated bond purchases at the height of the crisis when stocks were cheap and prices were falling. Major financial institutions were teetering and panicked investors were confronted with the possibility of a Great Depression-like collapse of the world economy. The first round of quantitative easing or "QE1" was an unprecedented attempt to stabilize capital markets and calm investors. In accordance with the bad times present great opportunities principle, it turned out to be an extraordinary time to invest.
Today, as we enter the sixth year of the Fed's zero interest rate policy and bond buying program, the market environment is quite different from the tumultuous days of the financial crisis. Stock prices are up nearly 170% since the lows of 2009; fears of bank failures and economic collapse have been replaced by excitement over new market highs and enthusiasm for hot initial public offerings.[1] Investor sentiment is extremely bullish, with bulls outnumbering bears 3.2 to 1 according to the latest Investors Intelligence Survey. Remarkably, there are fewer bears today than at the market peaks of 2000 and 2007.[2]

Given the heightened level of investor optimism it is not surprising to see increasing amounts of leverage. Margin debt is fast approaching a record high, up more than 70% from the summer of 2010. Previous margin records were set in 2000, just prior to the dot com bust, and in 2007, right before the subprime mortgage meltdown (see chart below). High margin debt suggests that at least some market participants are ignoring the principle of protecting financial strength. In general, it appears that the current situation is marked by aggressive buying— the very opposite of distressed selling— and is a long way from the bad times create great opportunities environment favored by successful wealth builders.



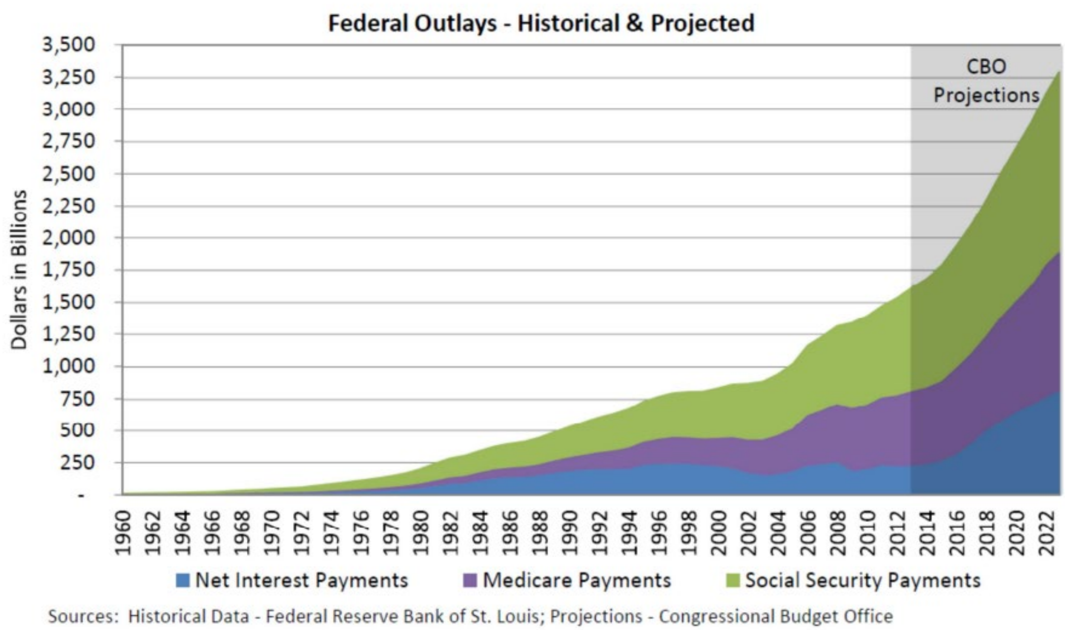
Source: NYSE

While the recent surge in the stock market has investors feeling more optimistic, higher prices mean investors have to pay more for a dollar of future income. The Federal Reserve's policies have resulted in an interest rate environment in which safe assets— savings accounts, certificates of deposits and short-term Treasuries— pay so little that returns after inflation are negative. Investors seeking to maintain their income are being forced to take on more and more risk. Rarely have investors had to pay more for income in the bond market than they do today. With respect to the stock market, income, or more specifically underlying earnings, has also become more expensive as share price gains have been outpacing earnings growth. The S&P 500's Cyclically Adjusted Price-Earnings (CAPE) ratio, a valuation measure based on average inflation-adjusted earnings from the previous 10 years, has recently climbed above 25. This level is higher than that of several major market tops, including 1937 and 1966, and is rapidly approaching the level of the 2007 peak (see chart below). In short, investors today have to pay up to *invest in assets that generate income*.



Source: Robert Shiller (Yale University)

The actions of the Federal government— interest rate cuts, bond purchases, tax cuts, unemployment checks— played a crucial role in preventing the 2008 financial crisis from spiraling into something even worse and, it follows, in creating the market environment investors enjoy today. That is the good news. The bad news is that with the Fed Funds rate at essentially zero, bond purchases continuing at a record pace, and Federal obligations escalating, the Government's rainy day fund looks pretty depleted. Both the Fed and Congress continue to "kick the can down the road" and in doing so seem to be ignoring our first principle of protecting financial strength. If the economy falters or the market stumbles the Fed has no room to cut interest rates. Furthermore, the Government's ability to increase spending and/or reduce taxes is likely to be severely constrained by growing debts and obligations.



In summary, as I look around today, I see high prices for income producing assets and plenty of evidence that investors and the Federal Government are putting the "pedal to the metal." In my opinion, individual investments that meet the criteria of the successful wealth builder are few and far between. Accordingly, I believe this is a time to conserve capital, fortify personal balance sheets, and patiently wait for better opportunities to shake out of whatever market or economic turmoil comes next. Earning almost nothing on the cash portion of an investment portfolio is frustrating but it is important to bear in mind that cash today may prove quite valuable as "dry powder" down the road. The one constant in the investment world is change, and, if history is any guide, better opportunities will come along before too long. I view my job as portfolio manager as similar to that of the farmer hired to manage the client's crop acreage. The farmer cannot predict the weather or future crop prices with any degree of precision but he can bring to bear timeless principles, experience, hard work and an open mind to enhance productivity, especially at planting and harvesting time. In the financial markets the times to buy and sell are not marked by the seasons, but I think the principles discussed in this letter are useful in making decisions regarding what to buy and when.

Phil McCauley III
December 2013

[1] Standard & Poor's
[2] Investors Intelligence Survey

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