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"On what principle is it that when we see nothing but improvement behind us, we are to expect nothing but deterioration before us?" - Thomas Babington Macaulay

Q3 2019 Market Commentary

Dear Fellow Investors,

With today's constant and sensationalized news coverage it is easy to lose sight of long-term goals. Most firms in our industry spend a great deal of time reporting economic figures and stock market returns. We too can comment on economic growth for the quarter and market returns for the year, but feel it is too easy to fall into the short-term, reactionary mindset that causes most investors to fail. As you're probably aware from our previous commentary, instead of obsessing over when the next recession will hit or what will lead to the next market correction, we believe our time is far better spent examining long-term trends we see shaping the future.

#1 - THE WORLD IS BETTER THAN YOU THINK: The following headline could have been written every single day for the past 25 years:

"THE NUMBER OF PEOPLE IN EXTREME POVERTY FELL BY 137,000 SINCE YESTERDAY"

Of course, not one news source actually ran this headline as slow, steady, and gradual progress doesn't grab as much attention as murders, scandals, terrorism, and natural disasters do. Recent work from a group calling themselves the New Optimists shows that "Our prevailing mood of despair is irrational and frankly a bit self-indulgent. We seem to have a tendency towards collective self-abuse and an unwillingness to believe in the power of human ingenuity." They note that humans are wired to expect the worst. In prehistoric days, when you took that first step out of your house it was wise to fear a lion lurking behind every object as being wrong once meant being wrong forever.

In today's hyper-connected world, our addiction to bad news has us obsessed with depressing or enraging stories thereby concluding that the world is much worse than it actually is. This leads to severe biases in our perception that aren't accurate. The late Hans Rosling dedicated a great deal of his life trying to teach people about these biases by creating the Ignorance Project to help identify what the public knows and doesn't know about basic global patterns and macro-trends. Through the creation of numerous quizzes and surveys his findings show that the majority of people in the developed world believe things are much worse than they actually are. Even random guessing would have been more accurate than the actual survey data captured proving how severe our biases can be. To take the quiz yourself please visit: http://forms.gapminder.org/s3/test-2018).

If you don't have a lot of time to review their massive amount of data at least take away some general rules of thumb when it comes to the world:

1. Most things improve
2. The world is rising out of extreme poverty
3. There are more social benefits happening (example: girls being educated around the world)
4. Things we are afraid of happen rather infrequently

There is an illusion in the way we think about progress because the standards are altered over time. Today, we do not like to hear about prisoners being tortured but only because of the recent emergence that torture is bad. During the 1700s torture was a normal part of the criminal justice system in England. Today, we're appalled by the deaths of migrants as they travel to new lands, but only because of the value we now place on human life. It wasn't that long ago that caring about the lives of unknown strangers from distant lands would have been viewed as absurd. Progress is happening like never before. We believe those that are able to recognize this and invest in the human ingenuity powering this progress will be greatly rewarded.

#2 – OUR FINANCIAL MARKETS ARE DOING THEIR JOB

In our last annual letter we expressed concerns about Wall Street's obsession with short-term results causing companies to stay private longer. We even had an example of an up-and-coming, disruptive company (Tesla) wanting to go private to not have to deal with the insane scrutiny and short-sightedness of the public market. We viewed this as a very unhealthy trend for financial markets. Fortunately, we are seeing this trend reverse.

In the past 12 months we have seen numerous high profile companies choose to come public: Uber, Lyft, Levis, SmileDirectClub, Peloton, Slack, Chewy, and Pinterest. The future also looks promising with Airbnb, Casper, and Aramco rumored to be eyeing 2020 IPOs. This is happening in spite of it being easier than ever to raise capital in the private markets. Further, many of these high profile IPOs have not done well after they've come public with several down substantially from their IPO price. Just this past month it was WeWork's turn to be put under the microscope. They were told their private market valuation was out of touch with reality, company leadership needs to change, and they need to show progress towards profitability. They rightfully scrapped their plans to come public and will look to implement these changes before reconsidering coming public.

There are real concerns about Private Equity being in a bubble that are certainly validated when one of the most prominent players in the space (Softbank) is willing to value WeWork at 3 times what the public markets say it is worth. Fortunately, we do not envision a scenario where any of these private equity firms cause systemic issues, as overall allocations to private investments still remain a sliver of what is allocated to public investments ($5.8 Trillion in global private markets versus $46.7 Trillion in worldwide regulated open-end funds as of year-end 2018). ***Instead, we believe the bigger takeaway is that the public markets are doing their job.*** Analysts are balking at companies showing little to no progress on making profits. Even with numerous high profile, high growth companies coming public we are not seeing euphoric investor behavior and outrageous price targets set by analysts. Instead, Wall Street is rewarding a clearly defined growth plan with improvements being made on cash flow generation and profitability.

TO SUMMARIZE – To reiterate our summary from our mid-quarter update, when we examine the U.S. economy we see a lot to be optimistic about – people are working, interest rates are low, the average consumer is in solid financial shape, our financial institutions are in solid financial shape, and rapid innovation can be seen everywhere. Although there are always issues that create fear and uncertainty (Trade Wars, Impeachment, Recessions) we've shown the ability to weather past storms and emerge as a stronger and more vibrant economy. We don't believe the next recession will do anything to change this and urge investors to focus on the long-term. If you recall, numerous investors have been waiting for the next big decline to invest. Do you recall when the last 20% decline was? It was during the 4th quarter of 2018, yet we still hear about how this is the longest bull market in history, overextended, and due to fail. We're not sure how some have completely glossed over what happened last year but do remind investors that 20% declines typically take place once every 7 years. If you're waiting for the next one, you might be waiting a long time.

Sincerely,

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Sources:

The New Optimists: https://www.theguardian.com/news/2017/jul/28/is-the-world-really-better-than-ever-the-new-optimists

Ignorance Project: https://www.gapminder.org/

Assets in public markets (Table 65):
https://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2019/19_fb_table65.pdf

Assets in private markets (Exhibit 7, page 15):
https://www.mckinsey.com/~/media/McKinsey/Industries/Private%20Equity%20and%20Principal%20Investors/Our%20Insights/Private%20markets%20come%20of%20age/Private-markets-come-of-age-McKinsey-Global-Private-Markets-Review-2019-vF.ashx

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