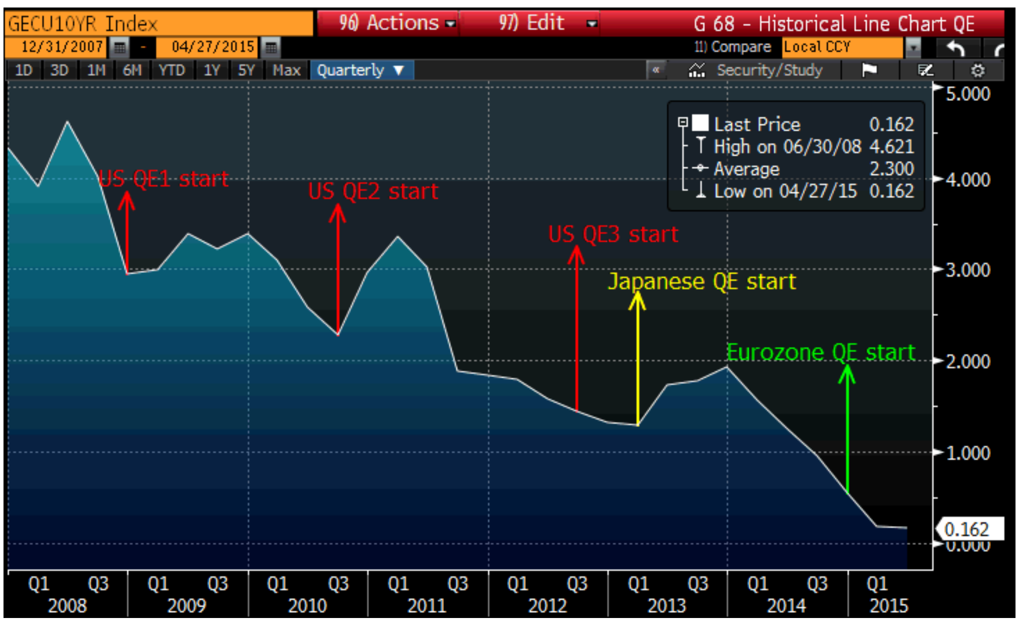
QE and the Low Animal Spirit World

Over the last several years, we've been living in a quantitative easing (QE) world, where balance sheets of major central banks around the globe have ballooned. For example, the Fed's balance sheet went from about $870 billion in August 2007 to $4.5 trillion today. As such, through this distortion, the price of money is getting cheaper by the day. It is not just that we have negative real rates but negative nominal yields in one-third of all European government bond markets! Over half of the 2-5 year European government bond markets have negative yields; the 10 year Swiss hit a low of -0.21%; the 10-year Bund hit a low of 5 bps and seems to be converging to zero. The below chart depicts this trend.

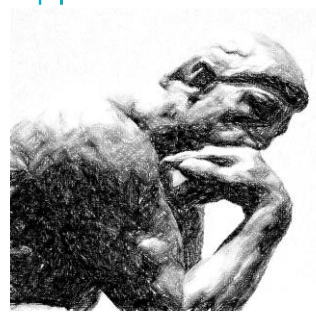
Chart 1: Evolution of 10 Year Yield of German Bund Through QE Programs



Not only governments, but even some borrowers are seeing negative yields. In mid-April, some borrowers in Spain saw mortgages rates fall below zero, which meant the bank owed them money!

This type and scale of coordinated intervention by central banks has never occurred. QE is the largest force in the market; yet no one knows its full effects. There are already some unexpected consequences, such as inducing more savings and less spending. Our search for assets with intrinsic value continues, and as dynamics and investment behavior are changing, we take a look at the some consistent trends we see emerging.

The Thinking Man's Approach



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Ignacio Pakciarz | CEO
Ilina Dutt | Research Analyst

We have been living in a QE world for over 6 years now, and money is getting cheaper by the day. This has unexpectedly induced savings and restricted spending amongst consumers. Corporations are also sitting on mountains of cash, and instead of taking bold action as hoped; they are plagued with low animal spirits. They are putting this money to work - but through M&A activity and share buyback programs – rather than making long-term investments in growth. While this does not create a foundation for long-term growth, it is supportive for equities for the time being. In this month's Thinking Man we discuss these trends in detail as we search for intrinsic value in this challenging environment.

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ideas@bigsurpartners.com

These have come from US corporations with low animal spirits; they are not investing in long-term value, but instead deploying cash with less aggressive strategies such as share buybacks and M&A activity. While this will not create long-term fundamental value, it is supporting equities for the time being.

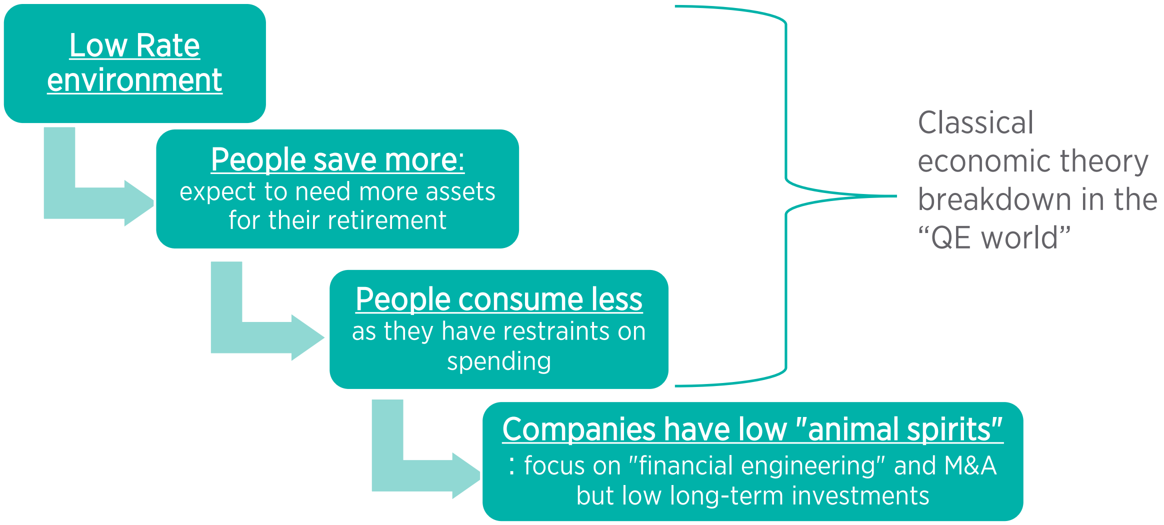
QE is Changing Classic Investment Behavior

QE economics challenges the rules of classical economics, where lower rates encourage an increase in consumption (and a decrease in savings). In the "QE world" and the world of "financial repression"*, lower rates are inducing more savings and less spending. This is a negative spiral which was never was predicted.

Why is this happening? Because savers notice that they need a larger volume of assets to be able to retire and live out of that income stream. In the "QE world" of today, to earn an income of $200,000 per year you need several times more assets (shares of S&P500, a 3 bedroom apartment, a 300,000 sq ft building, any asset with intrinsic value) than in the past. In simple terms, if the risk free rate is at 4%, a saver could have a guaranteed income of $200,000 with a financial net worth of $5mm. If, like in the QE world, the risk free rate is 0.2% a saver needs $100mm. This concept can be applied to any asset with an intrinsic value or yield. Asset inflation makes the expected returns or yields of the asset markets shrink.

Take Japan for example: in the total opposition to what classical economics teaches, low returns actually have made Japanese consumers spend less. The aging population is saving more in order to reach their target amount of assets needed for retirement, and thus spends and consumes less. This had always been assumed to reflect both the demographics and cultural traits of Japan. But that view will have to be revised, as there is evidence of the same thing happening in Europe. Germans are reacting to zero interest rates by saving more. The chain of behavior is demonstrated in Chart 2 below:

Chart 2: QE is creating unexpected consequences



Uncertainty and Low Animal Spirits

Both market and investment behavior have changed in the QE world, with the full consequences and effects still not wholly understood. Where does this leave us? There is no simple solution to investing in this increasingly challenging environment beyond keeping a diversified portfolio of quality assets with intrinsic value. With the QE experiment continually changing investment dynamics, we have been focused on identifying clear fundamental trends that can help direct our search for value in a difficult investment landscape.

Just as QE has investors feeling uncertain about where to allocate capital, we have seen that QE has also been prompting many CEOs to proceed with caution and manage their corporations with lower "animal spirits" – the motivation and confidence to take meaningful positive action. Management teams do not have the incentive to make significant long-term investments, as they perceive uncertainty about the effects of QE and macro-economic backdrop as well as high risks on the geopolitical and the regulatory fronts. Thus, we see corporate leadership asking, "How do we put the cash hoard we've built over the last several years to work in the most efficient manner?" Their attitude becomes one of "grabbing assets" which offer good relative intrinsic value, and we see three clear trends in this respect:

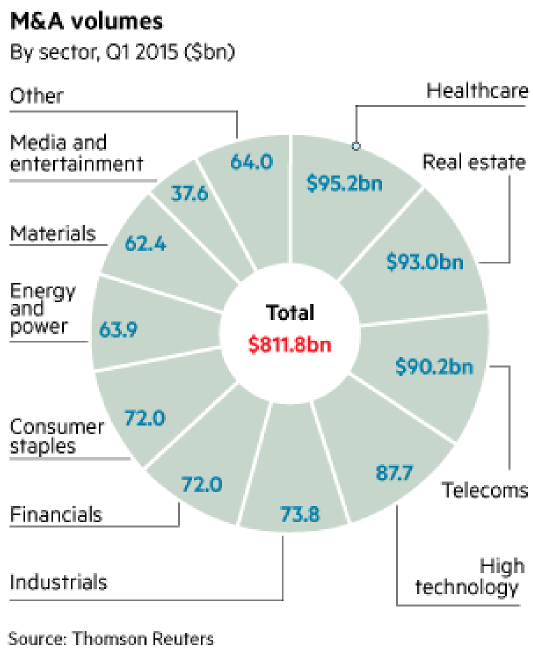
1. Record volume of M&A transactions;
2. Purchasing record levels of their own stock;
3. Increased corporate activism

These trends should be supportive of equities for the near term, even though they are not creating long-term growth going forward.

Record volume of M&A transactions;

Global mergers & acquisitions (M&A) activity during the first quarter of 2015 was at its highest levels since 2007. The value of M&A deals was $811 billion, up 21% over the same period a year ago. The US has been at the center of this, accounting for about

Chart 3: M&A Volumes by Sector Q1 ($B)



half of all M&A activity (US: $399 billion). This figure represents a 30% increase from the same time last year.[1]

The biggest deal of 2015 so far has been Heinz's takeover of Kraft, which will create a company worth $100 billion. The deal was led by Heinz owners 3G Capital and Berkshire Hathaway, who purchased Heinz in February 2013 (a transaction we wrote about in Thinking Man #4).

The sector with the most activity by total value of deals has been healthcare, reaching $95.3B in the first quarter (see Chart 3). Drug makers are desperate for new treatments that can replace the billion dollars of sales they will lose when their patents expire. We saw this play out in March when Pharmacyclics, a cancer drug maker with only a single product to its name, found itself the center of a fiercely contested bidding war amongst Johnson & Johnson, Pfizer and AbbVie. AbbVie came out as the winner in a $21 billion deal.[2]

Source: Financial Times

What does this tell us? Many companies are not confident enough about the future to put their capex to work and reinvest in long-term growth. They do, however want to do *something* with their reserves, and given the supportive M&A environment of growing confidence, stable economy and cheap financing, acquiring quality companies seems like a good option. Analyst consensus is to expect to see more deals going forward as confidence grows given that many companies face fewer opportunities for organic growth.

Purchasing record levels of their own stock

Over the last few years, we have seen corporations increase their participation in share repurchase/buyback programs. As companies continue to sit on mountains of cash, this trend has accelerated; the first quarter of 2015 was the strongest start to the year for buyback programs on record. The value of new share repurchase programs authorized by companies stood at $257 billion.[3] This figure excludes GE's announcement on April 10th that it was authorizing a $50 billion share repurchase program, which ties Apple's for the largest ever announced. At the current pace, stock buyback authorizations are set to total $1 trillion this year, surpassing 2007's record of $863 billion.[4]

Again, this signals that companies are reluctant to spend capex or make long-term investments; however, they are showing confidence in their own companies and helping to provide support for stock prices.

Increased corporate activism

In 2014, shareholder activists, investors who buy stakes in companies and push them to make financial or strategic changes, "cemented their position as a force in US markets and boardrooms."[5] Since the years after the crisis, corporate activism has been on the rise, as there is higher sensitivity

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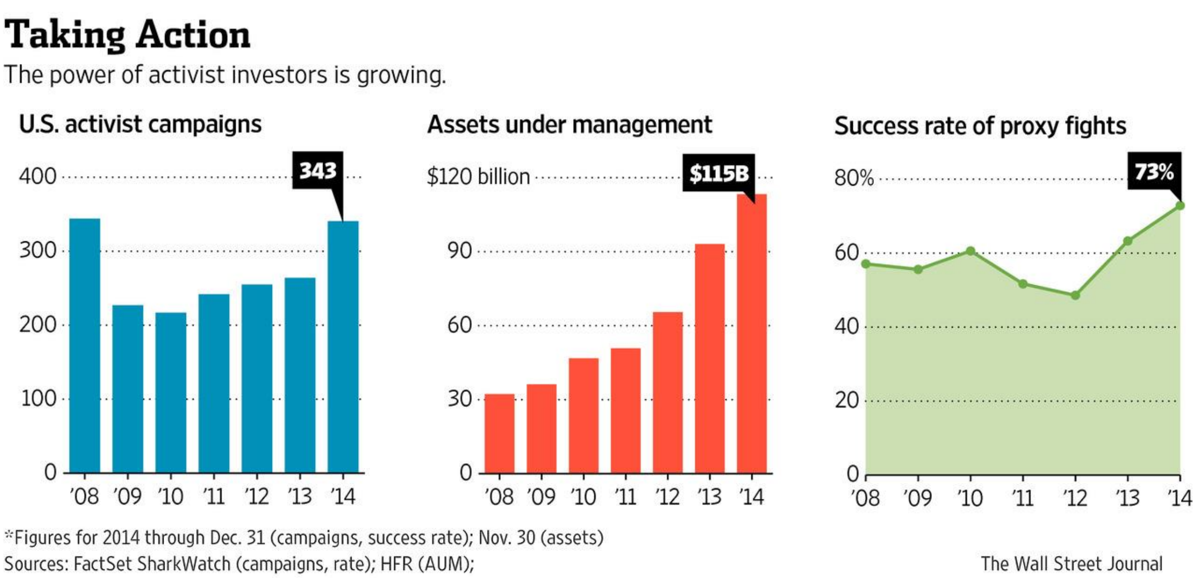
[1] Arash Massoudi, Joseph Cotterill, and James Fontanella-Khan, "Dealmakers have fastest start since 2007," Financial Times 30 March 2015
[2] Arash Massoudi and James Fontanella-Khan, "Halthcare sector leads feverish M&A activity," Financial Times 30 March 2015
[3] Dan Strumpf, "The Buyback Binge Rolls On With Record 1Q," Wall Street Journal 15 April 2015
[4] Strumpf
[5] David Benoit, "Activists Are on a Roll, With More to Come," Wall Street Journal 1 January 2015

to corporate governance, executive compensation and cutting the "excess fat" from corporate income statements.

Increased corporate activism has partially contributed to both deal making volumes and share repurchase programs. With current conditions of cheap financing and the shrinking pool of quality assets, activist investors encourage corporations to increase their deal making activities. In January, US activist fund Starboard Value led Yahoo to spin off its $40 billion stake in Alibaba and also urged Staples to buy Office Depot in a $6.3 billion deal.[1]

Last year, the majority of activist campaigns have focused on encouraging companies to either return that cash to shareholders in the form of a dividend or use it to fund a share buyback program, both of which are positive for equity shareholders. Activist funds significantly outperformed the global hedge funds over the last year: from March 2014 to March 2015, the HFRI Activist Index was up 9.3%, with the HFRI Global Hedge Fund Index only up 0.4.%.[2] Activist funds didn't only perform well return wise: Chart 4 below demonstrates the rise of corporate activism from different angles: the increase by number of campaigns, increasing success rate of proxy fights and finally higher assets under management. If activists continue to act was a "watchdog" for corporate boardrooms they can potentially help companies to stay focused on creating value for shareholders in the future.

Chart 4: Rise of Corporate Activism



Source: Wall Street Journal

Conclusion

[1] David Benoit, "Starboard Pushes Staples-Office Depot Deal," Wall Street Journal 20 January 2015
[2] Bloomberg Data

It is difficult to have strong conviction in this QE world, where the largest force behind the markets has both challenged classical economics and changed markets and investor behavior. However, we try to focus on intrinsic value and good fundamentals. With valuations in equity markets still offering relative value, with Central Banks probably watching stock market prices as a key barometer indicating how to act and with the 3 forces identified in this piece, the US equity market seems to be climbing a huge "wall of worry" and reaching new highs, while "animal spirits" are still quite low.

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