MAKENA STRATEGY INSIGHTS NOTE

Q4 2016

Shell Game: A Case for Active Management in Light of New Policy Proposals

The first three months of the Trump presidency have seen US equity markets continue to defy gravity, driven by much speculation around putative policy changes meant to re-ignite US growth. Hardly a day goes by without another record being broken by listed equities: as of March 14, 2017, for instance, the S&P 500 has gone 105 days without a down 1% day, breaking a 25-year-old record. With much uncertainty still surrounding policy change, markets seem to have focused on the positives whilst ignoring important details that paint a much less optimistic picture. We believe more than ever that in this environment, with more uncertainty than usual given the magnitude of the proposed reforms, active management will be the best approach to preserving the value of multigenerational capital. Last quarter, we showed how the corporate tax cut would not necessarily benefit the aggregate position of US equities, but would rather lead to some sectors benefiting while other sectors would be disadvantaged (most notably, large cap US equities). We also showed how a manufacturing renaissance in the United States coupled with a fiscal stimulus would lead to stronger inflation in the US, again benefiting certain sectors at the expense of other sectors while not necessarily improving the total aggregate situation of the US. This quarter, we turn to two other important aspects of President Trump's policy: the border adjustment tax, or BAT, and the tax deductibility of investment interest. Both reforms are monumental in magnitude – the BAT alone could cost the United States $385 billion in WTO approved retaliation from US trading partners[1]. Like those we explored last quarter, these reforms are not necessarily beneficial in the aggregate but rather shift the relative attractiveness of sectors, again leading us to conclude that active management is the best way to approach the current market.

Portfolio Strategy

We discussed in our previous quarterly letter the unambiguously inflationary aspects of most of President Trump's proposed policies. We surmised that using inflation to address income inequality was a much easier path for President Trump to follow relative to drastically increasing taxes and redistributing income accordingly. There have been two important developments in the policy landscape since we wrote our previous letter: one is the concept of "border tax adjustments," BAT, and the other is doing away with the deductibility of interest expense for corporations. We address both these important topics in turn.

If there is one high level take away from the analyses we are about to present, it is that neither of these policies would represent an improvement for the whole of the economy or for corporations as a whole. Rather, much like the reduction of corporate taxes, these two policy changes would result in benefits for certain sectors and offsetting costs for other sectors. In fact, outside of an outright fiscal stimulus, *all* of the proposed policies we have seen so far mainly involve rearranging the pecking order across sectors rather than an improvement for the whole of the corporate sector. Seen in this light, this policy "shell game" implies that relative value strategies across sectors should be well-positioned to generate strong performance. Importantly, this is exactly the environment in which long short equity strategies *should* flourish. Furthermore, the fact that the markets have rallied so strongly since the election may reflect a hope that actual policy implementation will end up being net positive, which certainly is a possibility. Unfortunately, for now we can only work with vaguely defined proposals until such time as policies are actually implemented. Many political observers have noted that the congressional calendar is so busy that it is distinctly possible that tax reform will not happen until late this year, lengthening the period of uncertainty under which we have to live as investors.

Interest Expense Deductibility – Profound Change in Corporate Balance Sheets Ahead

Over a year ago, in our October 2015 letter, we noted the high and increasing leverage globally across economies, most particularly in the corporate sector. Since that point in time, leverage has done nothing but increase, to the point that now many market observers feel very strongly that leverage has reached excessive levels (based on historical look back) and we are therefore imminently due for a credit contraction/distress cycle. There are two counters to this commonly held view: first, given historically low interest rates, all else equal, the debt carrying capacity of corporations is higher than it was in the past and therefore one should expect higher leverage then historically; second, the absolute level of leverage is a necessary but not sufficient condition to initiate a credit crisis. Indeed, if we look back at historic crises, there usually is a catalyst that precipitates the credit crisis. In the case of the housing bust, one could argue that the catalyst was the collapse of the two Bear Stearns hedge funds in July 2007.

Given central bank activity around Quantitative Easing/ultralow rates, and the lack of any catalysts, waiting for a distress cycle (and the associated highly profitable credit opportunities around such a cycle) has been somewhat akin to waiting for Godot. However,

[1] Peterson Institute for International Economics; Will the Proposed US Border Tax Provoke WTO Retaliation... March 2017

one of the Trump administration proposals – disallowing corporate interest expense deductions – has the potential to severely harm the high yield segment of the credit market, and the equity of companies issuing high yield debt. The intuition behind this analysis is simple: high yield companies issue debt to the maximum of their debt carrying capacity. Embedded in the calculation of debt carrying capacity is a boost to after-tax earnings thanks to the deductibility of interest payments. If that boost to after-tax earnings is removed, the debt carrying capacity of the company has effectively been reduced. We have gone through a painstaking exercise pulling data on a company-by-company basis to calculate the impact that removing interest rate deductibility would have on high yield companies. Figure 3 below shows the results. The effect of eliminating all of the interest rate deductibility at once is tantamount to increasing the leverage in the high yield universe by 60%. Clearly, no policymaker would enact such a drastic and instantaneous change. Most likely, existing debt stock would be grandfathered in to interest rate deductibility, and perhaps the deductibility of interest would be reduced over time for new debt issuance. Unfortunately, because equity markets are forward-looking, once the reduced debt carrying capacity aspect of this new rule becomes clear, one would expect equity prices to adjust down very rapidly.

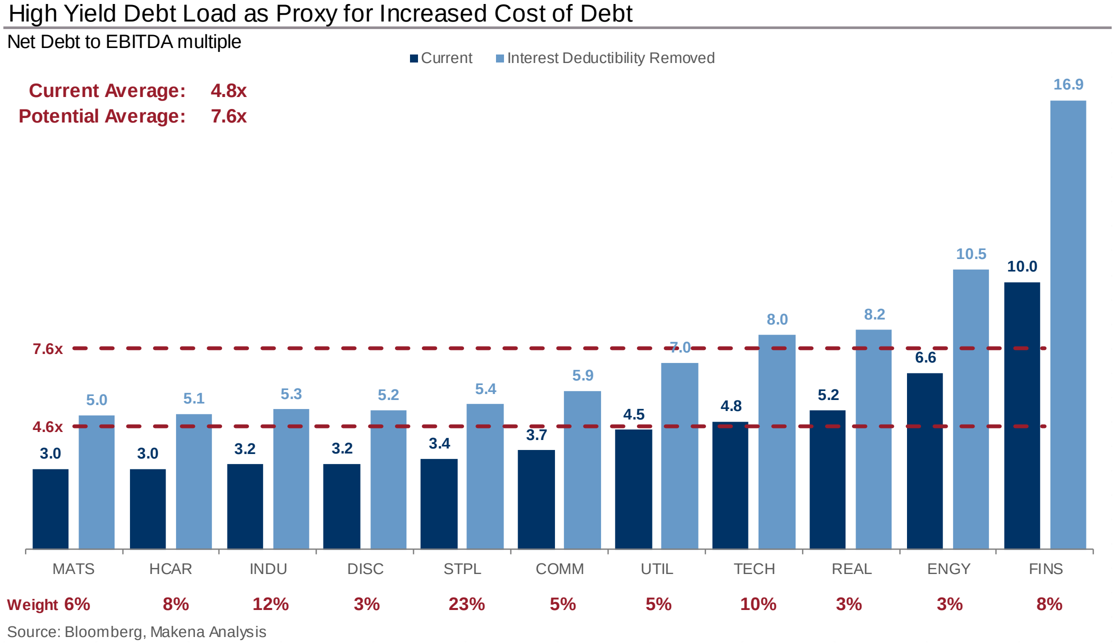

Figure 3: Effective Debt Load Increases by ~58% with Deductibility Removed

Outside of the high yield universe, removing interest rate deductibility would end decades of preferential tax treatment for debt financing versus equity financing. Said differently, the cost of debt for corporations would increase, thereby driving up the weighted average cost of capital (WACC) that companies use internally to calculate their required hurdle rates for capital expenditure projects. Ironically, removing the deductibility of interest would work at cross-purposes to another stated goal of the Trump administration, i.e. increasing capex and manufacturing in the US.

Implications for High Yield Debt

As highlighted above, if interest deductibility is removed, not only would every finance textbook need to be rewritten, US high yield firms would face impairment, the details of which would depend on how the policy is implemented. Grandfathering, staging, etc. would all serve to slow the rate at which defaults occur but a high yield firm would be forced to rebalance its capital structure before rolling its current debt load. This is a tall order given the shorter maturity of most high yield debt. Indeed, the high yield space is likely overvalued excluding any policy changes, given low spreads to Treasuries as shown in Figure 4 below. Finally, as the Fed continues to normalize interest rate policy, rolling over high yield debt will become increasingly expensive even if the policy catalyst never materializes. This alone may be enough to create a low but persistent default wave. Therefore, this specific policy proposal presents a good catalyst to initiate a distress cycle.

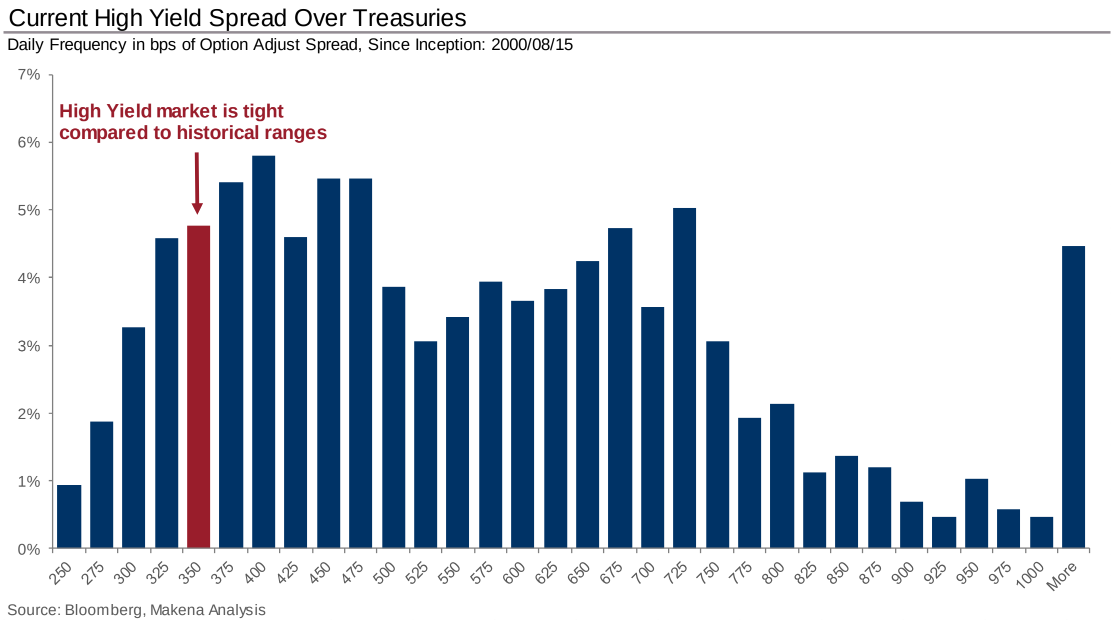

Figure 4: No Room to Run In High Yield

Border Adjustment Tax (BAT) – At Best an Inflationary Export Subsidy that Lowers Living Standards

The concept behind a border adjustment tax is simple: make foreigners pay taxes to the federal government. After all, the most preferred tax is a tax that someone else pays. Specifically, the BAT would tax anything the US imports from abroad (much like a tariff) while simultaneously promoting exports by allowing all revenue derived from exports to be tax-free to US companies. Assuming a 20% corporate tax rate, the arithmetic breaks down as follows: given that the US imports approximately 15% of GDP, the BAT would raise 3% of GDP in new tax; given that the US exports approximately 12% of GDP, the BAT would cost about 2.4% of GDP in export subsidies. As long as the US remains in a trade deficit situation, which has been the case for many years, the BAT would net to an additional 0.6% of GDP in federal government tax revenue, or approximately $1.2 trillion over the next decade. At first blush, this seems like a panacea since it would penalize imports while subsidizing exports, thereby helping to reduce the overall trade deficit. Unfortunately, economics are not this simple. It is very likely that the exchange rate between the United States and those countries from which it imports will change over time, but not enough to fully offset to the tax increase. The result is that part of the tax would be borne by US consumers in the form of higher prices for goods and services they consume. Said differently, the BAT would most likely lead to increased inflation, especially for goods. Such inflation would be particularly difficult for lower-income households that consume essentially all their income on a monthly basis.

Given that the BAT will (at least at the onset) raise net government revenue, the effect at the aggregate level of the economy will be negative. In other words, the total "size of the pie" will shrink slightly. Furthermore, there will be a substantial set of redistributions within the economy, with some sectors benefiting at the expense of other sectors. At one end of the spectrum are high margin, very specialized businesses such as pharmaceuticals. For these types of businesses, the BAT would likely not have much of an impact on US consumers of those goods. The inputs used in making prescription drugs are cheap relative to the finished product, hence the high margins. The input cost increase from higher import prices would be relatively small and could be absorbed easily by the business. Furthermore, services businesses that by definition do not rely on goods would be relatively unaffected by the BAT. Such businesses are on the left side of Figure 5 below, e.g. pharmaceuticals, software, banking, etc. At the other end of the spectrum are businesses that rely heavily on imported components or imported finished goods. Those businesses are highlighted in the red box in Figure 5 and include capital goods (equipment used for factories), automobile assembly, retailing, and energy. Unfortunately, businesses which rely the most on imports also happen to be those businesses with lower margins and therefore the lowest capacity to absorb any type of price change. An example is illuminating: imagine Walmart with its razor thin margins suddenly faces a 20% tax on all the items it imports. Given such thin margins, there is little Walmart could do except pass through nearly the entirety of the increased costs it faces. Recall that the bottom income quartile in the US spends all its income on goods and services, saving almost nothing in the process. This segment of the population will be hit hardest by the tax in the form of price inflation in the retail sectors.

It is not clear that the BAT would help the United States corporate sector in aggregate or the economy as a whole. Instead, it appears to be another "shell game" as we described above where certain sectors benefit at the expense of other sectors. In the BAT case, the domestically-oriented services sector would benefit whereas retail distribution and manufacturing assembly would be harmed, an interesting paradox to the manufacturing renaissance mantra.

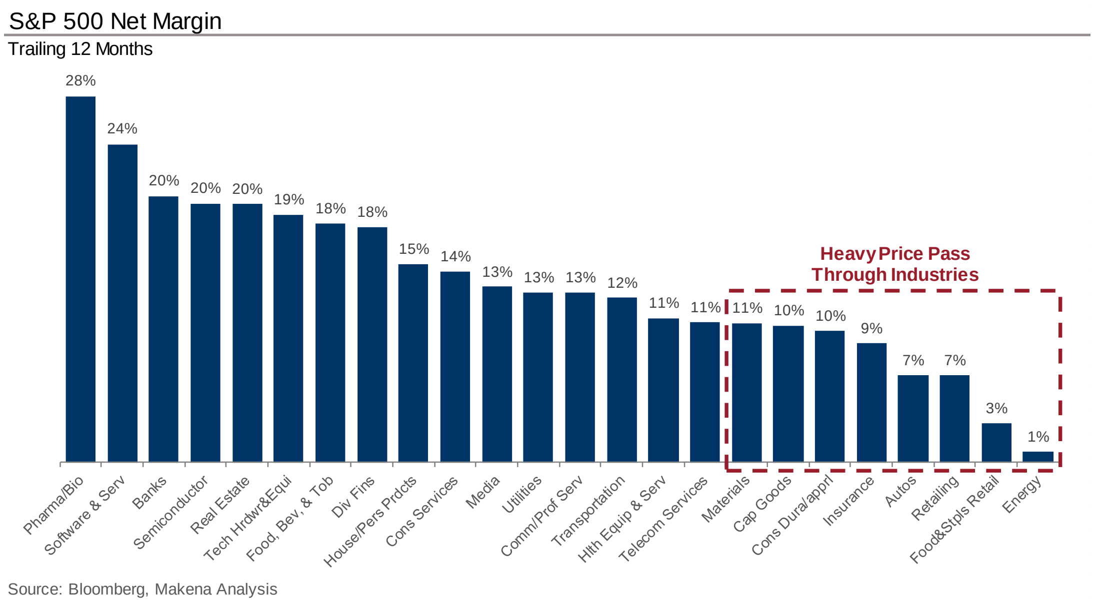

Figure 5: Margins Indicate Who Has Pricing Power

Implications for Equity

Given that the above policies represent more of a redistribution of wealth across sectors versus growth of the aggregate amount of wealth, the implication for equity markets is that headline index growth should not be significantly influenced by these policies. At the same time, given that the relative attractiveness across sectors will change substantially, stock/sector selection and relative value positions will be the name of the game. In other words, active management should be able to perform well in such an environment, with pure beta returns likely to be subdued.

Summary of Investment Strategy

In our Q2 2016 letter, we outlined a series of investment recommendations. Many of those themes remain unchanged, though we introduce some new themes based on an expectation of higher inflation going forward.

i. *Caution over growth companies during the run-up to and immediate aftermath of Fed rate hikes*

   Growth companies will likely exhibit sensitivity to the effects of a rate hike via the P/E multiple. However, in a world of scarce growth, they may be able to attract and sustain higher valuation multiples than they have attracted historically, suggesting that risk is perhaps somewhat muted.

ii. *Similar to (i) above, buy into long-term growth via EM equities*

   Growth *countries* will also likely exhibit heightened sensitivity to the effects of a rate hike. Indeed, many EM markets seem to have already priced-in the effect of rate rises. Moreover, in a world of scarce growth, they should be able to attract and sustain higher valuation multiples than they have historically. Said differently, some EM countries currently represent "growth at a reasonable price."

iii. *Prefer inflation linked bonds to nominal bonds*

   Evidence of inflationary pressures are mounting from a tighter labor market, with a likely boost by government policy as we outlined above. Real rates are likely to rise at the front end due to Fed policy but the impact at greater tenors is unclear at best.

iv. *Similar to (iii) above, buy real assets and commodities*

Many real assets and commodities respond with positive beta to inflation and to surprise inflation, making them helpful investments to protect the buying power of a portfolio. The implicit assumption is that real rates do not rise significantly from here, which given the growth outlook, seems reasonable.

v. *Longer duration vs. shorter duration in Fixed Income portfolios*

Uncertainty over the timing and pace of the Fed hiking cycle is likely to continue to generate substantial volatility in the short end of the curve and potentially less volatility in the longer end. Additionally, should market expectations price a lower growth rate and a lower inflation outlook following a rate hike, we could actually see a rally in the long end.

vi. *Neutral positioning for US dollar in currency portfolios*

Real rate rises would push a currency upward due to improved carry dynamics. However, the current outlook appears more inflationary, which has a mixed impact on currency: carry improves but the buying power for the currency is reduced.

vii. *US small and medium enterprises (including Private Equity) vs. large-caps*

With a strong dollar and weaker commodity prices, the US consumer has more disposable income, thereby favoring smaller domestically-oriented services companies. Potential tax code changes will only accentuate our preference for smaller capitalization domestically-oriented companies.

viii. *Long Europe exporters and periphery intra-Europe exporters*

Thanks to internal deflation across most of Europe, European exporters should see margins continuing to improve. The weak Euro will continue to bolster exports to outside the Eurozone and imports from peripheral Europe to the core as a substitute for imports from outside the Eurozone.

ix. *Long EM reformers vs. laggards (across asset classes)*

Some countries have embraced reforms since the last few crises, implementing flexible exchange rates, minimizing interventions in their domestic economies, and in general fostering an environment where private industry can thrive. These countries should be able to navigate volatility driven by exchange rates and the Fed's moves more successfully than the laggards that have not reformed.

The Partners of Makena Capital Management

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