

## MAKENA INSIGHTS

MAKENA CAPITAL MANAGEMENT

CY2018  
PERIOD ENDING  
December 31, 2018

Dear Makena Investors,

2018 was the worst year in the equity markets since the Great Financial Crisis (GFC) of 2008. For many investors, their best performing asset class was cash. For other investors, including Makena, positive contributions made by private investments in their portfolios helped cushion the blow from public risk-assets. The beginning of 2019 has been a different story as global equity markets have rebounded strongly from their December lows. We have commented before about the challenges facing long-term investors when they experience short-term volatility and a barrage of negative news stories. Many investors get seduced into becoming more tactical and short-term oriented, giving up on their long-term approach to investing. As the boxer Mike Tyson said, “Everybody has a plan until they get punched in the mouth.”

As a basketball fan, “March Madness” is my favorite time of the year. It is the end of the college basketball season when the best college teams in the U.S. compete in a single elimination tournament to determine the national champion in their sport. This year (2019), my favorite team, the University of Virginia (UVA), won its first national basketball championship under the leadership of coach Tony Bennett. March Madness also extended to the financial markets. Through March, the S&P 500 was off to its fastest start since 1998, after closing 2018 with the worst December since 1931. March was also a month of important deadlines – Brexit and a China trade deal – that came and went. These lingering concerns, along with many others (e.g., central bank policies), continue to roil markets and cause worries about declining global growth. Global growth concerns led to the first yield curve inversion since 2007. March also marked the 10<sup>th</sup> anniversary of the stock market lows of the Great Financial Crisis (GFC). The S&P 500 is up over 4 times from its intraday March 6, 2008, low of 666, following the greater than 50% decline from its prior peak. We are constantly bombarded with the view that we are late cycle. What should we do?

These are two versions of March Madness, one positive (basketball) and one negative (volatility). There are lessons from both versions of March Madness. This letter examines the current market and reflects on the wisdom of two famous investors – Warren Buffett and Jack Bogle – to help us think about what it means to be a long-term investor in a fully-valued late-cycle market. As we have written before, there are parallels between sports and investing. We will close by examining any takeaways from UVA’s recent championship win.

### **Market Environment: Late Cycle?**

Although 2018 started with a continuation of 2017’s global stock market rally, it closed the year with the worst December in U.S. markets since 1931. Global equities, as measured by the MSCI All-Country World Index (ACWI) declined 9.4% during 2018, the worst year since 2008’s 42.2% decline. Declining global growth and rising short and long-term interest rates alternated as the chief concerns during the year. The first part of 2018 was dominated by concerns about rising short and long-term interest rates while the final quarter was affected by concerns of future global growth driven by a weakening China, trade wars, a commodities slump, U.S. housing decline and an aggressive Federal Reserve Bank. The 10-year U.S. treasury yield rose from 2.46% at the beginning of the year to an intraday 3.25% on October 8, with most of the increase being driven by higher real yields. A CNN headline on October 4, “Bond yields rise to a 7-year high. Time to Worry?” characterized the angst felt by investors as the higher cost of capital rippled through every asset class. The Federal Reserve was the most active central bank attempting to normalize policy since the GFC, increasing the Fed Funds target four times during the year, to a range of 2.25% to 2.50% at their December meeting. Investors reacted negatively to Jerome Powell’s December press conference after the final rate increase. The market overreaction and indiscriminate selling reflected a concern that the Fed and some other central banks were oblivious to growing global economic headwinds. These concerns were misplaced as the Fed quickly changed its communication to the markets and other central banks around the world became increasingly dovish. Investors’ wariness about the extended bull-market (depending on measurement either the longest or second longest on record) has contributed to angst about the future. This was captured in a March 2019 article from CNBC, “Despite the recent rally, investor sentiment remains bearish, said Michael Hartnett, chief investment strategist at BAML.” In July, the U.S. economy will likely reach a record long economic expansion, exceeding the prior 120-month expansion

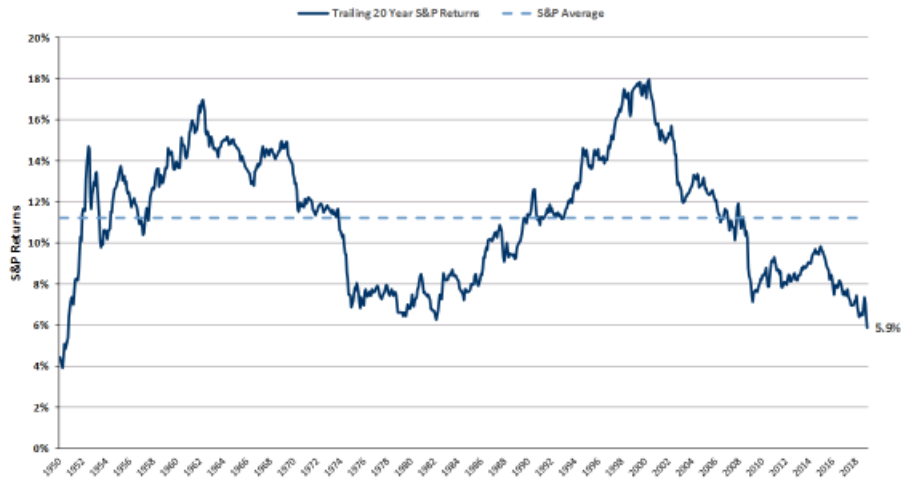
that ended in March 2001. Slightly more than half the economists surveyed by the National Association for Business Economics (NABE) expect a recession to occur this year or next and 77% expect the next recession to occur by the end of 2021. Increasing concerns about the next recession have led to the first yield curve inversion – 10-year Treasury yield falling below the 3-month Treasury bill yield – since 2007. The curve inverted on March 22 for six days but closed the quarter with a positive 1 bp spread. The 10-year Treasury closed Q1 2019 at 2.41%, below the yield at the beginning of 2018. Most of the move has been driven by a decrease in real yields, as the 10-year TIP yield decreased to 53 bps, reflecting expectations of lower future economic growth. Inflation expectations remain well anchored. Despite these concerns, markets have re-climbed a wall of worry (which they have done for much of this 10-year long bull market) to produce the best first quarter results since 1998. The S&P 500 returned 13.65% and ACWI returned 12.18% in Q1 2019.

Should we worry about being late-cycle and change our investment process? NO! Remember investment principle #2, we don't have an edge at timing our allocation to equities or other risk assets. Although most indicators, including length of the bull market and economic growth in the U.S., suggest we are late cycle, it is helpful to look at counterarguments. First, although the economic expansion is about to set a record for length of time in U.S. history, it falls far short of the 27-year expansion in Australia, as well as the Netherland's 26-year run that ended with the GFC. There have been a number of expansions that have exceeded the length of the current U.S. expansion. Also, although the expansion has lasted a long time, the total economic gains since the GFC have been tepid. Real annualized economic growth has been less than any other expansion since WWII, and the total economic gains from prior peak have been less than most economic expansions during this post-war period. During the American Economic Association panel discussion in January, retired Federal Reserve Chair Janet Yellen said, "I don't think expansions just die of old age ... Two things usually end them. One is financial imbalances and the other is the Fed, and usually when the Fed ends an expansion, it's because inflation has gotten out of control and the Fed needs to tighten to bring it down". Several minutes later, her predecessor, Ben Bernanke responded "I like to say they get murdered ... and right now I don't see anyone hiding behind the curtains." In 2016, Glenn Rudebusch, Director Research for the Federal Reserve Bank of San Francisco addressed this question in his paper, "Will the Economic Recovery Die of Old Age?" Dr. Rudebusch found no statistical evidence to predict a higher probability of recession based on the length of the economic expansion. As we have written before, recessions occur because of policy mistakes by central banks and other governmental officials or after periods of excesses, including capital spending and leverage. Second, let's look at the hypothesis that we are in the late stages of a bull market in equities. Although it feels like we are in a long-term bull market, it is instructive to look at returns not just since the GFC, but over a longer period, such as the past 20 years. The graph in Figure 1 shows rolling S&P 500 annualized returns from 1950 through the end of 2018. The rolling 5.9% annualized 20-year return ending in 2018 was the lowest since 1950, a period of time that included the Great Depression and WWII.

**Trailing 20 year S&P total return is the worst since 1950 and well below averages in the time period**

Total Return of S&P 500, 1991-2018, as of 12/31/18

Trailing 20 Year CAGR

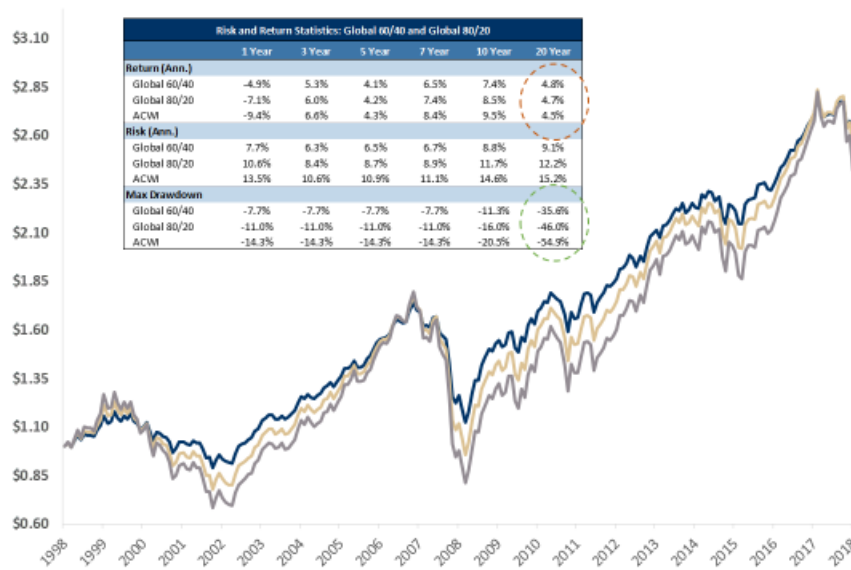


Sources: Shiller, FRED Economic Data. Shiller S&P Data is monthly and inclusive of annual dividends. FRED data is quarterly, seasonally adjusted annual GDP growth rates. FRED data begins 03/31/1997.

**Figure 1: Rolling 20-year S&P 500 Returns**

This hardly feels like a long-term bull market in U.S. equities. What about global equities? It looks even worse. Figure 2 shows the realized returns on the MSCI ACWI over the last 20 years and compares this to an 80/20 and 60/40 global stock bond portfolio.

**Lower Risk Portfolio: Same Return, Smoother Path**



Source: Bloomberg, Makena Analysis. Calculations are based on monthly data.

**Figure 2: Rolling 20-year ACWI, 80/20 and 60/40 Returns**

The 20-year return on MSCI ACWI ending at the end of 2018 was only 4.5% per annum. Interestingly, investors were not compensated for bearing equity risk during this period as the 80/20 portfolio outperformed the all equity portfolio

and the 60/40 portfolio did even better, compounding at 4.8% per annum with significantly less risk. Again, this is not a long-term bull market. Why? It was all about starting valuations at the beginning of this 20-year period. Circling back to our fifth investment principle: price matters!

We laid out a risk premium framework for calculating expected returns on equities in our year-end 2017 investor letter. The framework starts by comparing the earnings yield for each country within the MSCI ACWI to the country's respective **real** government bond yield. This produces a risk premium for each country that can be aggregated to the MSCI ACWI. The earnings yield is merely the inverse of the P/E multiple. We use the Shiller Cyclically Adjusted Price Earnings multiples (CAPE) for this valuation multiple, which helps smooth out earnings and allows for mean-reversion in operating margins over time. U.S. and global equity valuations were stretched in the late 1990s, especially in relation to bond yields at the time. U.S. and MSCI ACWI CAPEs were 40.7 and 37.1, respectively, at the end of 1998. The yield on the 10-year Treasury was 4.65%, nearly 200 bps higher than the yield at the end of 2018. The projected equity risk premium on MSCI ACWI was a well-below-average 20 bps, and the projected long-term nominal return was 4.3%. This projection was close to the realized 4.5% annualized returns of global equities over that time-period. Price matters!

### **Jack Bogle's Contributions: Being a Long-term Investor and the Value of Indexing**

Index and passive investing lost its most ardent supporter earlier this year. Jack Bogle passed away in January at his home in Bryn Mawr, Pennsylvania, at the age of 89. Although interest in passive investing started slowly, it gathered steam over the years, recently surpassing other strategies in net new fund flows from investors. According to Bloomberg, it is likely that assets under management (AUM) of U.S. passive funds will top active funds during 2019, noting recent Morningstar data that passive funds currently hold 48% of U.S. stocks compared to 52% for active funds.<sup>1</sup> This equal market share contrasts to a decade earlier when active funds held three times the AUM of passive funds. Jack Bogle founded Vanguard in 1975 and helped build it into the second largest asset management firm in the world, with \$5.3 trillion in AUM. Although he did not invent the first index fund, he deserves credit for popularizing this style of investing. Vanguard's First Index Investment Trust raised \$11 million in its initial offering in 1976. The fund is now called the Vanguard 500 Index Fund and has grown to more than \$400 billion in AUM. According to Jack Bogle, Vanguard has approximately half the total passive market share, followed by Blackrock and State Street Global.<sup>2</sup> The big three control about 80% of the market.

Jack Bogle was an active speaker and writer after retiring from Vanguard in 1996. His final book, "Stay the Course: The Story of Vanguard and the Index Revolution" was released in early 2019. He had a positive impact on many investors for two primary reasons. First, he offered investors a simple strategy that produced superior results for those who have no edge in security selection, investment manager selection or tactical asset allocation. Second, he was vehemently opposed to straying from long-term investing into what he referred to as "speculation" or short-term investing. Whether he was asked about market overvaluation, length of the bull market or risks from different corners of the world, his advice was the same, "stay the course." Although he did acknowledge in recent interviews that the market was more expensive than it was in the past, he did not advocate lightening up on equities, but rather lowering expectations of future returns.

Despite Jack Bogle's fervent support for passive investing, he expressed a couple of concerns about the current state of this market over the last year. In an interview in Barron's last May, he noted that the high turnover in ETFs compared to traditional index funds or individual stocks, indicated that these vehicles were being used for short-term trading.<sup>3</sup> His research found that the short-term focus for ETF investors was hurting their performance, with the average ETF investor earning 5.5% per annum versus 8.4% earned by the traditional index fund investor over the same time frame (2005-2017). This is consistent with the research from Bhattacharya, Loos, Meyer and Hacker, who analyzed data from a German brokerage firm.<sup>4</sup> They found that investors who included ETFs in their portfolios traded more frequently and had worse investment performance. Although many investors have conceded that they have no edge

<sup>1</sup> "Shift from Active to Passive Approaches Tipping Point in 2019", Charles Stein, December 31, 2018, Bloomberg

<sup>2</sup> "Bogle Sounds a Warning on Index Funds" by Jack Bogle, Wall Street Journal, November 29, 2018

<sup>3</sup> "Jack Bogle's Battle", by Leslie Norton, Barron's May 18, 2018

<sup>4</sup> "Abusing ETFs", Bhattacharya, Loos, Meyer and Hacker, Review of Finance, May 2017

in security or investment manager selection, some have replaced their bottom-up active management with top-down active management through the active trading of ETFs. There are now more ETFs than individual stocks in the U.S. The presence of all these ETFs, allow an investor to express any macro or thematic view. There are ETFs to invest in any geography, sector, asset class, and theme, including AI, Blockchain, and marijuana. It is unlikely that investors have an edge allocating capital across all these ETFs. I know that Makena does not! We remember core belief #2 and play to our strength, which is being long-term partners with investment managers who have the skill and patience to exploit inefficiencies and less liquid markets.

The second concern mentioned by Jack Bogle was included in his recent book and summarized by him in the Wall Street Journal last fall.<sup>5</sup> He is uneasy with the growing concentration of power among the three largest index providers. He is concerned about the policy implications of having so much share ownership across every company by these handful of investment firms. I would modify this concern and relate it to corporate governance. Being a public corporation is an attractive structure for efficiently raising capital to fund ideas and investments that are good for shareholders and society. However, the principal-agent costs associated with agents (management) operating a company for the benefit of themselves at the expense of owners/shareholders was first noted in research by Berle and Means in 1932.<sup>6</sup> Shareholder stewardship and engagement (including proxy voting and activism), corporate boards and the market for corporate control (i.e., M&A) help reduce these agency costs. I would reframe Jack Bogle's concern into a corporate governance issue. As the percentage ownership of index fund investors increases beyond a certain point, it is likely that principal-agent costs will rise. Active managers compete with each other based on the performance of their portfolios. They are motivated to produce higher returns, which can be improved by stewardship activity or active engagement with corporate management that reduce principal-agent costs. Alternatively, index funds are designed to match a benchmark. Any gains from stewardship activity will be shared equally across all index funds, but the costs are absorbed solely by those funds that actively engage with portfolio companies. This free-rider problem suggests we should expect less stewardship activity and engagement to reduce principal-agent costs from index funds. This problem with index funds was raised by Bebchuk, Cohen and Hirst (2017).<sup>7</sup> Higher principal-agent costs from passive investing should provide more opportunities for activists. This plays to our strength since we are invested with public equity managers who actively engage with companies (i.e., friendly activists) across the globe. This private equity approach to investing in the public markets outperforms indexing over time and allows skilled managers to help exploit mis-pricings and principal-agent inefficiencies that are more likely to occur with the growing market share of indexing. The trend towards passive investing may also lead to longer periods of underperformance by our Listed Equity managers as fund flows in and out of ETFs will cause price changes that are unrelated to changes in underlying portfolio company fundamentals. However, this provides more opportunities for our long-term focused managers to find mis-valued companies.

Warren Buffett has also repeatedly advised individuals to invest passively. The 2016 Berkshire Hathaway annual letter written by Warren Buffett paid homage to Jack Bogle, advocating that a statue be built to honor his contributions to investors. Buffett's and Bogle's advice to investors to avoid short-term trading and to remain a long-term investor is consistent with our first core principle and has helped millions of investors compound more wealth over time. However, their advice on indexing comes with a caveat. Although Buffett's and Bogle's recommendation to index is sound for investors with no edge in security selection, investment manager selection or tactical asset allocation, **the forward-looking returns of a passive portfolio will be insufficient to achieve a 5% plus inflation (i.e., 7%) return given today's lofty valuations in both stocks and bonds.** The forward return projected for a 60/40 passive U.S. stock bond portfolio is a meager 4.6% nominal, 240 bps below the required return (all return expectations based on valuations at year-end 2018). It would be fine if spending rates were cut from 5.0% to 2.6%, but many institutional and individual investors are reluctant to make such an adjustment. If investors took more risk, and invested solely in U.S. stocks, then the expected return would increase to 5.9%, which is still below the required 7% return and assumes more risk than most investors could stomach during a large market downturn (e.g., we saw two 50% equity market drawdowns over the last 20 years, and many investors de-risked their portfolios at the depths of the market, causing permanent loss of capital). Diversifying by adding less expensive non-U.S. equities helps, increasing the return on the

<sup>5</sup> "Bogle Sounds a Warning on Index Funds" by Jack Bogle, Wall Street Journal, November 29, 2018

<sup>6</sup> "The Modern Corporation and Private Property", Berle and Means, Macmillan publishing, 1932.

<sup>7</sup> "The Agency Problems of Institutional Investors", Bebchuk, Cohen and Hirst, Journal of Economic Perspectives, Summer 2017



passive 60/40 portfolio up to 5.0%, but it still comes up short. Adding more global equity risk (up to 100%), helps further, but only produces an expected return of 6.6%, and again comes with a level of volatility that most investors could not stomach. **The only way to achieve a return greater than 7 %, while taking a reasonable amount of risk (60/40), is to diversify further and use our endowment approach, which takes advantage of inefficiencies in less efficient and less liquid strategies (e.g., private equity).** The expected long-term return on the MEP is 8.2%, which would allow the portfolio to grow in real terms while meeting the 5% payout. This exceeds the 7.5% expectation at the end of 2017 because of the downturn in stock prices during the year. The case for our endowment investing approach in a low-return world is laid out in greater detail in a soon to be released Makena investor letter entitled “The Endowment Model Revisited.”

### **Warren Buffett and the American Tailwind**

Warren Buffett has shared a lifetime of investment wisdom over the years in his annual letters to Berkshire Hathaway shareholders. His most recent 2018 shareholder letter is no exception. He wrote:

*On March 11th, it will be 77 years since I first invested in an American business. The year was 1942, I was 11, and I went all in, investing \$114.75 I had begun accumulating at age six. What I bought was three shares of Cities Service preferred stock. I had become a capitalist, and it felt good. Let’s now travel back through the two 77-periods that preceded my purchase. That leaves us starting in 1788, a year prior to George Washington’s installation as our first president. Could anyone then have imagined what their new country would accomplish in only three 77-year lifetimes? During the two 77-year periods prior to 1942, the United States had grown from four million people – about 1/2 of 1% of the world’s population – into the most powerful country on earth. In that spring of 1942, though, it faced a crisis: The U.S. and its allies were suffering heavy losses in a war that we had entered only three months earlier. Bad news arrived daily.*

*Despite the alarming headlines, almost all Americans believed on that March 11th that the war would be won. Nor was their optimism limited to that victory. Leaving aside congenital pessimists, Americans believed that their children and generations beyond would live far better lives than they themselves had led. The nation’s citizens understood, of course, that the road ahead would not be a smooth ride. It never had been. Early in its history our country was tested by a Civil War that killed 4% of all American males and led President Lincoln to openly ponder whether “a nation so conceived and so dedicated could long endure.” In the 1930s, America suffered through the Great Depression, a punishing period of massive unemployment. Nevertheless, in 1942, when I made my purchase, the nation expected post-war growth, a belief that proved to be well-founded. In fact, the nation’s achievements can best be described as breathtaking. Let’s put numbers to that claim: If my \$114.75 had been invested in a no-fee S&P 500 index fund, and all dividends had been reinvested, my stake would have grown to be worth (pre-taxes) \$606,811 on January 31, 2019 (the latest data available before the printing of this letter). That is a gain of 5,288 for 1. Meanwhile, a \$1 million investment by a tax-free institution of that time – say, a pension fund or college endowment – would have grown to about \$5.3 billion. Let me add one additional calculation that I believe will shock you: If that hypothetical institution had paid only 1% of assets annually to various “helpers,” such as investment managers and consultants, its gain would have been cut in half, to \$2.65 billion. That’s what happens over 77 years when the 11.8% annual return actually achieved by the S&P 500 is recalculated at a 10.8% rate.*

*Those who regularly preach doom because of government budget deficits (as I regularly did myself for many years) might note that our country’s national debt has increased roughly 400-fold during the last of my 77-year periods. That’s 40,000%! Suppose you had foreseen this increase and panicked at the prospect of runaway deficits and a worthless currency. To “protect” yourself, you might have eschewed stocks and opted instead to buy 31/4 ounces of gold with your \$114.75. And what would that supposed protection have delivered? You would now have an asset worth about \$4,200, less than 1% of what would have been realized from a simple unmanaged investment in American business. The magical metal was no match for the American mettle. Our country’s almost unbelievable prosperity has been gained in a bipartisan manner. Since 1942, we have had seven Republican presidents and seven Democrats. In the years they served, the country contended at various times with a long period of viral inflation, a 21% prime rate, several controversial and costly wars, the resignation of a president, a pervasive collapse in home*

*values, a paralyzing financial panic and a host of other problems. All engendered scary headlines; all are now history.*

*Christopher Wren, architect of St. Paul's Cathedral, lies buried within that London church. Near his tomb are posted these words of description (translated from Latin): "If you would seek my monument, look around you." Those skeptical of America's economic playbook should heed his message. In 1788 – to go back to our starting point – there really wasn't much here except for a small band of ambitious people and an embryonic governing framework aimed at turning their dreams into reality. Today, the Federal Reserve estimates our household wealth at \$108 trillion, an amount almost impossible to comprehend. Remember, earlier in this letter, how I described retained earnings as having been the key to Berkshire's prosperity? So it has been with America. In the nation's accounting, the comparable item is labeled "savings." And save we have. If our forefathers had instead consumed all they produced, there would have been no investment, no productivity gains and no leap in living standards.*

*Charlie and I happily acknowledge that much of Berkshire's success has simply been a product of what I think should be called The American Tailwind. It is beyond arrogance for American businesses or individuals to boast that they have "done it alone." The tidy rows of simple white crosses at Normandy should shame those who make such claims. There are also many other countries around the world that have bright futures. About that, we should rejoice: Americans will be both more prosperous and safer if all nations thrive. At Berkshire, we hope to invest significant sums across borders.*

*Over the next 77 years, however, the major source of our gains will almost certainly be provided by The American Tailwind. We are lucky – gloriously lucky – to have that force at our back.*

There are three significant takeaways for investors.

- (i) First, he continues to make the case for investing in low-cost index funds. Over the 77-year period since he made his first equity investment, the return from investing passively in the S&P 500 was 11.8% per annum, producing a 5288-times return on investment. However, valuations of U.S. stocks were much more attractive at the beginning of this 77-year period than they are today. The Shiller CAPE was less than 11 times in March 1942, which equated to long-term expected nominal return of approximately 11.2% on U.S. equities.<sup>8</sup> This estimate was close to the realized return during that period. The Shiller CAPE at the end of December 2018 was 26.6, which equates to expected long-term returns on U.S. equities of 5.9% per annum, just ½ the annual return experienced since 1942.
- (ii) Second, the letter lists many "scary headlines" that occurred during the 77-year period, including wars, government turmoil, inflation, recessions, financial collapse, and burgeoning government debt. These are stories that armies of economists, advisers and investors constantly attempt to predict. What if these market pundits had a crystal ball in 1942 and could have seen all these events coming. Would they have remained invested in equities over that 77-year period? My guess is that most "smart" investors would have de-risked. Warren Buffett contrasts the returns from investing in stocks with investing in gold. Such an investment would have returned 4.8% per annum during this 77-year period and would have left an investor with only 0.7% of what they would have had being fully invested in U.S. equities. Although such macro risks will forever exist in the U.S. and other developed market economies, these risks are even more frequent and pronounced in the emerging markets. One of our high conviction India managers ran a similar thought experiment to Warren Buffett's, but in India over the past nine years. He listed off scary events in India and the rest of the world during each of those nine years. Again, a cautious macro-focused investor would have waited for a better entry-point to invest and would have missed out on the manager's 20% annualized return and 5X multiple over that period. How did our manager do it? By focusing on bottom-up company selection! The investors and advisers "who regularly preach doom" are often held out as the smart money. Some feel they have the ability of avoiding macro risks by jumping in and out of risk assets.

<sup>8</sup> The real return estimate for U.S. equities was 9.2%. There were no inflation surveys, but historical inflation averaged 2.4%, 1.3% and 1.7% per annum over the prior 5, 10 and 29 years so 2.0% was a reasonable forecast of future long-term inflation

We invest assuming we can't predict these "scary" events and can't time our way out of avoiding these risks. We build a portfolio of managers who can maintain their long-term mindset and be able to tune out the barrage of short-term distractions. Another example of such a manager is ValueAct. Their founder, Jeff Ubben, was interviewed on CNBC in January about his positions in financials. He was asked whether they were worried about being "late cycle"? He responded, "I just don't think that way". He said that markets have become more of a videogame, where people don't take the time to understand the underlying companies. People trade ETFs because of top-down views and stocks are traded from one computer to another.

- (iii) The theme of the Berkshire Hathaway letter is the "American Tailwind". The best line in the letter is, "In 1788 – to go back to our starting point – there really wasn't much here except for a small band of ambitious people and an embryonic governing framework aimed at turning their dreams into reality." Warren Buffett likes to invest behind such "ambitious people" who can turn their "dreams" into attractive businesses, operating within jurisdictions with attractive "rule of law" like the U.S. For much of Warren Buffett's life the American Tailwind was substantial since a large portion of the globe lived under economically and politically repressive regimes. The end of the cold war and the globalization of economic activity have helped other countries close this gap. The Heritage Foundation has published an index of economic freedom the past 25 years. The index has climbed slowly by over 5% during this 25-year period. Setbacks over the years included the period after the 1997 Asian financial crisis and the GFC. The U.S. is ranked number 12 globally. "Governing frameworks", management teams and businesses continue to improve around the world. Although the American Tailwind contributed significantly to Berkshire Hathaway's investing success throughout its history and it will continue to contribute in the future, he writes, "There are also many other countries around the world that have bright futures. About that, we should rejoice: Americans will be both more prosperous and safer if all nations thrive. At Berkshire, we hope to invest significant sums across borders." As an example, Berkshire Hathaway announced last August a \$300 million investment in One97, the parent company of Paytm, India's largest digital financial services company. Given valuation differences, we expect Berkshire Hathaway will continue to search for investments outside the U.S., as will we in our global search for the best opportunities.

To better understand the "American Tailwind" we looked at long-term returns for non-U.S. developed market equities – MSCI World-ex U.S. index – since the inception of the index (12/31/69). For the past 49 years developed market non-U.S. equities have lagged U.S. equities (S&P 500) by 180 bps per annum. (10.2% vs. 8.4%). That is a nice tailwind for the U.S.! However, the entire outperformance occurred since the GFC! U.S. and developed market non-U.S. equity returns were an identical 10.7% per annum from December 1969 through April 2008, the month after Bear Stearns failed. For the 10 years ending December 2018, the S&P 500 outperformed the MSCI World ex-U.S. by nearly 700 bps per annum (13.12% vs. 6.24%). This was primarily due to a rise in valuations in U.S. equities. Ten years ago, the CAPEs on each index were nearly identical (14.9 for the U.S. and 15.0 for non-U.S.). The December 2018 CAPEs diverged, with the U.S. having a CAPE of 26.6 and MSCI World ex-U.S. having a CAPE of 20.0.

### **Summary Takeaways: Market Environment, Bogle and Buffett**

- We don't have an edge predicting if or when our late cycle economy will roll over. However, we can look at valuations to understand whether we are being compensated for taking risk. High equity valuations 20 years ago did not provide a risk premium over bonds sufficient to compensate investors for bearing equity risk. If faced with this situation again, where the equity risk premium is close to zero, investors should diversify the portfolio into asset classes, geographies and strategies that offered alpha opportunities in inefficient asset classes. This is what endowments did 20 years ago.
- There is a risk premium today. However, investors should be prepared for low equity returns, and even lower bond returns. Achieving at least a 5% real return will require using the "endowment approach": investing successfully in inefficient and illiquid opportunities.



- Indexing can be good for some investors, who don't have an edge in security or manager selection, if they invest in a broad index of global stocks and bonds and rebalance. However, they need to set their expectations lower for future returns and reset their spending expectations accordingly.
- Indexing is bad if it encourages investors to time the market and be a top-down investor. ETFs may be contributing to this trend.
- The increasing share of indexing could lead to longer periods of underperformance for active managers, but this creates more inefficiencies for active management and shareholder activism.
- Although the American Tailwind produced spectacular returns in the past, the U.S. is relatively expensive today and other countries are catching a similar tailwind. Although the U.S. will continue to play an important role in our portfolio, we will continue to look for the best opportunities globally.
- Although U.S. equities outperformed non-U.S. equities by 180 bps per annum over the past 49 years, the outperformance occurred entirely since the GFC. Returns for both markets were an identical 10.7% per annum for the 38 years prior to the GFC. The recent lead has been driven by higher U.S. valuations.

### **Concluding Thoughts**

One of my favorite Strategists, Jason Trennert, says investing is more of a social science than a science. The positive or negative impact of people on the investment process prevents investing from being a hard science. Our sixth core investment belief is that people matter! Investment success is determined by the temperament of the people involved in the investment process. At Makena, we view investing as more of a team sport than an individual sport. Hence, in addition to learning from investment greats, like Warren Buffett, we also look to successful teams for what we can learn to improve our temperament and process.

John Wooden once said, "You can't let praise or criticism get to you. It's a weakness to get caught up in either one." John Wooden was one of the greatest coaches of all time. His 10 national championships are the most of any coach in men's division 1 college basketball history, with the current coach of Duke, Mike Krzyzewski, coming in second with five. Throughout their coaching careers, John Wooden and more recently, Tony Bennett taught basketball players skills and personal qualities that emphasized the success of the team over the individual and process over outcomes. Tony Bennett's focus on his team's basketball process and system were put to a test over the last year.

Tony Bennett joined UVA 10 years ago after helping build Washington State into successful basketball program in a conference that had traditionally been dominated by UCLA and Arizona. He took over this coaching position from his father, Dick Bennett, who provided the foundation for a basketball system, which was characterized by an intense man-to-man defense and a highly disciplined offense. Tony perfected this "pack-line" defense and disciplined offense into a unique style, which many basketball fans called slow and boring. It also required recruiting players who were devoted to working hard to perfect his defensive-team oriented philosophy as opposed to showcasing their offensive skills for the NBA. Tony Bennett's system was working. In March 2018 his UVA team finished the regular season ranked #1 in the country as they started the March Madness post-season single-elimination tournament, which would determine the national champion. Their first-round opponent was the University of Maryland Baltimore County (UMBC), a number 16 seed in the South region. UVA was a 20.5-point favorite to win the game. Since 1985, when the tournament expanded from 32 to 64 teams, a number one seed had never lost to a number 16 seed. On March 16, 2018, UMBC upset UVA, winning the game 74 to 54. The criticism of Tony Bennett's system ramped up after the defeat. Many "experts" claimed that his system would never win a championship and wouldn't be able to compete against teams like Duke, who were attracting future NBA stars. Perhaps Tony's system could win a lot of games in the regular season but was not suited to the playoffs? Perhaps he should adapt his system to play a faster-paced offense like other teams? He ignored the criticism, had faith in his system, focused his players on the details and worked on perfecting how they played as a team. Tony Bennett's mindset embodies the quote from coach Wooden. Like last year, they had a successful regular season, only losing three games, and entered the NCAA tournament as the #1 seed in the South region in 2019. They found themselves down at halftime to the #16 seed Gardner-Webb. Their faith in each other and the system were again, being tested. They came back to win that game and the following two games by comfortable margins. They went on to win the quarterfinal, semifinal and final games with last second heroics, ultimately rewarding the system and their faith in each other as teammates.

What are the lessons for us? Tony Bennett's experience is akin to an investor whose style is out of favor, but whose poor performance is extensively covered in every financial media outlet. Maintaining your process is very difficult in the face of such public second-guessing and criticism. The "endowment model" was criticized heavily after the GFC. Less disciplined investors could have abandoned the model for new approaches like smart-beta or ETFs. The better investors who have stuck with this process have been well rewarded, especially over the last year. Coach Wooden's quote was valuable advice for Coach Bennett and his UVA basketball team last year, but was equally valuable this year, now that they finally won. There were three types of investors who invested before, during and after the GFC. The first, had large drawdowns in 2008 and were never able to recover. The negative outcome and "criticism" forever changed their process. Unlike Coach Bennett, they constantly tried to reinvent themselves. The second type of investor successfully navigated the GFC because they were lucky or smart enough to make a good macro call. Their future process was also corrupted because the positive outcome and "praise" caused them to keep searching for the next "big short". They never found one... The third type of investor, the successful investor, didn't let their negative outcome and "criticism" or the positive outcome and "praise" alter their process. They continued their process and worked hard on the small details and teamwork that are necessary to maintain an edge in investing.

We close with another John Wooden quote: "The main ingredient of stardom is the rest of the team."

As always, we are thankful for your trust and support.

Larry Kochard, CIO on behalf of The Partners of Makena Capital Management

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