Mid-Year Investor Letter

June 30, 2020

Dear Makena Community,

We start this letter with a quote from a wonderful new book on behavioral mistakes made by people managing their finances and investments.

> *"The Seduction of Pessimism: Optimism sounds like a sales pitch; pessimism sounds like someone trying to help you…Pessimism also sounds smarter… it's intellectually captivating..."*
>
> — Morgan Housel in the "Psychology of Money"

Gloom sells! Pessimistic investors are often viewed as the smart ones. They capture the attention of the media and the broad investment community. Their credibility grows during recessions, market panics, and other cataclysmic events, which recently, took the form of a pandemic. This pessimism was on full display at the beginning of the year. Many of these "smart" pessimistic investors were battening down the hatches and heading to cash in the first several months of the year. Despite the seduction of pessimistic investors, their gloom often leads to short-term market timing and ultimately, lower long-term investment returns. Michael Cembalest, Chairman of Market and Investment Strategy at JP Morgan, refers to these well-known investors as the "Armageddonists."[1] He studied the impact of following their advice and found it was quite costly to long-term investment returns. Morgan Housel defines optimism as "a belief that the odds of a good outcome are in your favor over time, even when there will be setbacks along the way." This mindset ties more closely to our long-term philosophy and some of the themes we lay out in this letter. We will continue to risk-manage our way through periodic "setbacks," like a pandemic, while working to achieve our long-term objectives.

For those of you hibernating the first six months of 2020, the modest 3.1% decline in the S&P 500 index masked the dramatic moves along the way. The peak-to-trough 34% drawdown bottomed on March 23rd and was followed by a 39% rebound through June 30. The outperformance of growth over value stocks continued, with the S&P 500 growth index outperforming the S&P 500 value index by over 2300 bps! Performance across S&P 500 sectors highlights similar dispersion, as information technology and consumer discretionary generated attractive gains of 15.0% and 7.2%, respectively, while financials and energy produced sizeable losses of -23.6%% and -35.3%, respectively.

The pandemic accelerated trends that have been in place for years. Even though many parts of the economy ground to a halt during the lockdowns, people adapted how they work, consume and live their lives. People and companies have been increasing their reliance on technology over time. This growing trend of companies digitally connecting with their customers, suppliers and employees accelerated during the pandemic. It is unlikely to reverse course any time soon. McKinsey referred to the current environment as the Great Acceleration.[2] It has created winners across sectors (e.g., technology and consumer discretionary), but also within sectors, as those companies that adapt and innovate are more likely to survive and succeed. The ability to work, shop, and learn remotely has been and will continue to be a tailwind for technology-focused and technology-enabled companies. One of our high conviction venture managers has a framework to find technology-enabled consumer businesses which have not only received a boost from the current environment, but which will continue to benefit from the acceleration

[1] The Armageddonists, Michael Cembalest, 2019: https://www.linkedin.com/pulse/armageddonists-michael-cembalest/?trk=portfolio_article-card_title

[2] McKinsey & Company: July 14, 2020, "The Great Acceleration" by C. Bradley, M Hirt, N Northcote and S Smit

of long-term structural shifts well into the future. They have identified attractive companies with these durable advantages across eight consumer themes: work, education, healthcare, food, e-commerce, marketplace, dining and fitness. They have invested across all of these themes.

What does this acceleration mean for Makena? It reaffirms our first core investment belief, to maintain a long-term focus. We avoid the temptation to be tactical. We have no edge timing the market. We invest in long-term themes and we develop long-term partnerships with managers who have the skill to invest in secular growth companies with quality management teams. One of our long-term themes has been technology. We want to be long innovation. This is a theme that will continue to play out over many years, not just while we are in the midst of the pandemic. This theme is also related to two of our other core investment beliefs: playing to our strength and focusing on strategies where managers' skill can exploit inefficiencies.

As we regularly note in our communications, our investment objective is to provide long-term returns which will support a 5% annual payout while preserving and growing the real value of the portfolio over a long horizon. Makena takes a bottom-up approach to asset allocation while using our multi-risk-management (market, liquidity and idiosyncratic) framework. Our edge is being a long-term partner with extraordinary investment managers, and maintaining the discipline needed to be a long-term investor in a macro and short-term-focused market environment. Our philosophy revolves around six core beliefs set forth and described in detail in our year-end 2017 letter:

- Maintain a Long-Term Focus
- Play to our Strength
- Understand that Most Markets are Efficient: Focus Time, Effort and Capital on Less Efficient Markets
- Maintain Balanced Diversification
- Maintain a Value Discipline: Price Matters
- People Matter

Everything we do remains consistent with these core beliefs.

Adhering to our investment process and long-term philosophy helped us navigate the volatile market. We were unable to predict the severity and length of the pandemic and economic decline, but we focused on quality and growth investments since they were more likely to survive the downturn and generate attractive returns over a long timeframe. As we laid out in our spring letter, we used three factors to assess rebalancing the portfolio when markets and the economy scare most investors into cash:

Our Managers: Close relationships and constant communication with our managers have many benefits, especially during a market sell-off. Hearing our managers "pound the table" that **quality businesses** are on sale relative to their fundamentals gives us confidence that, as long-term investors, we will be compensated for increasing existing positions or initiating new positions.

- Expected Risk Premium ("ERP"): We try to measure how much we are compensated for taking equity risk relative to risk-free assets. The ERP, which we laid out in the spring 2020 letter, is a useful and complementary tool for gaining conviction to rebalance a portfolio. An elevated ERP following market sell-offs, such as the Volcker Recession in the early 1980's and the Global Financial Crisis in 2008, would have helped guide investors to rebalance into equities at those times.

- Equity Beta: The market sell-off caused portfolios' equity betas to fall. Achieving Makena's investment objective of providing a long-term return to support a 5% annual payout, while preserving and growing the real value of the portfolio, requires a meaningful allocation to equity risk. While a falling equity beta

alone is not a sufficient reason to rebalance, it is important to consider in tandem with the other two factors.

Tying it all Together

Long ago, Ben Graham taught me that "Price is what you pay; value is what you get." Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down.

— Warren Buffett, Berkshire Hathaway 2008 Letter to Shareholders

Two of the more over-used words in investing are "quality" and "value." Although the greatest investor of all time eloquently uses and understands these two terms, there are many other investors who do not. What do we mean by "quality" and "value?" We have actively discussed the quality bias in our equity portfolio and that we rebalanced into quality-oriented managers in March/April. We have also articulated that a value discipline is one of our six core investment principles. We'll start by addressing value investing.

Everyone has a different interpretation of value investing, but many researchers and index providers compare the price of a stock to its book value or earnings. A stock with a low price to book ratio would be considered a value stock. It has become accepted wisdom that value investing produces attractive returns over a long timeframe. This belief is shared by fundamental investors, quantitative investors and academics. The most famous fundamental value investor is Warren Buffett. Many academics have studied the outperformance of value investing, but Professors Gene Fama and Ken French have produced the most widely cited research. Data from Ken French show that value outperformed growth from 1927 to 2019 by an average of 4.5% per annum.[3] Explanations for this value return premium include a market inefficiency and compensation for risk. However, this outperformance has narrowed and even reversed in recent years. Value performed well the past 20 years, the period that began at the peak of the dotcom bubble and ended in June 2020. The Russell 3000 Value index outperformed the Russell 3000 Growth index by nearly 100 bps per annum over this timeframe. However, over the past 40 years, the Russell 3000 Growth and Value results were nearly identical, with the Growth index outperforming by 4 bps per annum. The reversal has occurred largely over the past 15 years, as the Russell 3000 Value index underperformed the Russell 3000 Growth index (through June 2020) by 500 bps per annum! Has the value return premium disappeared or is this a mispricing that will lead to a mean reversion in future value and growth returns? I believe there are two drivers of this value conundrum, neither of which is likely to reverse. First is the secular decline in real bond yields and second is the fact that simple valuation ratios are imperfect representations of investment value. We'll explore both below.

One cause of the value underperformance has been the decline in long-term real bond yields. For decades, there was no statistical correlation between the return on treasuries and value stocks, as measured by HML, the return on a portfolio that is long value and short growth stocks.[4] This changed in the decade 2010 – 2020. The correlation coefficient has been a very statistically significant -0.48 over the last decade. Value stocks have underperformed growth when bonds did well. An overweight to growth has been a replacement for bonds. This makes sense since the value of growth stocks comes from cash flows in the distant future and increasingly negative real yields increases the present value of such cash flows. The question is whether this will persist.

"We're not even thinking about thinking about increasing rates… through 2022"
— Jerome Powell, June 10th, 2020

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[3] Online Data Ken French web site: https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html#Benchmarks
[4] HML is defined by Fama, E. F.; French, K. R. (1992). "The Cross-Section of Expected Stock Returns". The Journal of Finance.

At the virtual Jackson Hole summit and the September FOMC meeting, Jerome Powell expanded upon his June speech by extending the likely period of zero nominal interest rates through 2023 and clarified the Fed's new policy regarding inflation. In 2012, Janet Yellen laid out a formal 2% inflation target for the Fed. This 2% inflation target had been viewed as a ceiling on inflation that the Fed would accept before it tightened monetary conditions. The new Federal Reserve framework articulated by Powell says that going forward, there will be instances when the Fed will actively seek a higher than 2% inflation rate to offset extended periods (e.g., now) when inflation has been below target. The Fed will target average inflation. The revised framework suggests a shift in the relative priority between inflation and unemployment, emphasizing a greater desire for more employment relative to less inflation. This dovish policy strategy shift, and the promise of maintaining nominal rates at zero, even as inflation climbs above 2%, is bullish for growth investments.

Second, we view value investing as more than applying a simple valuation ratio. Value is a strategy where the intrinsic value of each investment – the present value of the future cash flows – exceeds its market value or price by a sufficient margin of safety. Ratios like price to book and price to earnings are too simplistic. Recent research has found that the traditional value metrics are unable to capture the value of intangible assets. Economists Jonathan Haskel and Stian Westlake have researched the impact of companies' increasing investments in intangibles in their book, "Capitalism without Capital: The Rise of the Intangible Economy."[5] Intangible assets aren't solely owned by technology companies, but also by companies across other industries, which are technology-enabled. It doesn't include just hardware and software, but also includes intellectual property, proprietary data, brand value, management systems and business processes. It is heavily affected by management quality and capital allocation skill. These are companies that dominate growth indexes. Valuing such growth companies with blunt tools like price to book and price to earnings ratios doesn't capture the difference between good, mediocre and bad investments. These simple metrics may work for companies with more tangible than intangible assets, but not for most companies. According to research from Bank of America, Carlyle and AON, 84% of the S&P's assets are now intangibles, increasing from 32% in 1985. Simple valuation metrics were more effective in 1985 than they are today. This creates opportunity for investors to exploit inefficiencies within the growth (including technology) universe, who have the skill to estimate intrinsic values or the present values of future cash flows from these more difficult-to-understand businesses. Haskel and Westlake write, "investors who can understand the complexity of intangible-rich firms will do well. The greater uncertainty of intangible assets and the decreasing usefulness of company accounts put a premium on good equity research and an insight into firm management." Circling back to a point we raised in this letter's introduction, technology investing allows us to exploit an inefficient investment opportunity set. One of our core principles is to focus on investment strategies that are less efficient, to allow skilled managers to generate excess returns. Our colleague, Jackson Garton, discussed at Makena's May (virtual) annual client meeting, that the four S&P sectors with the highest cross-sectional return dispersion were communication services, informational technology, health care and consumer discretionary. These sectors dominate growth indexes. They are the four largest sectors within the S&P 500 Growth index, representing 78% of that index, compared to being only 36% of the S&P 500 Value index. The high dispersion within these sectors is evidence of less efficient market pricing and an attractive opportunity set for skilled investment managers to add value.

The little-known Nomad Investment Partners is a fabulous case study of an investment firm that successfully applied their skill to identify a narrow set of attractive companies within the growth universe. They were one of the most successful investment managers I have ever known. Nomad was founded by Nicholas Sleep and Qais Zakaria in 2006, after spinning out of Marathon Asset Management. Miles Johnson highlighted their investment approach and the cult following that they have developed, in the Financial Times this past summer.[6] They had a

[5] J Haskel and S Westlake, "Capitalism Without Capital: The Rise of the Intangible Economy", 2018, Princeton Publishing

[6] M Johnson, "Cult figure in investing one of the few to grasp the promise of internet stocks", August 5, 2020, Financial Times

unique understanding of the valuation, strategy and execution of technology-enabled consumer companies like Amazon, Costco, Asos and Ocado. Their investment returns were exceptional. They were so successful that they returned investors' capital in 2014 and retired. The most interesting thing about them was their background. At Marathon they were deep value investors, investing in "cigar butt" companies. They learned earlier than others, that what was once a good strategy to outperform, had become more prone to investing in value traps – investing in bad companies with bad management teams at low prices – companies that were cheap for a reason. Their skill as investors enabled them to understand the value of intangibles at their portfolio companies, since by simple valuation metrics these companies were all grossly overvalued.

Let's return to quality. You can think of quality as the opposite of a value-trap. Quality companies are good businesses run by good management teams. They generate growing revenues and cash flows. They are "expensive" or growth companies within indexes because their valuations relative to earnings or book value are high. Quality public equities owned by Warren Buffett include Coca Cola and Kraft Heinz. They produce steady cash flows and have moats, which reduce competition. In the case of consumer staples companies, moats include the brand value, and for technology companies it includes all the intangibles discussed above. They are often asset-light companies (excluding intangibles) and their management teams are superior capital allocators, allowing them to reinvest in their businesses to produce future growth. As Jackson Garton described at our May 2020 virtual annual client meeting, one of the reasons we like technology companies (in addition to the long-term tailwind, the inefficient opportunity set and it playing to our strength) is that they are **quality** companies. We look at three metrics to help identify quality: high gross margins, low financial leverage and high return on equity (ROE). Technology has the highest ROE, lowest leverage and the third highest gross margins across all sectors.

As a long-term investor, we want to be long quality.

We will conclude the letter by addressing a final question.

Are we worried the current market is a replay of the dotcom bubble? First, the bubble in 2000 wasn't just within technology stocks but the broad market. The late 1990s had an expected **negative** ERP given the high equity valuations relative to bonds. This compares to today where bonds are generating negative real yields so the ERP is slightly above its historical average at 4%. We are currently compensated for bearing equity risk unlike the peak of the dotcom bubble. Second, we are careful to avoid exposure to momentum. Some of the worst market excesses are due to the boom in retail trading (not investing) on new mobile platforms, which help drive prices higher in certain crowded momentum names like Tesla and Apple. Third, it is important that our growth and technology-focused managers maintain a valuation discipline. Although simple valuation ratios don't tell the full story regarding the valuation of growth companies, it is certainly possible that investor exuberance will drive market values above intrinsic values for many companies. We rely on our managers to understand valuations and to be disciplined. For public equity managers this means having the discipline to rotate into new positions or cash when prices get too high. For hedge fund managers, in particular those with an edge investing in technology stocks, it means increasing their short book and reducing their net. For private managers it means pulling back on new investments and taking some chips off the table. There is a lot of investor interest in mega-cap technology stocks, and it is possible that the recent gains are overdone. They are at risk for mean-reversion, due to their size and the regulatory scrutiny they will likely face in the coming years. It is incumbent upon us to understand the valuation framework of our managers and the portfolio moves they make in response to market moves. As opposed to a replay of the dotcom bubble, the excesses that I am more worried about are leverage and investors reaching for yield, both being a

byproduct of the historically low level of bond yields. It is tempting for companies and managers to employ excessive leverage, given the historically low cost and availability of credit. We will be on the lookout for this risk.

I will close by circling back to Morgan Housel's definition of optimism, "a belief that the odds of a good outcome are in your favor over time, even when there will be setbacks along the way." We will resist the constant seduction of pessimism and market timing but will continue to manage our balanced portfolio according to our core beliefs, while being prepared for and actively managing the periodic "setbacks along the way."

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

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