Annual Letter 2017

To Our Clients and Friends of Parthenon LLC

The stock market marched onward and upward in 2017. The S&P 500 total return, with dividends, was 21.8%. It was a relentlessly positive year for stocks - this was the first year that the S&P 500 had a positive return in every month. Volatility has apparently left the building as well, as the market completed the longest period without at least a 2% decline in over 50 years. In last year's letter, we suggested having modest expectations. As you can surmise, market timing sages we are not. It is always preferable to be cautious and pleasantly surprised, instead of exuberant and disappointed. The bond market did what the bond market seems to always do, which is very little. Yields moved modestly and remained low, even as the economy accelerated and the Federal Reserve raised short-term rates three times for a total of 0.75%. The 10-year Treasury bond started the year at 2.45% and ended at 2.41%. Finally, the most important economic event in 2017 was the passage of corporate tax reform, with the top marginal rate cut to 21% from 35%. While it remains uncertain how much of the tax reduction will ultimately end up on corporate bottom lines, it is undoubtedly a meaningful enhancement to earnings and equity valuations.

The S&P 500 has returned an annualized 15.8% for the past 5 years, well above the historic annual averages of 9% to 10%. We tend to lean into the wind, so this robust stock rally elicits caution in our value-laden psyches. However, a further examination shows it is a little more complicated and perhaps less obvious that the market is as overextended as the 5-year returns would indicate. The 10-year annualized results are 8.5%, a little below the long-term average. Not so fast you say - that period begins with 2008, the worst year in over 50 years. How about 20 years, which starts with 1998, a very strong year for the market? The 20-year number is only 7.2% annualized, also below the long-term averages. Which is it: is the market overvalued after the strong 5-year run, or undervalued after the less than stellar 20-year results? Ben Graham, considered the father of value investing, when asked about the market's value after an extended strong run, once replied that it was overvalued but not as overvalued as it looks. That sums up our feelings as well. Based on consensus 2018 estimates, the S&P 500 is valued at 18 to 19 times forward earnings. The historical average is approximately 14 to 15. Other market valuation metrics are also above historical norms, some well above. Overall, while valuations give us pause, it is likely that low interest rates, an accelerating global economy, reasonably strong earnings growth, and corporate tax cuts will somewhat offset the relatively high overall stock valuations. Nevertheless, the margin of safety is getting thinner as the market marches ever higher.

In nearly every annual letter, we discuss (probably ad nauseum to long-time clients) that we cannot and will not predict the short-term direction of the market (well, maybe just for fun but not, as they say, for profit.) Ask us what the market will do in 2018, and you are likely to get a shrug and an artful verbal deflection. We would like to have a strong, actionable market conviction - it would sure make our investment work easier. Unfortunately, we think our prediction, along with any other, would be of little value given the randomness of short-term market moves. We recently read that the average prediction for 2017 in a survey of 18 Wall Street analysts was that the S&P 500 would rise 5.5% for the year. Any prediction we make would only provide false comfort and an errant sense of forecasting precision. As Clint Eastwood (aka Dirty Harry) said, "A man's got to know his limitations."

As the market has marched on, and stock valuations have expanded, one issue we have discussed around the office concerns the practical difference between market timing (which we do not attempt), and disciplined value investing (which we champion) at times of high valuations. Market timers move in and out of the market according to their market forecasts thereby attempting to capture the upside while avoiding the declines (good luck with that). Value investors generally do not abandon the market based on predictions. Instead, they may sell individual stocks deemed too expensive, and pass on stocks of companies they would otherwise wish to own due to unattractive valuations. Most of the time there is little similarity in practice between the two approaches as value investors can find enough compelling opportunities to stay reasonably fully invested. But do they end up in the same place when markets have an extended run? We struggle with that as disciplined investors operating in a not undervalued market. We continue to work to balance our price discipline with an awareness that the market may rise much higher before any decline and/or increased volatility presents many compelling opportunities. In addition, we are aware that overall economic growth and corporate earnings advances may render today's valuations less egregious as company valuations "catch-up" to current stock valuations. In this environment, we will strive to find the best opportunities we can, while passing on things that we think have an unacceptable risk of significant loss.

Finally, we will circle back to the opening paragraph and repeat once more the same recommendation we had last year, with even more conviction. In projecting your equity portfolio value over the next 5 to 7 years, we continue to advise tempered expectations for total returns at least moderately below the historical averages. While little surprises us in the short-term, we will be surprised if returns are above average for the intermediate period from current levels.

Currency of the Future?

You can take those dollars out your wallet and leave your credit cards at home. There is a new currency in town. It's the future and it will replace those old, stodgy dollars (and euros, yen, etc.) We kid, of course, but judging by the soaring price of Bitcoin and the evangelical faith of its promoters, maybe it will. Bitcoin is the first, and most famous, "cryptocurrency." It was created by a still unknown software programmer (or programmers) in 2009. The software created basic rules for Bitcoin, which operates on a decentralized network of computers that are not controlled by a central government authority or institution. The underlying technology is known as "blockchain," and is expected to have a significant impact in many fields. There are ways to "mine" for Bitcoin and the number of Bitcoins that can ultimately be created (mined) is finite. It was conceived as both a new means of exchange (currency), and a store of value (a digital gold or silver). The beauty and appeal to early adopters was that it would be beyond government control and manipulation. That would make Bitcoin immune to the risk all government issued currencies face – that the government behind the currency will debase it through excessive issuance. Bitcoin, with its anonymity, also became popular with a less than savory element for criminal uses – illegal drugs, ransom payments, money laundering, etc. It has quickly moved more into the mainstream, and can be used to make legitimate consumer purchases in some venues. The primary use for now seems to be as a speculative investment (gambling?) vehicle. How speculative? Well, the price of a Bitcoin soared nearly 20-fold in 2017, from around $1,000 at the start of the year to over $19,000 before falling back some at year end. Think about that – something that didn't exist 10 years ago, is not backed by any government (and its corresponding gross domestic product, tax revenues, or natural resources), has no industrial use at all (it does not make good jewelry either), and exists only in the digital world, soared 1900% in less than one year. The total value of Bitcoin outstanding exploded from approximately $16 billion to over $250 billion. Of course, the established financial exchanges could not let this opportunity pass by, so now one can trade futures (bets on the rise or fall) on Bitcoin on reputable exchanges. Cryptocurrency Hedge Funds are being created seemingly by the hour, and while Bitcoin is the first and most famous, more cryptocurrencies have been released and more are on the way.

We are not experts on cryptocurrency and barely even qualify as novices. Our interest is primarily as bemused spectators on what appears to be a classic speculative mania and a very interesting study in mass psychology. Nevertheless, we are hesitant to call it a bubble (many observers are not so reticent), because we have no idea how one would even value Bitcoin. Without any value to anchor a judgment, how would one know the price is bubble-like? Perhaps, as the proponents say, it is just getting started. There are some not so subtle signs though that the excitement is getting out of hand. A company called Long Island Iced Tea Corp. (money losing naturally) changed its name to Long Blockchain Corp. and announced a shift in corporate focus from the beverage business to the "exploration and investment in opportunities that leverage the benefits of blockchain technology." The stock soared over 250% on the news (you cannot make this stuff up).

Our primary investment interest centers on the risk, if any, to the general financial system from the potential bursting of the cryptocurrency mania (should it burst). The cryptocurrency phenomenon appears to be too small to pose a major systemic financial risk and is mostly a financial sideshow. As the total value of the cryptocurrency market increases and the movement into the investment mainstream continues, the risk of a more widespread impact from the speculative bubble bursting may grow as well.

Sunny Days

Investors have enjoyed a very favorable backdrop for stocks since 2009 – low inflation and low interest rates along with continuous, and now accelerating, economic growth. In addition, the just enacted and very generous corporate tax cut adds to the positive milieu. These are indeed sunny days for equity investors. While we can see few obvious clouds for 2018 (and we do look for clouds), investment storms tend to arrive unannounced. Sunny days are the most opportune time to again assess expectations and plans and be certain that asset allocations are appropriate for both short-term needs and long-term goals. We constantly assess all our portfolio structures in that light, in preparation for the day when the weather may not be so benign.

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J. McFerran Barr, II Thomas A. Corea

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Tony H. Coffey Todd P. Lowe Matthew W. Carper

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