DOUCET ASSET MANAGEMENT, LLC

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Doucet Value Momentum Portfolio
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Bienville Model

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Drawbridge over Troubled Water

Famed investor Warren Buffett coined the term *economic moat* to describe his philosophy of investing in companies with sufficient ability to defend their profits from oncoming competitors looking to invade their castles, so to speak. These *wide moat* stocks have distinct competitive advantages that provide a greater buffer against investors losing money, or so the logic goes. Companies like Morningstar have hopped on board this bandwagon by launching wide moat indices, ETFs, and rankings. And frankly, it is easy to understand why; it is beautifully figurative language. It is also terribly ironic in a way, as the word conjures imagery of castles and medieval defenses, while investors these days are nothing if not offense-minded. Irony aside, though, there really could not be a more appropriate terminology for the times. Markets and the broader economy are fraught with disconnects that need bridging before an investor can prudently deploy capital. Individuals, after all, have their own financial castles to protect. With markets as frothy and seemingly irrational as those of today, these same individual investors would be wise to begin constructing moats of their own.

Out of Cynk

As a case in point, consider the current state of technology stocks. For those who thought they would have to wait an eternity to see the emergence of another tech bubble, their wait may already be over. Take Cynk Technologies, for example. Just last week, the company's stock price climbed to $14.71 a share from only 6 cents a few months ago, producing a market cap of over $6 billion. What is truly remarkable about this meteoric rise is the fact that Cynk has but a single employee, is based out of Belize with no verifiable address, and has no revenue of which to speak. But hey, at least they don't have much overhead! The lack of overhead, however, was not enough to quell suspicion and the SEC formally halted trading last week.[1]

As extreme as this case may be, it is illustrative of a bigger point. That is, the stock price of Cynk Technologies is not the only thing that is out of sync, so are market valuations and underlying fundamentals, in general. This trend is most evident in technology stocks, where the dawn of the social media era and app mania has thrown valuations and multiples seriously off-kilter. Remove the masking effects of stock buybacks, and they seem downright ridiculous. Many of these stocks, such as Facebook and Twitter, are trading at wide moat multiples, but without the requisite wide moats. Even tech companies that once had wide moats have seen them drained by technological advances and the emergence of fresh competition, leaving them with mini-moats at best. But again, you wouldn't know it by looking at their valuations.

As the table below illustrates, the Price-to-Earnings (P/E) and Price-to-Book (P/B) ratios of these tech companies are well above historic norms. Some don't even have a P/E ratio due to lack of positive earnings.

Although there are major differences in the current market and the dot-com era, the phrase *tech bubble* is becoming more commonplace. In late April, well-known hedge fund manager, David Einhorn, was quoted saying "There is a clear consensus that we are witnessing our second tech bubble in 15 years."[4] In fact, the Federal Reserve itself warned of excessive valuations stating in its July Monetary Policy Report "Nevertheless, valuation metrics in some sectors do appear substantially stretched—particularly those for smaller firms in the social media and biotechnology industries, despite a notable downturn in equity prices for such firms early in the year."[5]

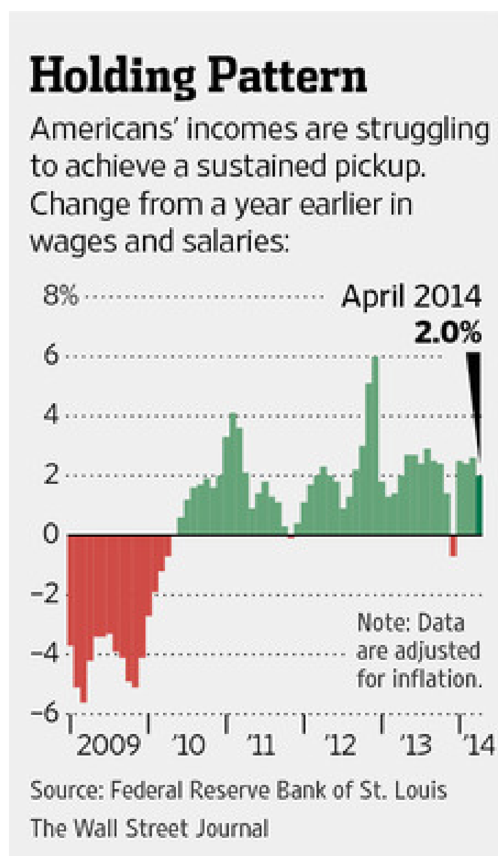
Ticker	Company	Net Income (TTM $MM)	P/E	P/B
AMZN	Amazon.com Inc	299.00	564.3	15.8
BIDU	Baidu Inc	11,011.33	37.7	10.3
COUP	Coupons.com Inc	(17.05)		7.4
FB	Facebook Inc	1,912.00	89.8	10.3
GOOG	Google Inc	13,026.00	31.2	4.3
LNKD	LinkedIn Corp	(9.29)		7.0
NFLX	Netflix Inc	162.83	167.6	18.1
OPEN	OpenTable Inc	22.61	73.1	10.3
TWTR	Twitter Inc	(750.66)		7.4
S&P 500 Long Term Average			15.35	2.9

Source: Bloomberg & Bespoke Investment Group

Although the disconnect between valuations and fundamentals is easy to see in tech stocks, it is really present across the board. No asset class is immune. For example, yields on Spanish bonds are at 225 year lows[10], despite the fact that Spain is still experiencing 25% unemployment and is not two years removed from a severe debt crisis[6]. Spreads between high yield bonds and Treasuries are the tightest they have been since the financial crisis and within shouting distance of all-time tights, despite the fact that Treasury yields are near all-time lows and junk bond yields, on the whole, are lower than the long-run average of the 10-year Treasury.

Central Bank 'Round-Up': Mowing Low vs. Weed-n-Feed

Such disconnects as these are not merely coincidental, but rather are symptomatic of the fact that central banks around the world, through their efforts to stop the economic bleeding and to kick start growth, have financially engineered a world that just doesn't make sense anymore. Like weeds in a yard, disconnect after disconnect has popped up throughout the financial landscape, as the law of unintended consequences has taken hold. And just as how mowing a yard full of weeds low enough can make it appear to be a healthy lawn; enough disconnects in the market can make things appear as if they are normal and healthy. But in reality, they are still weeds.



Just about the only way that one could successfully rationalize the disconnect that exists between current market valuations and fundamentals would be if the broad economy was doing so well that continued, robust growth was a given. But is that really the case? It may be true that stated unemployment, at 6.1%[7], and inflation, at 1.6%[8], are near the Fed-set Holy Grail levels for a healthy economy of 6% and 2%, respectively. But, labor force participation, at a measly, 63.2%, is still at a 36 year low[9]; real world inflation paints a different picture than stated inflation; wage growth remains tepid (see chart); real short-term rates are negative; and margin debt remains at a record high. And don't forget, it is ultimately consumer demand that boosts the economy, and thanks to many of the stats mentioned above, the consumer is stretched, to put it very mildly. These are all things that we have written about in previous newsletters over the past couple of years, and they are all still true. In fact, that only thing that has really changed is that stock prices are higher and bond spreads are tighter than when we wrote about those topics originally. Does that really sound like an economy so healthy that robust growth is assured? Or does it sound more like a neatly manicured lawn of low cut weeds?

Conclusion

Even if the 'lower for longer' camp, as it is called, is proven accurate and yields stay put and markets do still have some room to run, is that reason enough to abandon the rational in hopes of eking out a few more dollars? We don't think so. There are few certainties in life and almost no guarantees in the market. While we make no claim on the timing of ultimate events, valuations across all asset classes are elevated; the arrows in the quiver of the Fed are running low; and negative real rates across the globe are creating a real possibility that the economy could eventually slip back into a recession.

When the tide does turn, higher valuation stocks and lower quality bonds will feel the brunt of the market wrath. For that reason, we believe that investors should boost liquidity in their portfolios; invest in equities that fit several growth themes and are not solely correlated with a strong equity market; and seek out yield in a yieldless environment by focusing on inefficient areas of the fixed income market without sacrificing quality or extending duration. Instead of raising a white flag and lowering the drawbridge for fear of missing out on gains, we recommend that you look for red flags and shore up your own moat. Your portfolio is your castle, and there is no moat wide enough to protect it if it is positioned incorrectly.

Sincerely,

Chris L. Doucet
Chief Executive Officer

Footnotes

1. "Cynk Technology's Valuation Defied Gravity Without Revenue, Rousing SEC," *wsj.com*
2. Bloomberg Data
3. "Think Big – S&P 500 Historical P/E Ratios" Bespoke Investment Group 5/20/14
4. "David Einhorn: We Are Witnessing Our Second Tech Bubble in 15 Years" *www.wsj.com/monebeat* 4/22/2014
5. "A word of caution about a tech bubble from Janet Yellon" *www.salon.com* 7/15/14
6. http://.ycharts.com/indicators/spain_unemployment_rate_lfs
7. http://data.bls.gov/timeseries/LNS14000000
8. "Uptick in Inflation Could Pressure Fed" *www.wsj.com* 6/17/2014
9. "White House Economists See Few Labor Force Dropouts Returning" *www.wsj.com* 7/14/2014
10. "The Great Insanity In Context (200 Years of European Bond) *www.zerohedge.com* 6/9/2014

Admin Notes

- Form ADV: Please contact our office at (205) 414-9788 if you would like to receive a current copy of our Form ADV II or the Schedule H Brochure.
- Proxy Solicitations: If you receive calls regarding proxy voting, we suggest that you inform the caller that you have delegated Doucet Asset Management full authority to vote the proxy on your behalf. Please note that we are not able to prevent these calls from being placed to you directly.