DOUCET ASSET MANAGEMENT, LLC

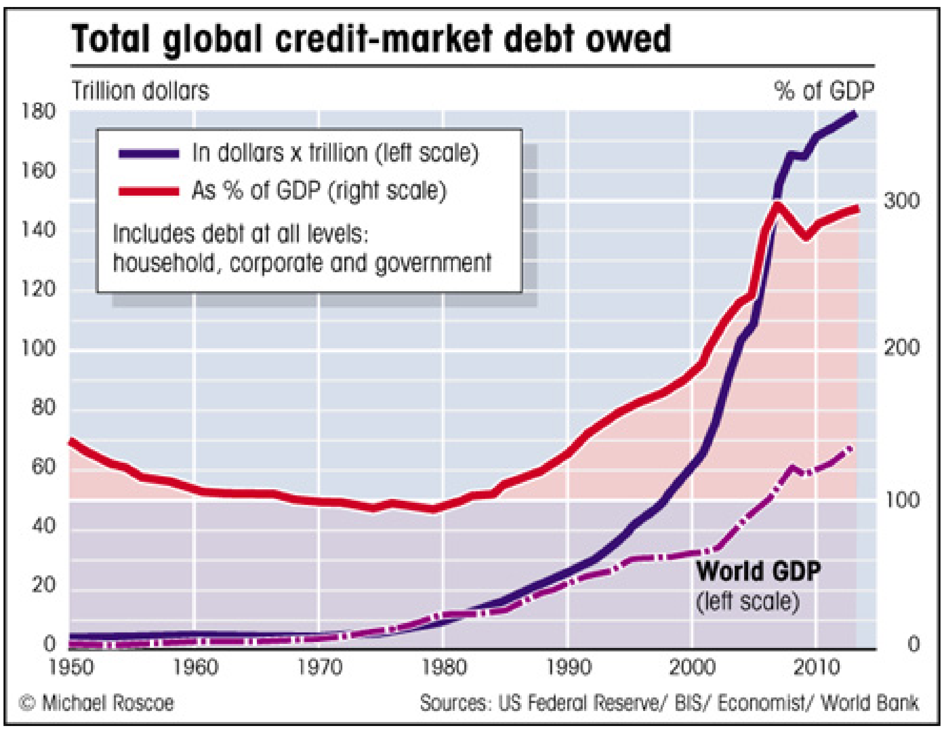
Quarterly Newsletter
Q3 2015
Doucet Value Momentum Portfolio
Doucet Value Income Portfolio
Fixed Income Strategy

July 2015

Treaty of Ver*sigh* 2.0

Let them eat baklava.

The Treaty of Versailles was one of the peace treaties marking the end of World War I between the Germans and the Allied Powers. Its terms were so punitive to the Germans that it is oftentimes credited for the rise of the Nazis and the Third Reich in 1930s Germany, and the ultimate outbreak of World War II. 96 years later, despite three Greek government bond defaults in the past several years, the E.U. (ironically, lead by Germany) presented an economic bailout package to Greece that has about as much chance of succeeding as the original Treaty of Versailles. Failure is almost a certainty given the Draconian austerity measures dictated in the terms of the agreement and their prevailing attitude towards the repayment of debt and fiscal controls. Since gaining its independence from the Ottoman Empire in 1821, Greece has been in some form of default on their debt more than 50% of the time, and there is even a recorded account of a default dating all the way back to the 4th century B.C. It would be foolish for the investment community to assume this Treaty of Ver*sigh* 2.0 will be any different.

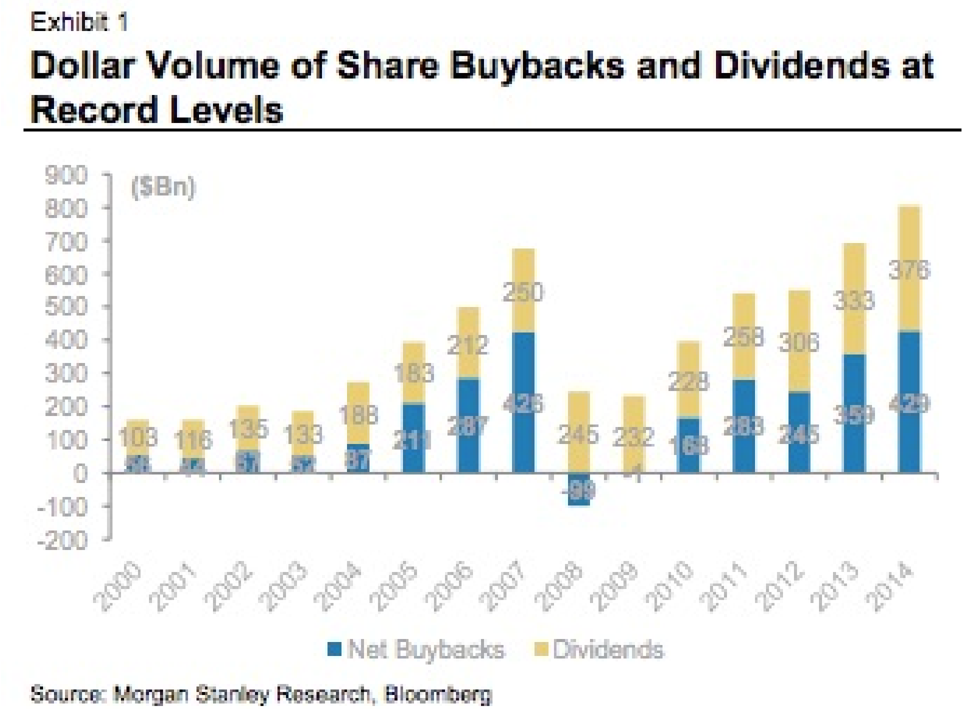


My Big Fat Greek Balance Sheet

The world is suffering from an acute case of *debt-itis* and Greece is merely its current high profile poster child. Similar to subprime debt in the Great Recession, Greek debt is merely a symptom of a much larger problem – the world is awash in debt. The world entered into a balance sheet recession in 2007 and now appears to be heading in that direction once again. The only cure for *debt-itis* is a combination of lower debt levels, higher revenues/earnings and time. This fiscal penicillin, however, is simply not being dispensed; total debt levels throughout the world have grown dramatically. According to the McKinsey Global Institute, U.S. government debt stood at $9 trillion in 2007 and is now above $18 trillion. Even more, China's total debt has nearly quadrupled, rising to $28 trillion from $7 trillion in 2007, and it now stands at 282% of GDP."[1] During this time period, global debt (public and private) has increased by $57 trillion, three times faster than the growth of world GDP."[2]

Robbing Petros to Pay Paulos

Junk or high-yield credits in the corporate bond world (bonds rated below a bank investment-grade rating) have already grown by 147% since 2007 and 369% since 2001.[3] Even if corporate earnings were to remain the same, high-yield credits as a percentage of the entire corporate debt market will likely continue to grow. Bank investment-grade corporations are doing things that serve to impair their balance sheets, all in the name of building stockholder value. Their actions have the potential to drop them below bank investment-grade status in the future, further swelling the ranks and upping the percentage of junk credits in the market. According to Bloomberg, "companies in the Standard & Poor's 500 Index have started paying out more money to shareholders than they produce in operating earnings."[4] In the first quarter of this year, S&P 500 companies spent $144.1 billion on share repurchases and paid out $93.6 billion of dividends, together equating to 104.1% of profit, up from 95.1% in the fourth quarter of last year.[4] The last time this phenomenon occurred was in the second quarter of 2007. "Two quarters later, the figure peaked at 156.5 percent of profit – and the bull market ended." according to David Wilson of Bloomberg.[4]

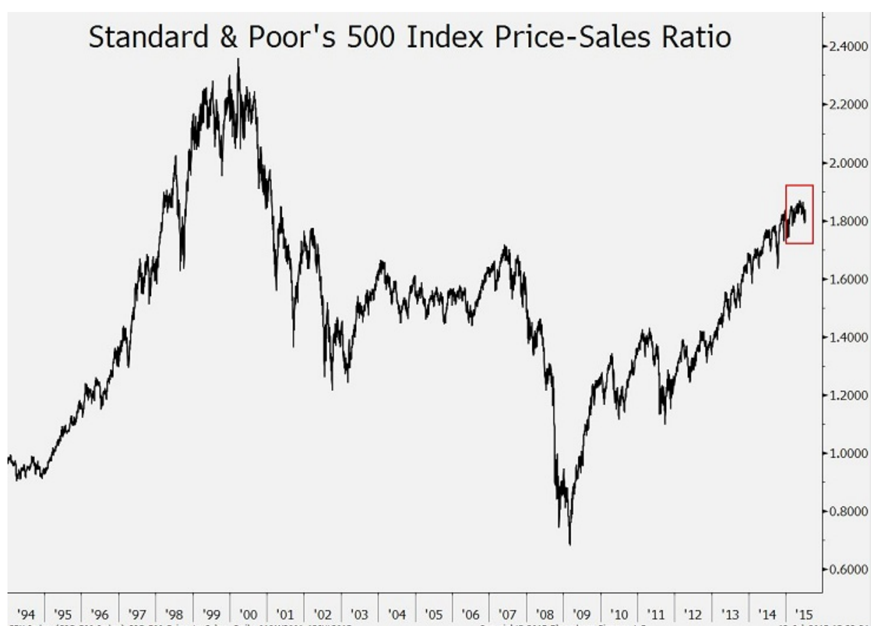


It is worth noting that over 80% of all share buybacks are being done by investment-grade companies, approximately 40% by those rated BBB and another 40% by those rated single A.[5] This is significant because issuers such as these have ready access to capital markets and are taking advantage of this access to fund their buyback activity with cheap debt. In fact, the corporate bond market saw a record $577 billion worth of net issuance of bonds in 2014.[5] If earnings of those companies were to slow even a little, this could adversely affect debt service coverage ratios and hinder their ability to service their debt. This could result in credit downgrades, which in turn, would make borrowing costs more expensive, negatively impact future earnings and further swell the ranks of high-yield credits.

Regardless of how well-intentioned it may be, recent reform legislation may make matters worse should too many bond investors head for the proverbial exit door at the same time. According to Bill Gross, bond manager of Janus Capital, Dodd-Frank Legislation effectively transferred the risk from the too-big-to-fail banks to shadow banks, such as large fund complexes. He suggests there is a "liquidity illusion" in markets today.[6] In the past, big banks were willing to step in and provide liquidity during times of distress in the bond market. Dodd-Frank, however, has increased capital requirements for banks and forced these same institutions to curtail overall risk taking activities. It will therefore be incumbent upon shadow banks and individual investors to pick up the slack in the next downturn should something like a Grexit default cause money to seek a safer home. But can they? With more debt and of lesser quality, it will be a tall order for them to do so. If they cannot, this could exacerbate downward pressure in both bond and stock markets, fueling a viscious cycle.

Icarus Markets with Wings Made of Wax

While disconcerning, current headlines have not been all bad for investors; they have helped to create opportunities for investors in both equity and bond markets, alike. We have already begun to take advantage of some of these opportunities in our portfolios. Compared to our benchmarks, our bond accounts have benefitted nicely by simply investing in securities with short average durations and strategically adding positions in dislocated sectors, such as Energy, as spread widening occurs. (Please read our Fixed Income Quarterly for more details and our thoughts on fixed income securities).



By several traditionally used valuation metrics, stocks, have become expensive versus their 10-year averages, and in our opinion, are Icarus markets with wings made of wax. The price-to-earnings ratio of the S&P 500 is roughly 18.28x its trailing-twleve-months versus a 10-year average of less than 17x; the price-to-book ratio is 2.87x compared to an average of about 2.2x; and the price-to-sales ratio is at 1.84x times, which represents the highest level since February 2001. All of these ratios appear out of whack, despite the fact that roughly half of the stocks in the

S&P 500 are now in correction mode or down more than 10% from their 52-week highs. Even so, we believe there are still only a handful of real opportunities in the equity market.

Most energy related stocks and interest rate-sensitive sectors such as Utilities and REITs, have seen significant downturns in their prices, creating both values and value traps alike. As we wrote in our Q115 newsletter, "we are confident oil prices are nearing a natural floor, and, ultimately, prices will reverse course making many energy-related issues great long-term investments." The oil market is playing very much by the script it has laid out in the previous three substantive energy price downturns I have witnessed over my almost 30-year career. While the road ahead may be an uneven one, we continue to believe in an oil recovery and view the sector as an intermediate-to-long-term opportunity. We feel the same way about selected names in the REIT space, where a number of names are trading at 25% to 50% discounts to their intrinsic values, though we feel the overall sector is overvalued. Even with their interest rate sensitivity, the size of these discounts make these particular names look cheap and should give them some downside protection if and when interest rates do begin to rise.

While value and opportunities in the markets already exist in isolated pockets today, they will become more widespread and evident as earnings slow, the Fed reverses course and cost of capital around the world increases. In the interim, we believe it is imperative that we remain patient, have a slight cash bias and be ready to pounce on opportunities when they do resurface. While we do not believe the Treaty of Ver*sigh* 2.0 will be as momentous as the original one, Greece and other credits will continue to *sigh* and markets will ultimately swing.

Sincerely,

Chris L. Doucet

Chris L. Doucet
Chief Executive Officer

Footnotes

1 Richard Dobbs, Susan Lund, Jonthan Woetzel, and Mina Mutafchieva, "Debt and (not much) deleveraging", McKinsey Global Institute, February 2015
2 Christian Broda and Stanley Druckenmiller, "The Fed's Faulty 1937 Excuse", WSJ.com, April 15, 2015
3 "Leveraged Finance Insights: Rising Interest on Rising Interest", Morgan Stanley Research, June 26, 2015
4 David Wilson, "S&P 500 Spending on Buybacks, Dividends Exceeds Operating Profit", Bloomberg, June 26, 2105
5 "Credit Continuum: The Buyback Bonanza – A Credit Perspective", Morgan Stanley Research, April 28, 2015
6 Jeff Cox, "Bill Gross: Here's what could trigger a 'run on the shadow banks'",cnbc.com, June 30, 2015

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.

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