DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter
Q2 2016
Fixed Income Strategy
Doucet Value Momentum Portfolio
Doucet Value Income Portfolio
Mutual Fund Strategy

April 2016

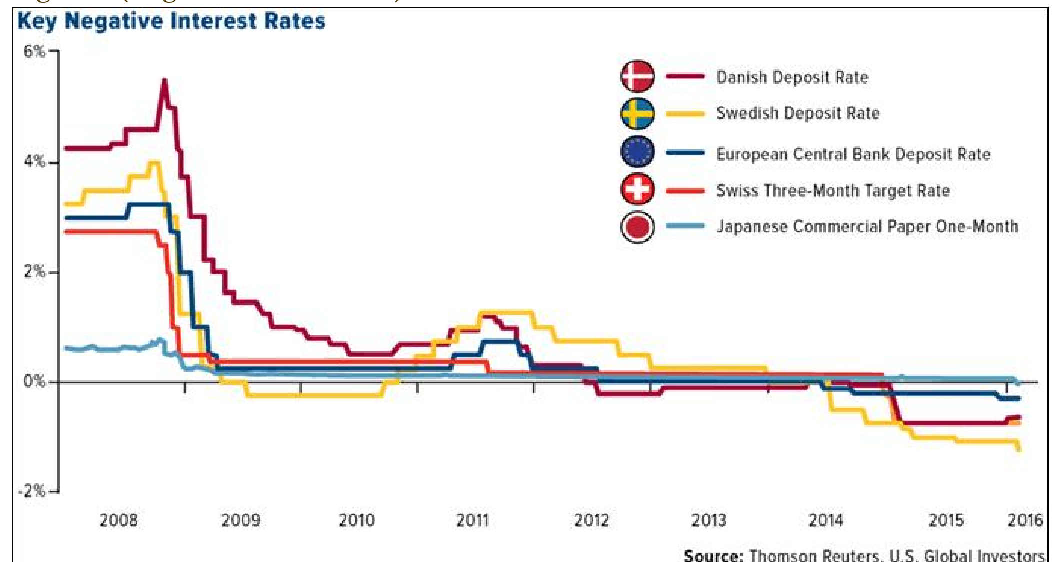
*Frank*enomics 101:

NIRP, ZIRP & *Flowmageddon*

In January, 1803, a mad scientist by the name of Giovanni Aldini journeyed to London with his travelling science show. He was given the body of a hanged criminal, George Foster, who had been executed for murdering his wife and child, to use in his act. Through the use of a series of wires, rods and batteries, Aldini electrocuted the deceased body which caused the face to twitch, an eye and the mouth to open, and the body to actually sit up straight in the coffin. He managed to convince most of the crowd the corpse had come back to life! It is believed by some this event served as the inspiration for Mary Shelly's famous work, *Frankenstein,* which was published 15 years later.

Today, our economies and markets have become variations of Aldini's science extravaganzas. Central Bankers have become modern day Victor Frankensteins experimenting with shock treatments of their own as they have attempted to breathe life into ailing economies and over-extended markets. Negative interest rate policy (NIRP) and zero interest rate policy (ZIRP) are just two recent examples of policy prescriptions administered to the market with questionable results. Now there is even serious consideration being given, by at least one Central Bank, to the idea of a new version of "helicopter money" wherein money is printed and given directly to cash-strapped governments for infrastructure projects, bypassing lawmakers altogether. All of these machinations are real world examples of policymakers run amuck. Side effects have included distorted real asset value and bad behavior exhibited by many investors and money managers. But what will be the long-term consequences of this new version of economics that would be more appropriately be called *Frank*enomics?

Figure 1: (Negative Interest Rates) Less Than Zero



Bubble-Wrapped Economy

History is replete with examples of infamous economic bubbles ending in spectacular bursts including the Tulip Bulb Mania in the 1600s, the South Sea Bubble in the 1700s, the British Railway Mania of the 1800s, and the Dot Com-Era in the 1990s. But there has never been a bubble quite like the current sovereign bond bubble, which has so readily been accepted by the masses and intellectuals, alike, and both perpetuated and heralded by policymakers. Currently, an "estimated 30-40% of developed bond markets" now produce negative yields to investors who buy them including about 75% of all Japanese Government Bonds." To put it another way, investors now have to *pay* the government interest for the safekeeping of their money in 30-40% of all sovereign bonds in the developed world or roughly $7 trillion! This is unprecedented and has only happened for brief periods in the past under the most dire of markets and economic turmoil (think Great Recession and World War II).

The significance of these extraordinary measures being taken by Central Bankers is that all financial securities are priced, at least in part, off of short-term interest rates. The thought process is "when money yields nothing" investors will be

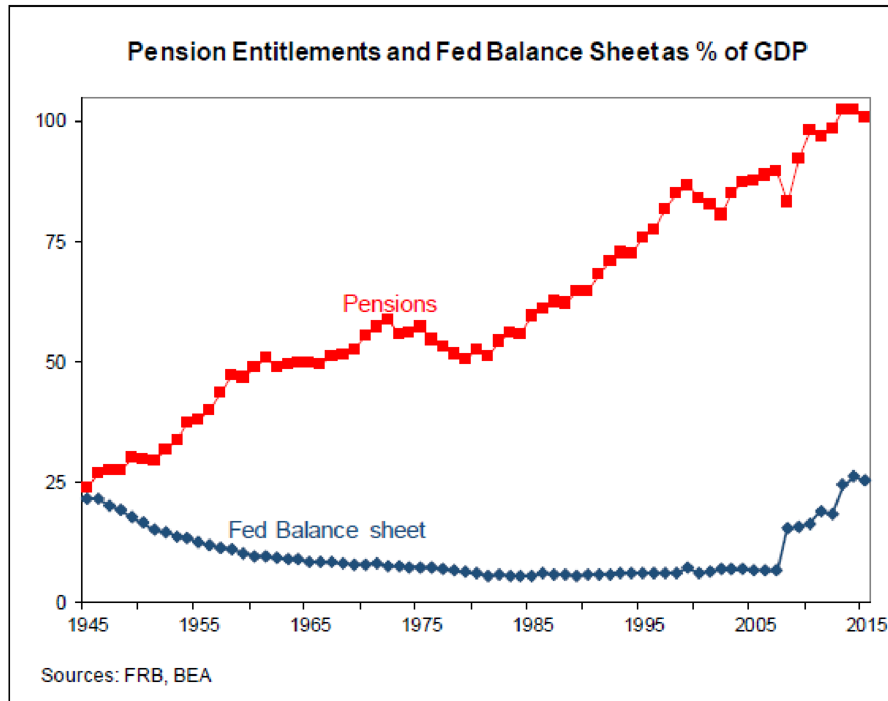
forced to buy riskier assets than they did a few short years ago just to produce the same returns. However, under this new NIRP world, *good* inflation is harder to produce, valuation of financial securities becomes less important, and currency price swings become more frequent and more violent. The hope is by injecting this monetary medicine into the economy capital spending will increase, business activity will become more vibrant, and inflation will rise. What is not known at this point is the unintended consequences and undesirable side effects on financial stability and the functioning of capital markets that the application of this expensive money will have.

The world economy has never been used as a virtual economic laboratory by all Central Bankers before now. In a recent speech, IMF Managing Director, Christine Lagarde, stated point blank the "financial sector may need to revisit its business model in the context of a negative rate environment and adapt to it."[1] Both the ECB President, Mario Draghi, and BOJ Governor, Haruhiko Kuroda, have defended their NIRP stances and stated they would even be willing to push rates *further* into negative territory if needed. But obvious adverse consequences are already beginning to surface.

Taking Candy from a Baby Boomer

The 75 million Baby Boomers in the US represent the largest single demographic group among the domestic population. Many are retired or are nearing retirement age. The grand NIRP experiment could not be happening at a more inopportune time for this age group. Simple math and investor behavior dictate that as people get older, they become more conservative with their investments and desire more fixed income securities in their portfolios. Yet, traditional safe-haven government bond investors like retirees, life insurance companies, trusts, and pensions have been squeezed out of the government bond markets by Central Banks. Since they can no longer rely on income from sovereign credits like US Treasuries for any meaningful yield to realize the same returns on investments versus just a few short years ago, they must own a higher percentage of stocks or corporate bonds in their accounts than they might have historically.

Figure 2: Pensions & The Fed Balance Sheet



According to Brian Reynolds of New Albion Partners, this dilemma has always been big, it has become super-sized, but it will become enormous as our population continues to age. In Figure 2 Reynolds shows that "Pensions have gone from 50% of GDP three decades ago to over 100% of GDP today. Their assets have gone from $1 trillion to $14 trillion in that time." Reynolds argues that not only do pensions dwarf the Fed balance sheet in pure size, but also "their importance to the financial system has grown." With interest rates at effectively zero and a yield return bogey of 7.5% for pensions, there is little choice but for them to increase the risk in their portfolios or increase contributions to these accounts dramatically to meet cash flow needs of the participants. As a result, credit demand around the world has increased tremendously while Central Banks have attempted to supercharge their respective economies on the backs of these same savers. As we mentioned in a recent newsletter, the equivalent of 100% of corporate earnings went into the issuance of corporate bonds last year which coincidentally mirrored the amount of corporate stock buybacks in 2015. This has helped fuel domestic stock indexes to near record levels, despite the fact that price-to-earnings multiples for the market are nearing 20 times and earnings are expected to have declined 10% in the first quarter. The dynamic duo of high multiples and declining earnings create a toxic combination for traditional growth investors in the market and for the economy in general.

Flowmageddon Does Not Guarantee Safety

Just at a time when the indexes are nearing their all-time highs, more hedge funds closed in 2015 more than in any other year since 2009 and investment advisors are overwhelmingly recommending that their clients sell their actively managed portfolios in favor of passively managed portfolios like ETFs and index funds. Morningstar recently termed this occurrence "Flowmageddon" as investors are opting out of active investment strategies and into passive ones. It is not surprising that an estimated 90% of hedge funds are fundamentally driven or are "value" investors. In other words, these managers look at things like cash flows, book value, and price-to-sales to help them determine how much a company is worth and potentially valued in the future. When the majority of stock money goes into an index, investors are by definition investing in larger, more expensive stocks. Most passive index strategies simply do not capture the returns from most value-oriented strategies because of the small dollar weightings these stocks receive in equity indexes. If history repeats itself, the timing of *Flowmageddon* could not be ill-timed for the typical investor.

Value Investing…It's Alive!

Figure 3: Value vs Growth since 1/1/2016

There is an argument that has raged on since the beginning of time in the financial services industry: which stocks perform better-high growth stocks or low valuation stocks? The real answer is, it depends. Famed financial researchers, Eugene Fama and Ken French attempted to answer this very question. They determined that the cheapest (value) stocks outperformed the most expensive (growth) stocks roughly 87% of the time in rolling 10-year periods from July 1926 to December 2015. However, there are periods like 1996 through 1999 and 2013 through 2015 when investors abandoned value in favor of growth.

As we mentioned in our last newsletter entitled *Say Adios to the Zihuatanejo Market*, a plethora of similarities between 2000 and 2016 exist and we laid out our case for a change currently underway in market leadership from growth to value investing. While one quarter does not a trend make, 1Q16 suggested we are correct in our analysis and, from all appearances; there has been explosive flow through this same trend in 2Q16. Not only has value outperformed growth so far in 2016, it has outperformed in every single market cap category reinforcing my expectation that the shift is real and widespread.

It is my ardent belief that investors must position assets (both stocks and bonds) away from the indexes and focus on fundamentally-based investing to ensure the highest level of success in the markets over the next several years. So far in 2016, this philosophy is already bearing fruit, as we are witnessing significant outperformance in our two managed equity portfolios, Value Income and Value Momentum. Further, by employing the same mindset towards fixed income investing, our bond composite outperformed its index in 2015 and is positioned right where we want it to be going forward, as described in our Fixed Income Quarterly Report. Just as continued Central Bank shock treatments to the economy are not the answer to creating vigorous levels of economic activity, index funds are not the prescription for portfolios suffering from the effects of

NIRP and ZIRP. However, history suggests this policy induced *Franken*econmics is dangerous and investors will need a heavy antidote of value to keep their portfolios healthy and alive.

Sincerely,

Chris L. Doucet, CEO

Footnotes

1 Miller Tabak & Co, Anthony Karydakis, Chief Economic Strategist

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.

The above views are those of Doucet Capital and Chris Doucet, and are not necessarily the views of Institutional Securities Corporation. Doucet Asset Management, LLC is independent of Institutional Securities Corporation (ISC). Chris L. Doucet is a Registered Representative of ISC. Past performance does not guarantee future returns.

REGISTERED INVESTMENT ADVISORY SERVICES PROVIDED BY DOUCET ASSET MANAGEMENT, LLC. SECURITIES OFFERED THROUGH INSTITUTIONAL SECURITIES CORPORATION, DALLAS, TEXAS, MEMBER FINRA, SIPC (214)520-1115. THIS NEWSLETTER IS FOR INFORMATION PURPOSES ONLY. NOTHING IN THIS NEWSLETTER CONSTITUTES AN OFFER TO SELL OR A SOLICITATION OF AN OFFER TO BUY ANY INTEREST IN ANY SECURITY, OR IN ANY INVESTMENT VEHICLE MANAGED BY DOUCET CAPITAL, LLC OR DOUCET ASSET MANAGEMENT, LLC, OR ANY OF THEIR AFFILIATES. NOTHING IN THIS NEWSLETTER CONSTITUTES PROFESSIONAL OR FINANCIAL ADVICE, OR RECOMMENDATIONS TO PURCHASE OR SELL A PARTICULAR SECURITY. CERTAIN INFORMATION DISCUSSED IN THIS NEWSLETTER MAY CONSTITUTE FORWARD-LOOKING STATEMENTS WHICH CAN BE IDENTIFIED BY THE USE OF FORWARD-LOOKING TERMINOLOGY SUCH AS "MAY," "WILL," "SHOULD," "EXPECT," "ANTICIPATE," "TARGET," "PROJECT," "ESTIMATE," "INTEND," "CONTINUE" OR "BELIEVE," OR THE NEGATIVES THEREOF OR OTHER VARIATIONS THEREON OR COMPARABLE TERMINOLOGY. DUE TO VARIOUS RISKS AND UNCERTAINTIES, ACTUAL EVENTS OR RESULTS OR THE ACTUAL PERFORMANCE OF ANY OF THE INVESTMENTS DISCUSSED HEREIN MAY DIFFER MATERIALLY FROM THE EVENTS, RESULTS OR PERFORMANCE CONTEMPLATED BY SUCH FORWARD-LOOKING STATEMENTS. ALTHOUGH DOUCET ASSET MANAGEMENT, LLC BELIEVES THAT THE EXPECTATIONS REFLECTED IN SUCH FORWARD-LOOKING STATEMENTS ARE BASED UPON REASONABLE ASSUMPTIONS AT THE TIME MADE, IT CAN GIVE NO ASSURANCE THAT ITS EXPECTATIONS WILL BE ACHIEVED.