JAG CAPITAL MANAGEMENT LLC

Perspective is Everything

Norm Conley | CEO & CIO

> "Believe me, we are in a bubble right now, and the only thing that looks good is the stock market, but if you raise interest rates even a little bit, that's going to come crashing down. We are in a big, fat, ugly bubble."
>
> - Donald Trump
> *(During the 9/26/16 Presidential debate)*

> "The market is The Great Humiliator. It wants to humiliate everyone but has a strong preference for the biggest and most famous."
>
> - Ken Fisher, Forbes Magazine
> *(Portfolio Strategy column 1/12/04)*

One of the most frustrating but central tenets of investing is that successfully predicting the short-term future path of the stock market (i.e. market timing) is essentially impossible. Indeed, to paraphrase Ken Fisher, price movements seem almost predestined to embarrass and confuse as many people as possible. This year's particularly confounding stock market action is an excellent case in point. After posting its worst-ever start to a calendar year (which smacked investors with an 11% decline between New Year's Eve and February 11), optimism was in short supply. Full valuations, cratering commodity prices, slow economic growth, and disappointing earnings results were all cited as reasons to be cautious. Add to those factors the surprise UK "Brexit" vote in late June, a truly bizarre U.S. presidential election campaign, ISIS-inspired lone-wolf terror attacks, and the continuous stream of point/counterpoint from the Fed on the prospect for higher interest rates, and one would be forgiven for being fearful of a big pullback in stock prices. Not so fast! In a surprising (humiliating?) turn, the S&P 500 rallied almost 20% from the February lows, leaving the benchmark index with a year-to-date total return of almost 8% at the end of the third quarter.

By their very nature, surprising events can have a tendency to induce fear. We think Mr. Trump spoke for many when he declared the stock market to be in a "bubble." From our perspective, this has been a truly hated bull market for years now. There is a widely-held belief that the Fed is propping up the stock market, and that the big gains we have seen since 2009 are somehow artificial. Slower-than-normal economic growth and disruption in the labor market is seen as evidence that the stock market has become unmoored from the "real economy." Trump knows this line of thinking has lots of adherents in the American electorate, and our sense is he knew that this comment would gain him some traction with voters who may be feeling economically disenfranchised. But is he right?

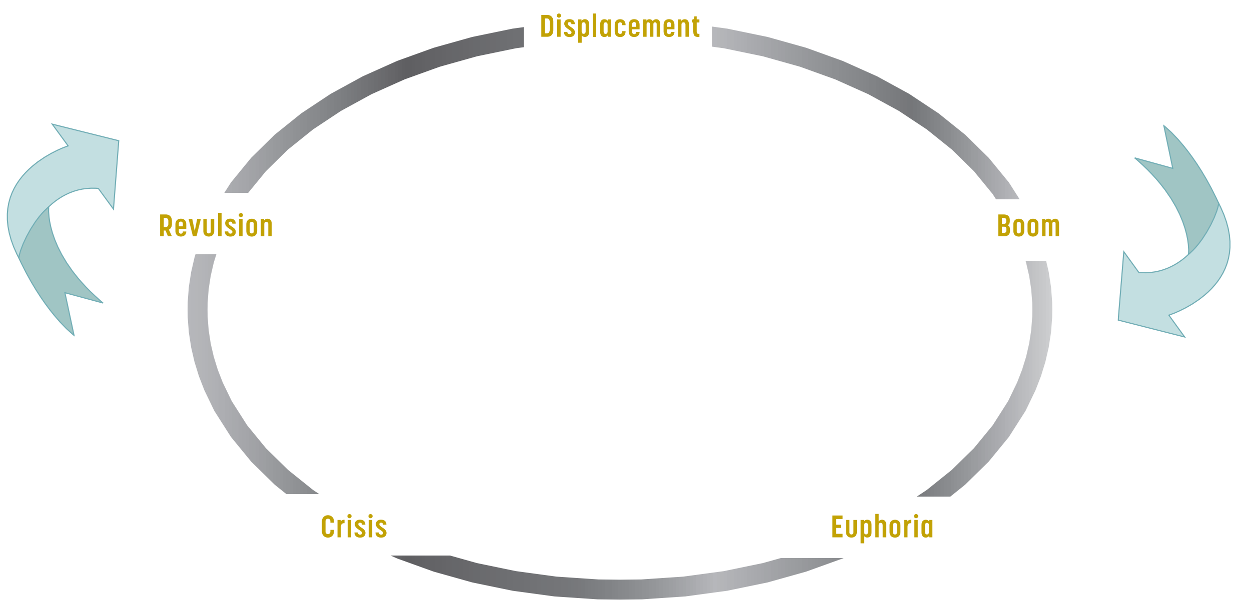
We think not. Trump's comment on the stock market reminded us of a famous exchange from a 1988 vice presidential debate, when Dan Quayle attempted to counter the perception that he was too

inexperienced for the job (he was 41 years old at the time). Quayle noted that he had more experience in Congress than John F. Kennedy had at the time he ran for President. Lloyd Bentsen famously replied, "Senator, I served with Jack Kennedy. I knew Jack Kennedy... Senator, you're no Jack Kennedy."

For our part, had we been able to respond to Trump's comment at the debate, we would have said something like, "Sir, we have lived through bubbles (the tech, commodity, and housing bubbles have all blown up and popped within the last 20 years). We know bubbles... Sir, this is no bubble."

Bubbles are actually fascinating phenomena, and they have been the subject of a lot of academic scholarship over the years. Charles Kindleberger was an economic historian and author whose 1978 book *Manias, Panics, and Crashes* is considered by many to be the definitive study on them. Here is how Kindleberger illustrated the anatomy of a bubble:

Anatomy of a Bubble
The Kindleberger-Minsky model



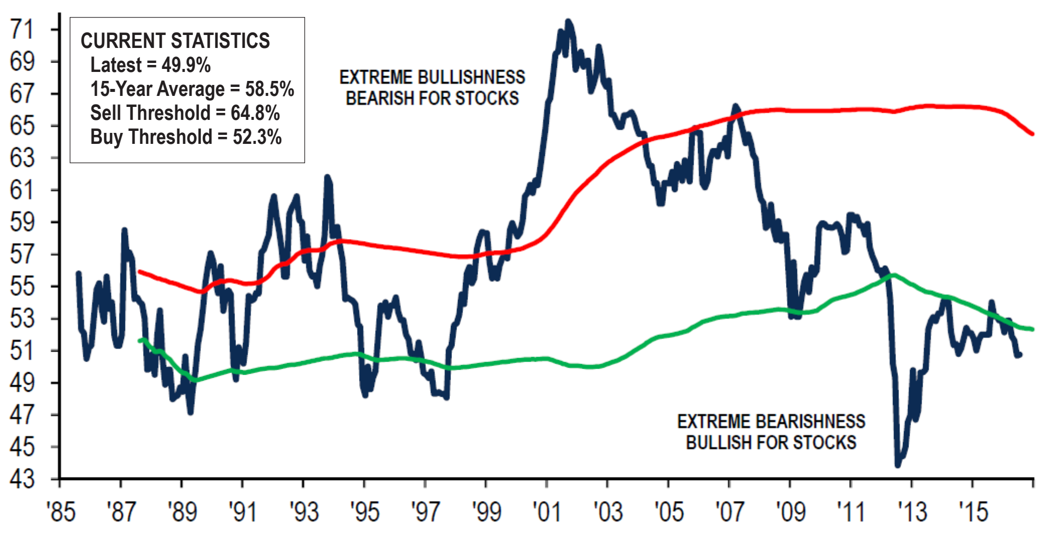
Source: Kindleberger, SG Cross Asset Research

According to Kindleberger, all bubbles start with some basis in reality, such as a disruptive technology development or an important change in the economy. The Dot-Com bubble is a great example to review. In the mid-1990's, people began to perceive that the Internet would be transformative to our society and to most businesses (Displacement). By the latter 1990's, this belief had led to a proliferation of dot-com IPO's, many of which doubled or tripled in price within days or weeks (Boom), which reinforced the narrative that the Internet was going to change the world for the better. Eventually, almost everyone came to believe that they could make "easy" money in dot-com stocks, just like the early investors who had gotten in several years before. According to Kindleberger, "There is nothing so disturbing to one's well-being and judgment as to see a friend get rich." Even sober-minded investors who had stayed on the sidelines were drawn into the rush. This resulted in a period of very steep price increases from late 1999 through early 2000, as more and more people piled into the same types of stocks (Euphoria). Reality eventually bit, of course. Many of the IPO's from the late 1990's turned out to be pure fantasy. In dozens of cases, there were no actual earnings, and the business plans to generate earnings proved to be full of hot air. Many Internet company founders and insiders began to sell their stock, some reaping billions of dollars. In the spring of 2000, the selling picked up steam and begot more selling (Crisis). In the final stage of a bubble, prices overshoot to the downside. By 2002, most Internet companies were either out of business or more than 90% off of their previous peak prices. Whereas just a couple of years prior everyone loved technology stocks, now they hated them. Investors looked for scapegoats, and the press was only too happy to oblige (Revulsion). We think even a modestly thoughtful examination of current market conditions disproves Trump's bubble accusation. Although the market is far from cheap at 21x trailing EPS for the S&P 500, market multiples rarely sit at comfortably "average" levels. In point of fact, valuation multiples move up and down around the long term average, depending upon a variety of factors. Moreover, as a general rule, P/E multiples tend to expand during a bull market—and make no mistake, we are definitely in a bull market. According to Bespoke Research, only 2 of the 13 prior bull markets since 1928 were characterized by multiple compression. And 4 of those 13 prior markets exhibited peak P/E multiples that were higher than our present multiple.

Also, it is important to point out that investors do not make their investment and asset allocation decisions in a vacuum. In practice, we must compare various asset classes against one another, hopefully with an eye toward achieving an optimal risk-adjusted return profile for our goals and needs. At 21x trailing earnings, the S&P 500 trades at an earnings yield of 4.8%, a premium of more than 3% over 10-year US Treasury yields and 1.5% over BAA-rated investment-grade corporate bonds. Additionally, it is worth noting that the dividend yield of the S&P 500 is roughly .5% higher than 10-year Treasuries. Given the fact that Treasuries offer no chance of upside if held to maturity, the sub-2% yield is thin gruel for investors who hope to achieve long-term growth of their capital over the rate of inflation. To us, all of these metrics imply that stocks remain relatively attractive when compared to bonds. Put another way, it probably makes sense for long term investors to maintain a bit more equity exposure than they would if interest rates were closer to "normal" levels.

Perhaps the strongest counterpoint to Trump's comments is the fact that investor exuberance – a key ingredient to the development of any bubble - is in short supply. Both professional and retail investors are far from euphoric about the stock market's prospects. The Bank of America Merrill Lynch Sell-Side Indicator(see chart below), which

Sell Side Consensus Indicator
(as of 30 September 2016)

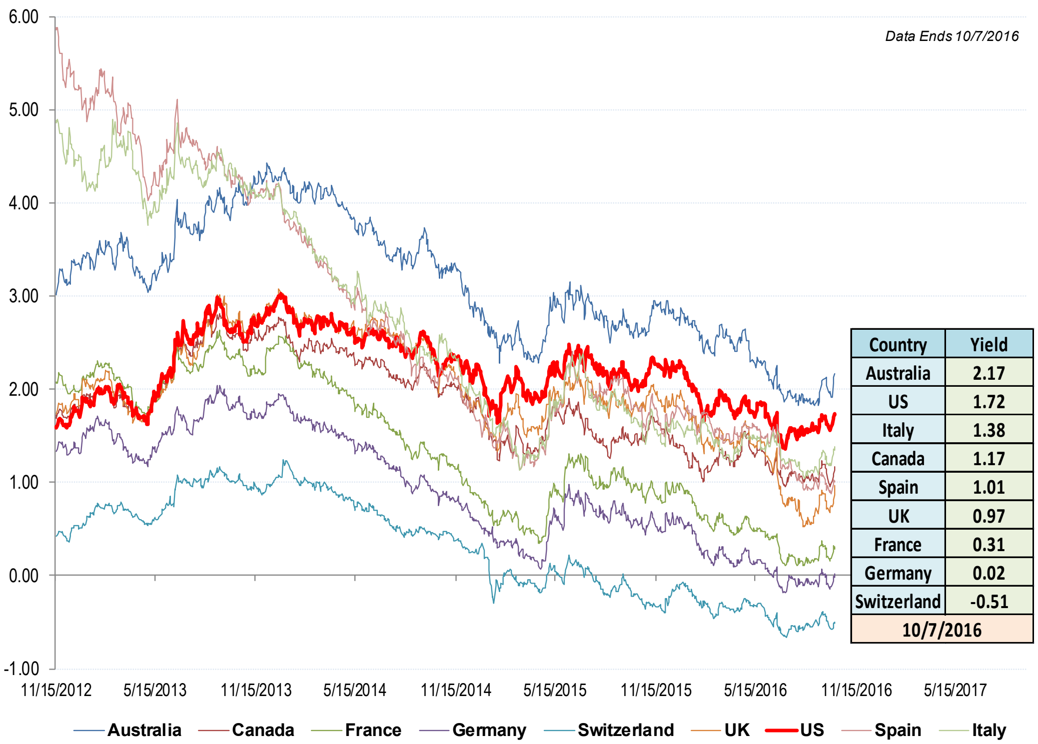


Source: BofA Merrill Lynch Global Research US Equity & Quant Strategy
Note: Buy and Sell signals are based on rolling 15-year +/- 1 standard deviations from the rolling 15-year mean.
A reading above the red line indicates a Sell signal and a reading below the green line indicates a Buy signal.

tracks the recommended equity allocation of Wall Street strategists, has declined to 49.9 from 54 last summer. As a group, these strategists are more bearish today than they have been over most of the last three years. Individual investors are also not showing a lot of enthusiasm about stocks. Only 28.8% of individuals surveyed by the American Association of Individual Investors (AAII) during the week of 10/5/16 characterize themselves as "bullish," which is well below the 10-year average survey reading of 37%. In fact, AAII sentiment has been below average for the last 48 weeks, even as the S&P 500 has approached all-time highs. It will not surprise our more cynical readers that both of these readings have tended to be reliable opposing indicators in the past. In other words, the more optimistic investors are as a group, the lower the prospective return of the stock market tends to be, and vice versa. Therefore, while past performance is no guarantee of future results, blasé investor sentiment makes us lean a bit more constructive on the markets than would be the case otherwise.

Contrary to our cautiously optimistic take on the stock market, we are far from bullish on sovereign (i.e. government-backed) bonds. U.S. Treasury yields are at or near all-time lows, as are most other developed country's bonds (see chart below). In fact, globally there are now almost $10 trillion of bonds that pay negative yields. Yes, you read that right. Anyone buying a bond with a negative yield is guaranteed to lose money at maturity. In effect, buyers of negative-yielding bonds are paying borrowers for the privilege of lending them money! If this sounds backward to you, you are not alone. This is a strange and unprecedented condition in the financial markets.

10 Year Govt. Bond Yields Around the World



Source: Bloomberg, JAG Capital Management

As most experienced bond investors are aware, bond prices move inversely to interest rates. This means that all else being equal, the market value of a bond rises when rates fall, and vice versa. The magnitude of the price impact of interest rate increases with the length of maturity of the bond. Therefore, longer-term (i.e. 20-30 year maturity) bonds are much more sensitive to interest rates than short-term (i.e. 1-3 year maturity) bonds.

Since interest rates have fallen so much for so long, longer-term bonds issued by our Treasury and other governments have delivered great returns. Since the end of 2009, the Bank of America Merrill Lynch 15+ Year U.S. Treasury Index has delivered annualized returns of more than 9% (!), an extraordinary rate of return for what is considered to be (if held to maturity) "risk free" assets like Treasury bonds.

"Two men looked out from prison bars. One saw mud, the other saw stars."

- Dale Carnegie
How to Stop Worrying and Start Living

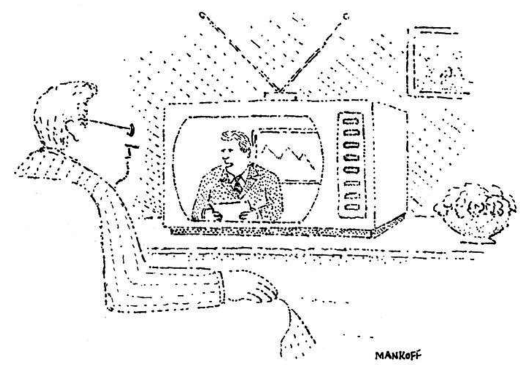
The problem for investors in government bonds is their aforementioned sensitivity to interest rates. The multi-year decline in rates to current levels has driven the huge bull market in returns (remember: as rates fall, bond prices rise). But any meaningful increase in interest rates will cause prices to fall, especially in longer-term bonds. With interest rates hovering near or below zero, the only way investors in many government bonds can hope to earn a return is for rates to fall even farther. If that were to occur, they could re-sell their bonds to other investors at a profit. Barring that, the prospects for a good outcome are slim indeed.

We think that conventional wisdom holds that inflation and interest rates are going to stay "lower for longer" as far as the eye can see. This belief, combined with what we think is a "bubble" in fear of uncertainty, has driven monumental amounts of capital worldwide into government bonds. In deference to "The Great Humiliator," we like to think through what kinds of things would have to happen to surprise investors hiding out in government bonds. Our ideas include the following unexpected developments:

- An end or a reduction in quantitative easing by central bankers here or abroad
- A market-driven increase in long-term interest rates
- An up-tick in inflation
- Continued strength in the U.S. dollar
- Improving economic data in a large global economy like the U.S. or China

Basically nobody thinks that any of these outcomes are likely to happen, but we believe that all of them have a non-zero chance of occurring. If any actually pan out, poorly-positioned bond investors could be hit with surprising and deeply unpleasant price declines.

Our overall approach to managing bond portfolios has 3 main elements that we hope will help our clients navigate this interesting environment. First of all, we are keeping our bond portfolios' average maturities relatively short, so that we can be somewhat insulated against potentially higher long-term interest rates. Secondly, we are tilting our holdings more towards corporate bonds than government-sponsored bonds. Corporate creditworthiness has continued to improve, but corporate bond yields remain very attractive compared to Treasuries. This creates an opportunity to capture incremental yield, while at the same time minimizing interest rate risk. Finally, we have added Treasury Inflation-Protected Securities (TIPS) to many of our core fixed income portfolios. TIPS yield less than comparable nominal Treasury bonds, but they offer an annual adjustment to principal value that is tied to the rate of inflation. If inflation stays dormant over the next several years, we will not give up too much return potential with our TIPS positions. But if inflation unexpectedly ignites, TIPS returns could be very attractive. We like that combination of risk and reward.



On Wall Street today, news of lower interest rates sent the stock market up, but then the expectation that these rates would be inflationary sent the market down, until the realization that lower rates might stimulate the sluggish economy pushed the market up, before it ultimately went down on fears that an overheated economy would lead to a reimposition of higher interest rates."

Thankfully, the Presidential election is now less than 30 days away. If history is any guide at all, roughly half of us will be disappointed or even infuriated by the result. But at least it will be over soon, and we and the news media can move on to other matters. We do not expect our investment thesis to be changed materially by this election or any future elections. Multiple studies have shown that Presidents and politicians have less impact on the economy and the markets than they or their opponents claim. If you are tempted to see "mud" on November 8th after the polls close, we would gently encourage you to look skyward. There will be "stars" to invest in over the coming 4 years, no matter who occupies the Oval Office.

Disclosures

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