CUBIC ASSET MANAGEMENT, LLC

2016 1st Quarter Stock Market Commentary

WHEN LESS IS MORE, MORE OR LESS

Economists report that a college education adds many thousands of dollars to a man's lifetime income - which he then spends sending his kids to college.

\- Bill Vaughn

The English language is loaded with idioms – "You look like a million bucks," or "I am feeling under the weather," for example, mean that you look great and I feel lousy, respectively. Occasionally, the meaning connoted by the expression is the opposite of what a literal translation would be. "I could care less" is colloquially used to express a complete lack of interest in something, even though it literally means that I do have some interest. "I couldn't care less" expresses no interest at all. Similarly, falling "head over heels" for someone implies you are so smitten as to be topsy-turvy, despite the fact that the usual orientation is with our head over our heels, so that this is hardly unusual at all.

Another common idiom is "You can't have your cake and eat it too." We use this to mean that life is full of choices and compromises, and by choosing one option we must usually forego another. But of course, if you have a cake, you could actually choose to eat it. What you could not do is "eat your cake and have it too," since by eating it first you preclude the latter choice. As an interesting side note, this linguistic distinction was instrumental in the capture of Ted Kaczynski, more generally known as the Unabomber. When the Washington Post and the New York Times published his manifesto Industrial Society and its Future, it included the following sentence. "As for the negative consequences of eliminating industrial society — well, you can't eat your cake and have it too — to gain one thing you have to sacrifice another." His brother David Kaczynski recognized that their mother had always maintained that this was the correct form of the idiom. This and other similarities in Ted's writing style and his political beliefs, convinced David to pass this information, along with old family letters demonstrating Ted's writing style, to the FBI, who employed forensic linguistics to compare the manifesto to other pieces of his writing. This information helped convince a judge to submit a search warrant which ultimately led to his capture in the woods in Montana.

The business world is rife with "you can't have your cake and eat it too" decisions. How much reduction of customer service is acceptable to increase efficiency? Should a manufacturer

sacrifice margin to achieve higher revenue growth? Would it be better to slash capital spending to boost current earnings or increase it to generate future earning power?

One of the most basic of these trade-off decisions is whether or not to go public. Private companies are just that - private. They may be as small as a sole proprietor, or as large as Cargill (with annual revenues of $120 billion) or Dell ($59 billion). Generally speaking, they are owned by their founders, management and a few key investors. Prior to 2012, private companies were limited to at most 500 shareholders. But the JOBS Act of 2012 (Jumpstart Our Business Startups) expanded that to 2,000 individuals.

There are several advantages to staying private. Probably the most important is the ability to think about and implement longer-term strategies. Public shareholders tend to demand quarter-over-quarter and year-over-year growth. This is inconsistent with the need to invest heavily in the infrastructure and personnel necessary to drive future earnings. This is precisely why most start-ups turn to angel investors or venture capitalists for early funding, since their three to five year horizon is more congruent with the needs of a development stage venture.

There is another big advantage, which is not having to incur the staggering compliance and accounting expenses associated with becoming and remaining a public company. PwC (the former Price Waterhouse Cooper) has estimated that the printing, legal and accounting fees of preparing an offering document and going on a road show average $3.7 million, plus an additional $1 million for the expenses of reorganizing in a manner consistent with being public. Once public, a company needs to recruit a Board of Directors and beef up financial controls to comply with Sarbanes-Oxley. These costs run yet another $1 million each year. Finally, there are the expenses for increased staffing for internal tax, legal and human resources functions, as well as external tax and legal advice, which are estimated to be $1.5 million per year.

But being public has advantages, too. The most obvious is the ability to raise capital. Huge operations like Walmart ($490 billion in revenue) or Exxon ($280 billion) frequently need to tap the capital markets to support expansion plans. The amounts are simply too large to be provided by the limited investor base of a private company. Then there is the ability of public companies to reward employees with stock and stock options, enabling them to attract top talent and create more management depth.

An unintended consequence of the Federal Reserve's zero interest rate policy post the 2008-9 financial crisis has been to enable entrepreneurs to have their cake and eat it too. Many managements have been able to avoid the cost and regulatory scrutiny associated with being public, while repeatedly tapping vast pools of available venture capital seeking out the possibility of higher returns than are available in the credit markets. Companies like ride-sharing firm Uber or accommodation sharing company Airbnb have been able to achieve valuations in excess of $50 billion and $25 billion, respectively, in multiple financing rounds without ever having to be answerable to public shareholders. The sharp line between public and private investments that was intended to protect the average investor against risky, less transparent investments has become increasingly blurry.

This best of both worlds for entrepreneurs is not quite as satisfying for early stage investors and employees who in prior eras could have counted on an IPO to create liquidity for their theoretically untradeable positions. To accommodate them, a large informal network of lawyers and business brokers developed in Silicon Valley to match sellers of restricted stock with buyers eager to get a piece of the "next big thing." In advance of their IPOs it was relatively easy to obtain shares in Facebook and Twitter, for example. Generally speaking, the buyers were either wealthy private investors or hedge funds. Because the transactions are private, some investors paid one price for shares at the same time that others paid a different price. There is, to put it mildly, a great deal of guesswork in valuing a young company without public financial statements.

But in keeping with the observation by Edwin Land, inventor of the Polaroid camera, that "Anything worth doing is worth doing to excess," more and more categories of investors began clamoring for a piece of the action. Brokerage firms like Merrill Lynch and Morgan Stanley are offering selected startups like Uber to their wealthy clients via special partnerships set up to hold only shares in one company, at the same time that literally millions of Americans of more modest means have exposure to a broad range of private investments like Uber, Dropbox or Brazilian online retailer Peixe Urbano via mutual funds. The line between public and private is becoming increasingly blurry.

Traditional open-ended mutual funds value their holdings every day at the close of trading and then permit investors to buy or sell shares at the net asset value (NAV). So how do you value shares which do not trade? You guess. The Wall Street Journal analyzed closely held technology companies valued at more than $1 billion. For twelve companies they found different funds valuing the shares at different prices on the same day. Ride sharing firm Uber was valued on June 30, 2014 at $40.02/share by the BlackRock Global Allocation Fund. Vanguard U.S. Growth Fund Investor Shares carried the holding at a lower value of $39.64. Hartford Growth Opportunities Fund thought it was only worth $35.67, while Fidelity Contrafund priced the shares at $33.32. The gap between the high and low valuation was more than 20%.

This is far from the most extreme example. Cloudera is an open source software provider. It was priced on June 30, 2014 at $13.10 by the Hartford Growth Opportunities Fund and $14.56 by the Optimum Small-Mid Cap Growth Fund, while T. Rowe Price Global Technology Fund valued it at $27.83, more than double the lowest valuation.

The opacity of the worth of holdings in private companies can have dire consequences for investors. In the second quarter of 2014, T. Rowe Price was carrying the value of Peixe Urbano at $7.41 per share. Anyone selling shares in the mutual fund during that period received the NAV determined using that price. The in-house analyst in charge of valuing that holding decided that the company was no longer viable as a going concern, and wrote down its value to $0.03, a mark-down of 99.6% in a single day. Selling on that day would have been costly, and extremely annoying. Shortly after writing the value of the holding to almost zero, the company was acquired by the Chinese online retailer Baidu for $2.22, 7,400% more than the reduced value. Sometimes the value of private company shares is much less than it should be and sometimes it is much more.

But hidden in this discussion is a potential problem. A mutual fund is simply an investment company that pools the money from many investors and invests in stocks, bonds, money market instruments or some combination of them. Its distinguishing feature is that investors purchase shares in a mutual fund directly from the fund. The transaction price is the NAV (net asset value) of the fund, which requires the valuation of each holding each day. This enhanced liquidity is one of the most attractive attributes of a mutual fund, because it eliminates the need to find a suitable buyer in a secondary market. Moreover, it assures that transaction prices will occur at NAV rather than at a premium or discount. But what would happen if a large number of mutual fund shareholders decided in a panic to cash in on the same day if the fund had 15% of its assets (the current legal limit) in the shares of privately held companies which could not be traded? It might be necessary to restrict investors access to their own funds.

This is not at all a far-fetched scenario. In December, the Third Avenue Value Focused Credit Fund, which had $2.5 billion, experienced a wave of withdrawals after a period of poor performance. It met initial redemption requests from cash holdings and by selling its most liquid holdings. Eventually, though, it was left with only relatively illiquid assets, and it informed the SEC that it was freezing redemptions and placing the remaining assets in a liquidating trust that would sell assets gradually over the next year. But the first investors out the door were made whole.

In the aftermath of the Great Depression, Congress passed the Glass-Steagall Act (1933) which separated investment banking and commercial lending activity from taking place in a single bank. It was thought at the time that risky investments by commercial banks trading for their own portfolios had exacerbated the downturn. Over the ensuing sixty years lax enforcement and the exploitation of loopholes in Glass-Steagall led to a blurring of the line between commercial and investment banks and it was ultimately repealed in 1999 by Gramm-Leach-Bliley. Many believe that the financial crisis of 2008-9 would never have happened if the original regulatory framework was maintained.

Similarly, the 1940 Act regulating mutual funds distinguished between retail investors and "accredited investors." The latter are generally institutions or individuals who meet certain income and net worth requirements, which presumably gives them the sophistication and access to professional advice to evaluate the risks of a prospective investment, as well the ability to better withstand a large loss. Retail investors are deemed less able of making informed decisions and have thus been the focus of the SEC's investor protection programs. But at the same time as low interest rates have forced mutual funds to search for extra returns beyond their traditional universe, regulators have allowed the line between public and private companies to become a bit blurred. It does not take a Nostradamus to foresee the potential for a crisis if mutual funds with a promise of daily liquidity are unable to keep that promise, because they are holding too many illiquid assets. Is it really worth the risk just so that half the households in the U.S. can say they own a piece of Uber?