January 30, 2019

Banyan's equity composite was down 1.75% in 2018 while the S&P 500 was down 4.38%. Although we outperformed on a relative basis, we never enjoy reporting losses, however small. It was a difficult fourth quarter for markets, and we did not escape unscathed. The S&P 500 gave up 13.52% in the quarter. We gave up 12.90%.

Check your pulse if that doesn't get your attention. It got ours. Markets are fairly efficient, and the signals they send should be taken seriously. We therefore take notice when the S&P 500 has one of its worst Decembers ever with cyclical sectors such as industrials getting clobbered. The market is concerned the economy is flirting with a recession, and it sounded the alarm.

The market's concern is valid. Economic data clearly weakened towards yearend, and yet the Fed seemed committed to tighten credit further. This is problematic. After the 2008 Financial Crisis, central banks embarked on an unprecedented monetary experiment that had very real effects. For example, nominal interest rates went *negative* in nations with banks *paying* interest on mortgages.[1]

Now, this ultra-easy money experiment is ending, and no one knows what lurks below the surface. When money is free, it isn't respected, and credit-fueled malinvestments (i.e. dumb decisions made with borrowed money) are more likely. This can create credit bubbles that expand undetected for years. When money tightens, however, bubbles can burst, and industries built atop them crumble.

Think of it this way: the extension of credit creates buying power for borrowers, and, when spent, it becomes another's income. This credit-fueled demand attracts economic resources as business improves. When credit tightens, however, the energy source (i.e. credit) dries up and buying power evaporates. Adequate nourishment is no longer available to support the industry's bloated firms. They shed labor and cut spending to survive. An industry-wide recession is suddenly underway.

This plays out over and over again in an economy. At times, it is an isolated event (e.g. the energy complex in 2015). At other times, it is systemic, and the entire economy goes into a recession (e.g. the housing complex in 2008). The challenge is anticipating the effects of credit cycles in advance. Few investors have consistently done so, and we have no illusions we are among the anointed few.

Fortunately for us, seeing the future isn't necessary to enjoy investment success. Appropriately assessing *long-term* business value and demanding an adequate *margin of safety* will more than suffice. This does not mean we ignore potential credit issues; it simply means we think about credit *one business at a time* and with a *long-term* perspective. Allow us to elaborate:

1. **Risk & Time** | Risk cannot be defined absent the context of time. They are tied at the hip. To us, risk is the chance of suffering a *permanent* loss of *purchasing power*; it is not the chance of suffering a *paper loss* in the next *quarter*. Our concern, therefore, is not *stock prices* over a few *months*. Our concern is *business fundamentals* over many *years*.

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[1] *See* Negative Rates Around the World: How One Danish Couple Gets Paid Interest on Their Mortgage, *available at* https://www.wsj.com/articles/the-upside-down-world-of-negative-interest-rates-1460643111.

2. **Value & Price** | Value is the sum total of future cash flows discounted to the present, but an evolving business's future cash flows are not knowable. An apt simplification is to think of value in terms of a business's "earnings power yield" (i.e. earnings power ÷ price) within the context of interest rates. This helpful simplification focuses our attention on the *long-term* sustainability a business's *earnings power* relative to the price we must pay for it.

3. **Margin of Safety** | With that said, no conceptual simplification can change the fact that an evolving business faces an uncertain future. Unanticipated setbacks are a part of life, and they can alter the long-term prospects of a business. A business's long-term earnings power may therefore deviate from our expectations. Demanding a margin of safety guards against this uncertainty. A *fair* "earnings power yield" simply won't do; it must be *overly generous*.

An example will bring this together. We purchased Parker Hannifin (PH) in the fourth quarter. It is the world leader in motion-control technology (i.e. circulatory systems of industrial equipment). Roughly 52% of Parker's sales are to Original Equipment Manufacturers ("OEMs"), and OEMs' sales are dependent on credit – few farmers pay cash for new John Deere tractors. Thus, Parker's OEM business weakens materially when credit dries up and end-market buying power evaporates.

With this in mind, we analyzed Parker's past performance in a credit crunch. In 2009, the depths of the worst credit crunch since the Great Depression, Parker's adjusted free cash flow fell 17.2% but recovered to prior levels the very next year. The Financial Crisis was therefore a minor, albeit scary, blip in Parker's history due to its resilient aftermarket business and exemplary working capital management. This *long-term* perspective coupled with an *overly generous* and growing "earnings power yield" nearing 7.5% made us comfortable buying the beaten-up stock.

As you can see, a proper perspective on value and risk makes all the difference when investing. There are always looming threats to the economy, and the pain caused when those threats come to fruition is real. If you are always afraid to invest because of those threats, however, you will fail to participate in the greatest wealth creator on Earth – American enterprise. Getting on and, more importantly, *staying* on that gravy train is the path to **<u>building permanent wealth</u>**.

Sincerely,

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