October 14, 2019

Banyan's equity composite gained 21.6% through the third quarter of 2019 while the S&P 500 gained 20.6%. Before celebrating, recall the wild ride we took in 2018. Over the last twelve months, which includes the fourth quarter tailspin, the S&P 500 gained a mere 4.3%; our equity composite gained 6.0%.

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Although our primary focus is public equities, we closely monitor capital markets more broadly. They inform us on the relative attractiveness of the securities we own. Of late, we've noticed unusual signals coming from certain pockets of capital markets. Specifically, behavior in private equity and long-duration bond markets is stretching the bounds of reason. Consider the following:

1. **WeWork** | WeWork, a private equity darling, is a real estate company that leases long-term and sublets short-term. This unoriginal business model was valued at $47 billion in a private equity funding round in 2018. That same year, WeWork *lost* $1.9 billion on $1.8 billion of *revenues*. In other words, it spent *twice* as much as it brought in from customers.

2. **European Bonds** | In the third quarter, the yield on Germany's 30-year bond hit *negative* 0.26%. Lenders are *paying* Germany to take their money for three decades. Worse still, Austria's 100-year bond (i.e., it matures in 2117) yield fell to 1.13%. The latter's mid-August price chart is below. We would expect Bitcoin prices to behave this way. Not bonds.

The risk that owners of these assets are bearing is extreme, and the reward is pennies, if anything. Capital requires nourishment in the form of an earnings stream. The more nourishment, the higher the "yield" (i.e., earnings per dollar invested). At times, this fundamental truth is forgotten. Past price appreciation infatuates buyers, and focusing on capital nourishment is seen as prehistoric.

Consider us dinosaurs. If capital is malnourished, it will wither and eventually die. This is common sense. An unprofitable firm will eventually deplete its asset base and fail absent continual infusions of external capital. External infusions will not be forthcoming, however, so long as those with capital are behaving reasonably. The objective is to *build* wealth. No one sets out to become poorer.

> ***"Speculative operations are all concerned with changes in price. In some cases the emphasis is on price changes alone . . . . I think that is a rather important classification of speculative operations."***
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> \- Benjamin Graham, Lecture 10, *Current Problems in Security Analysis* (1947)

Those that forget this fundamental truth have a name – speculators. They forgo nourishment with hopes of offloading an asset at a higher price to a greater fool at a later date. As prices rise, they're emboldened by strong performance, which seduces others to join their ranks. More capital flows in, prices rise further, and the cycle gains steam. The positive feedback loop causes a bubble.

When the positive feedback loop stalls, however, owners are left holding a bag of empty promises. WeWork's owners learned this the hard way. In the third quarter, the firm tried to offload stock to the public. Public markets balked. Then, WeWork cut its valuation by 60%, but public markets still rejected it. The IPO was finally shelved. Discipline was lacking; public markets supplied it.

Owners of long-duration bonds may be in for a similar surprise. Recall Austria's 100-year bond mentioned above. Now, suppose Eurozone inflation rises ever-so-slightly, and investors demand a mere 1% more yield to own the bond (i.e., the bond's yield rises from 1.13% to 2.13%). In this event, the price of the bond must fall a stomach-churning 47.5%. That's downright frightening.

At Banyan, we keep Mr. Graham's wisdom firmly in mind. Our focus is *not* on price appreciation. Rather, our focus is on the yield an asset offers relative to the risk of ownership. Price appreciation is simply a happy byproduct we enjoy if others come to agree with our reasoning. As a result, we shun markets bubbling with speculative behavior, which is critical to ***building permanent wealth***.

Sincerely,

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