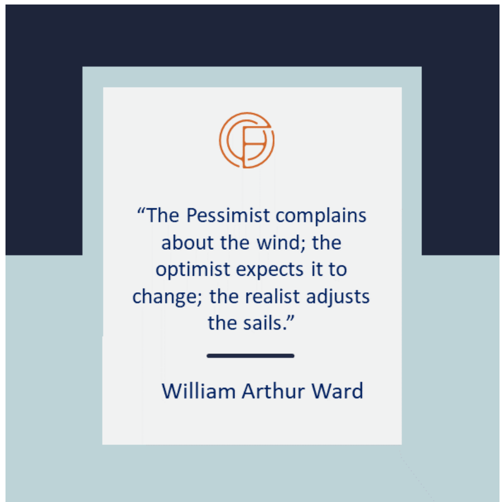
O.F.O. Partners



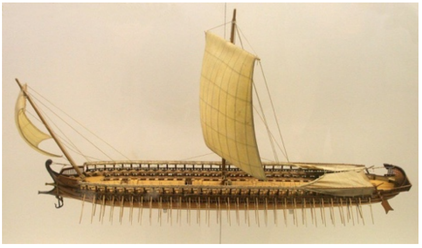
Sailing Along
September 30, 2019

Greetings from O.F.O. Partners. The theme of this quarter’s letter is *change*. Sometimes when things change slowly, they transform into something entirely new without being noticed. We believe that financial markets, after a decade of relative quiet, have invisibly transformed in this way. We’ve borrowed a nautical myth and the analogy of a ship to help navigate today’s conditions.

Part One: The Ship of Theseus

In Greek mythology, Theseus was a storied king. If he ruled today, he would have 70 million Twitter followers. Long after his reign, Theseus’ ship was preserved to honor his contributions to Athenian democracy. Crews diligently replaced each plank, sail, rope, and dowel over time as the originals decayed.

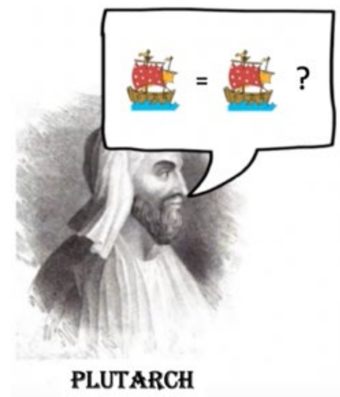
Centuries later, the philosopher Plutarch saw the boat in the harbor. He observed that after years of accumulated replacements, none of the ship’s original equipment remained. Plutarch wondered; with steady and ongoing changes, at what point did it stop being Theseus’ ship and become something new?



“When an object has all its parts replaced,

is it still the original object?”

The ship of Theseus paradox has been debated all the way back to Plato in 400 B.C. Slow change matters. It displaces an object’s identity, even if the replacement parts appear to function identically to the old. As financial markets evolve, they too succumb to transformation.



Since 2009, the U.S. economy has delivered its longest expansion on record. It’s a great time to ask structural investment questions while thinking about Theseus. Have financial markets lost the identity they possessed when they sailed away from the last recession? While investors were quietly discarding financial planks and beams, what exactly were those components replaced *with*?

Interest Rates

The cost of credit is a good place to start. In 2009, the yield of the 10-year treasury bond was more than double today’s level of 1.7 percent (figure one). Investors have enjoyed a decade of low interest rates. The result is that the benefit of declining rates for borrowers has diminished through time. Savers, in contrast, have sunk slowly like the ghost of Davy Jones, and are bottom-feeding on risky assets in search of income. Both trends have gradually removed a margin of safety and flexibility that may be mourned in the future.

Figure One

Figure Two

Interest Rates in the *Developed* World
As of 8/28/2019

Country	Policy Rate	6-Month	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	30-Year
Switzerland	-0.75	-1.21	-1.16	-1.17	-1.19	-1.18	-1.16	-1.13	-1.11	-1.11	-1.13	-1.08	-0.88	-0.61
Germany	-0.40	-0.78	-0.84	-0.90	-0.94	-0.95	-0.90	-0.91	-0.88	-0.84	-0.78	-0.72	-0.58	-0.24
Netherlands	-0.40	-0.83		-0.87	-0.91	-0.89	-0.83	-0.77	-0.74	-0.67	-0.65	-0.58	-0.46	-0.24
Sweden	-0.25	-0.50		-0.66		-0.74	-0.73	-0.66		-0.58	-0.49	-0.38	-0.22	
Denmark	-0.65	-0.78		-0.90	-0.91		-0.91	-0.87		-0.79		-0.69		
Finland	-0.40		-0.77	-0.82	-0.81	-0.80	-0.78	-0.69	-0.65	-0.57	-0.53	-0.46	-0.29	-0.02
Austria	-0.40		-0.72	-0.81	-0.81	-0.79	-0.74	-0.70	-0.62	-0.60	-0.55	-0.47	-0.24	0.10
Japan	-0.10	-0.27	-0.27	-0.31	-0.32	-0.35	-0.35	-0.37	-0.39	-0.38	-0.34	-0.28	-0.09	0.15
France	-0.40	-0.72	-0.75	-0.82	-0.86	-0.84	-0.77	-0.71	-0.65	-0.59	-0.52	-0.45	-0.15	0.37
Belgium	-0.40	-0.79	-0.77	-0.82	-0.82	-0.76	-0.67	-0.64	-0.57	-0.52	-0.45	-0.38	-0.11	0.46
Ireland	-0.40		-0.60		-0.67	-0.65	-0.56	-0.45	-0.37		-0.21	-0.12	0.17	0.68
Spain	-0.40	-0.55	-0.52	-0.57	-0.56	-0.45	-0.39	-0.26	-0.18	-0.11	-0.04	0.05	0.46	0.91
Portugal	-0.40	-0.55	-0.53	-0.63	-0.50	-0.40	-0.35	-0.21	-0.15	-0.09	0.02	0.09	0.44	0.95
Italy	-0.40	-0.29	-0.23	-0.24	0.07	0.20	0.39	0.44	0.66	0.73	0.76	0.99	1.50	2.03
United Kingdom	0.75	0.73	0.40	0.34	0.29	0.30	0.29	0.24	0.27	0.31	0.38	0.46	0.71	1.01
Australia	1.00	0.99	0.87	0.73	0.68	0.68	0.68	0.73	0.78	0.82	0.87	0.89	1.13	1.49
New Zealand	1.00		1.73	0.80			0.85		0.97			1.08	1.25	
Canada	1.75	1.62	1.54	1.33	1.27	1.22	1.17		1.14			1.12		1.38
United States	**2.13**	**1.88**	**1.74**	**1.51**	**1.42**		**1.37**		**1.42**			**1.46**		**1.92**

Concept courtesy of @CharlieBilello https://www.biancoresearch.com

Can you imagine a schooner that slows down rather than accelerates as the wind blows? Many investors are struggling with the financial equivalent of this puzzle today. Outside the U.S. there is more than $15 trillion of public debt outstanding that yields *less than zero*. This means that lenders must pay to accept the risk of entrusting their money to borrowers. The situation inverts the basic premise of the time value of money. Figure two shows a curtain of red numbers representing the affected countries. It's a sheet that continues to unfurl toward the shores of the U.S.

Corporate Debt

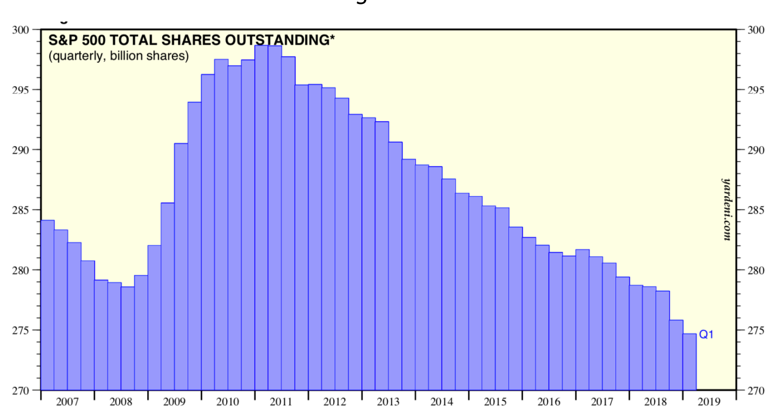
In 2019, nonfinancial business debt exceeded $6.5 trillion, a 73 percent increase from mid-2009. To some degree, this is a rational response to low interest rates. Companies can thrive with cheap debt.

However, covenant protections have declined precipitously, leaving forty percent of investment-grade companies with obligations that look more like junk. More broadly, this era of stable rates and low defaults has induced a troubling wealth effect among investors: a belief that risky assets have become practically risk-free.

Share Buybacks

According to Goldman Sachs, U.S. companies now return more cash to shareholders in dividends and stock buybacks than they generate in free cash flow. Figure three shows that since 2010, companies have grown earnings by reducing share counts.

Figure Three

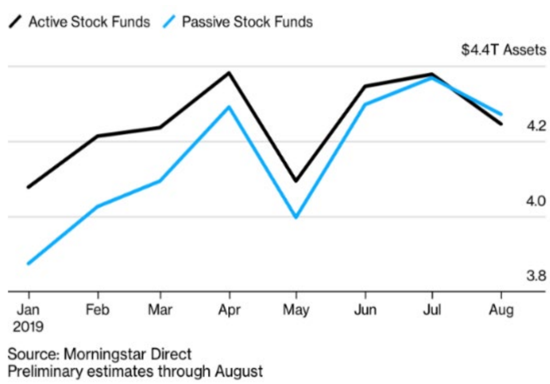


* Total basic shares outstanding for current S&P 500 companies with data for all periods and adjusted for stock splits and stock dividends.
Source: Yardeni Research and I/B/E/S data by Refinitiv.

This source of demand for stocks is a rising tide in good times, but it can drain away quickly when confidence springs a leak.

Active and Passive Management

Passive investment strategies overtook active managers in September as the dominant class of equity ownership. For the first time, the majority of stocks are now bought and sold passively as broad market baskets rather than selected based on individual merit or value. At O.F.O., we support many aspects of this trend because it allows investors to capture high-quality, tax efficient, inexpensive, diversified returns.

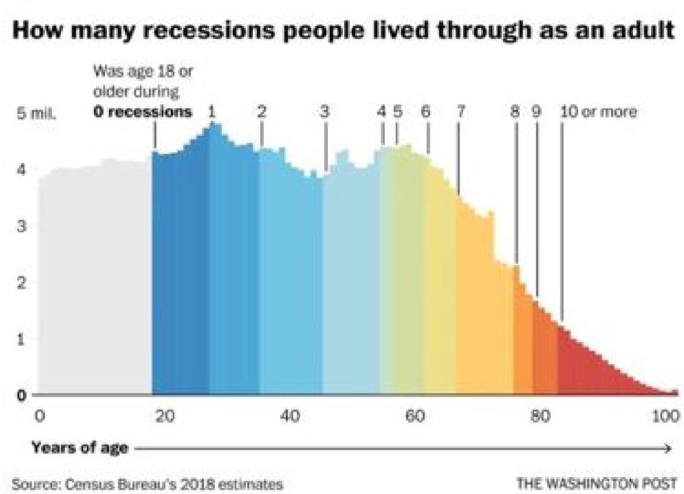


The passive investment boom also transformed markets in ways that were invisible during a long economic expansion. The displacement of $15 trillion of assets to Blackrock, Schwab, and Vanguard has regulators concerned about the systemic risks of these non-bank institutions. Indexing also lowers the bulwark protecting market mechanisms like price discovery, liquidity, and volatility.

We believe that investors will eventually seek a balance between passive strategies and active managers, but harmony may not settle in until after the next cycle has tested the weakest planks.

Fair Winds & Following Seas

Figure Five



In the myth of Theseus, the ship was transformed over time with good intentions by capable craftsmen. Likewise, in markets we at O.F.O. Partners see many quality opportunities against a backdrop of low inflation and unemployment, advances in technology, and sectors with real value. Our caution recognizes that in the myth, the replacement ship's functioning was identical

to that that of the original. In the case of markets, we're not so sure. Figure five depicts a shrinking pool of investors that have experience navigating recessionary conditions. We've shown here that drifts in interest rate policy, corporate leverage, and stock purchasing behavior have contributed to a transformed seascape.

Our job on behalf of clients is to evaluate structural changes like the examples above, and to be aware

that the future will not be like the past because time changes all things. We overcome the danger of slow invisible change by meeting it head-on with research, experience, independence, and methodical planning. Our previous quarterly letter entitled *Free Solo* addressed this type of preparation in detail.

For the balance of 2019, we will review portfolios and adjust positions in ways that are optimal for each client. At O.F.O., we constantly evaluate strategies of all types to protect client capital. With your partnership, we have the opportunity to succeed in these transformed markets while still enjoying the significant returns and good performance that we have sailed through so far this year.

We look forward to seeing you soon,
Christian Connolly, Ezra Levine, Doug Moon & Karen Sugar

Team O.F.O., lending a hand to neighbors at Father's Bill Place in September

Part Two: Third Quarter Market Summary

The S&P 500 has returned 20.6 percent so far this year, with growth stocks continuing to lead value stocks by about 5 percentage points. Technology and real estate are the strongest performing sectors, while energy and healthcare have lagged although each remains positive.

Small company shares have trailed larger companies, returning 14.2 percent year to date. International shares have risen 12.8 percent for the year, with the emerging markets sector returning 5.9 percent.

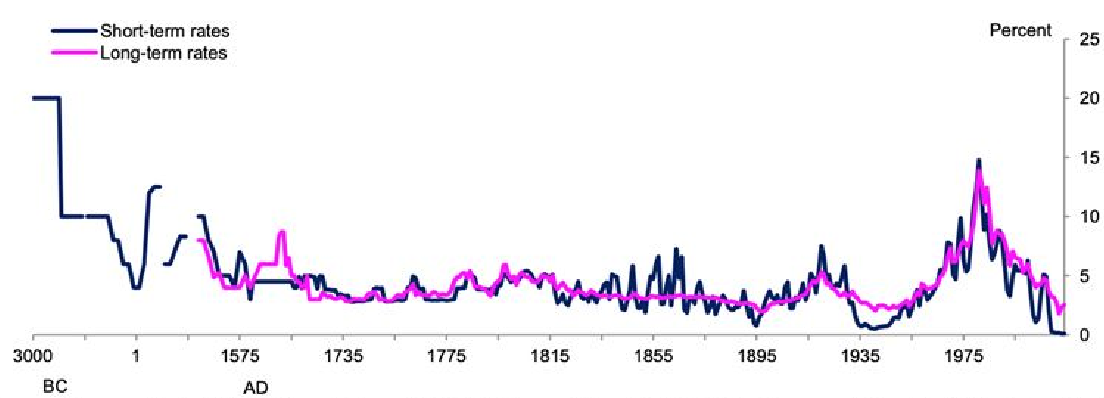
Asset Class	Trailing Returns (%)				
	QTD	YTD	1-Year	3-Year	5-Year
U.S. Stocks					
Large Cap	1.4	20.5	3.9	13.2	10.6
Large Cap Value	1.4	17.8	4.0	9.4	7.8
Large Cap Growth	1.5	23.3	3.7	16.9	13.4
Mid Cap	0.5	21.9	3.2	10.7	9.1
Small Cap	(2.4)	14.2	(8.9)	8.2	8.2
International Stocks					
Developed Markets	(1.1)	12.8	(1.3)	6.5	3.3
Emerging Markets	(4.2)	5.9	(2.0)	6.0	2.3
Bonds					
Short-Term Taxable	0.7	3.4	4.6	1.8	1.6
Intermediate-Term Taxable	1.4	6.4	8.2	2.4	2.7
Short-Term Municipal	0.3	2.1	3.0	1.5	1.2
Intermediate-Term Municipal	1.0	5.7	7.9	2.7	3.1
Cash					
Cash/Cash Equivalents	0.6	1.8	2.4	1.5	1.0
Satellite					
High Yield	1.3	11.4	6.4	6.1	5.4
Real Estate	7.3	27.9	20.3	9.3	10.7
Commodities	(1.8)	3.1	(6.6)	(1.5)	(7.2)

Most bond markets have also generated strong returns; from 6.8 percent (municipal bond composite) up to 13.2 percent (broad corporate bonds). International and high yield bonds have participated in this uptrend as well.

The U.S.

In the U.S., the yield curve inverted during the quarter, which has historically been a harbinger of recession 12-18 months out. Along with lower growth forecasts, this action pushed long-term rates to their lowest level in 5,000 years.

Short and long-term interest rates



Source: Bank of America/Merrill Lynch. Bank of England. Homer & Sylla, "A History of Interest Rates"

The trade dispute with China continued to capture headlines as well. In both deeds and words, the Trump administration has driven corporate investment and manufacturing activity downward, first by applying 15% tariffs on $112 billion of new Chinese imports and then by directing U.S. CEO's to stop trading with China. The resulting decline in activity will continue to weigh on corporate earnings. The first and second quarters of 2019 both revealed modest year-over-year earnings declines after strong gains in 2018.

Europe

Two personalities and a looming deadline dominated European financial news in the quarter. First, Christine Lagarde assumed the Chair of the ECB. Investors are curious about her stance on fiscal stimulus in the face of a slowing European economic engine. Boris Johnson continued his high-stakes approach to Brexit in the U.K., recommitting to a negotiating strategy of leaving the European Union by October 31, with or without a deal.

Part Three: Now Hear This

Here are a few articles and sounds tied to the questions we've pondered this spring.

A Good Walk Spoiled. Revisionist History Podcast

Malcolm Gladwell picks a fight with the game of golf, in an episode featuring the paradox of the ship of Theseus in a big way.

Negative Rates are Rewriting the Rules of Modern Finance

This Bloomberg news item illustrates the mathematical and practical reasons that negative interest rates don't work

Financial Reforms Have Made Banks Safer but Markets More Brittle

The last few weeks saw unusual swings in the demand for cash in the banking system. The Fed is working to fix the plumbing.

Is China a Currency Manipulator? Trade Talks Podcast Episode #95

Keynes and Bown discuss the Trump administration's decision to name China a currency manipulator.

The Trade War & The Fed: Trade Talks Podcast Episode #94

Adam Posen of the Peterson Institute discusses the Federal Reserve's decision to cut interest rates for the first time in 10 years.