IFB255: Howards Marks and the Ongoing Sea Change

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Dave

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All right, folks, welcome to Investing for Beginners Podcast. Today we have episode 255. And today we're going to talk about a recent Howard Marks memo called the sea change that Andrew read and thought that this would be kind of a really interesting discussion for us to talk about some of the comments that Howard made during his memo, and maybe how that can impact investing now, in the past, and going forward, and so I'm going to turn it over to Sir Andrew, and then we'll go ahead and get started.

Andrew

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I feel like I'm not gonna be able to do Howard Marks enough justice. So first off, like go read his memo, because it's really, he does a way better job at describing it than I ever would. Well, Howard Marks is a legend in the investing world. He started, you know, decades before I was born in this industry. And he made his bread by doing value investing, or they would buy distressed debt.

So basically, they were buying bonds, and they are buying into the margin of safety. And they are basically buying the bonds that nobody wanted. So as your quintessential contrarian, you know, buy low sell high kind of strategy. And he talked about in the memo, how the reason why that opportunity was there. I mean, there were several reasons. But one of the big reasons was that people were not issuing or buying debt, that was an investment grade. So he says that, like when he first started out, even the idea of risk and like a risk

adjusted return, or people say, you know, well, high risk, high return, Low risk, low return, like that kind of an idea wasn't even around back then it was literally like, if something's too risky, you just don't touch it period.

So there was a lot of money that wasn't touching these bonds that were considered high risk, because they weren't investment grade. But somebody who was smart and can look at the numbers and evaluate risk and manage risk, could do very well by making good risk adjusted investment decisions. So yeah, I might be taking on more risk with this company. But it's trading at such a cheap price that I buy enough of these, I'm gonna get a good return buying enough of these. And that's kind of how he made his bacon back in the day.

And he's talked about a lot of different things that have changed over the years. He says that was one of them, where investors started thinking of risk not as something you avoid completely, but as something that you manage, along with how much return you're trying to get. And he also talked about how everything we're seeing today around interest rates, inflation, these things are really bucking the trend with what we had seen in the previous 40 year time period.

And so it is a high likelihood that what we see moving forward is going to be very different from what we've seen over the last 40 years. And so you have to be careful, because just because things worked 20 years ago, 10 years ago, the last five years, those kinds of investment strategies, if they were based on different paradigm, then they're not going to work. Well if the paradigm shifts. And there's a lot of mounting evidence to say that that paradigm has potentially shifted in a major way. And you can start with interest rates,

Dave

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how do interest rates impact investments? That's a

Andrew

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great question. Interest rates determine how valuable cash is. And you can think of as simple as if the bank is gonna pay me 10% interest just to sit in the bank. I mean, that's a pretty trade. So why would I take on the most riskiest company in the world and buy their stock and maybe lose all my money when I could just make 10% of the bank. But if the bank's only paying you half a percent, or 0%, to hold your money, well, other more risky investments sound more appealing, because at least they pay you something.

So it's a very simplistic idea, but really, that's kind of what happens and, you know, finance types, we love to take all of those concepts and make them super complex with all these fancy numbers. But at the end of the day, that's kind of what it comes down to. And so as interest rates come down, the prices of risky investments goes up, asset prices go up, home prices go up, all these asset prices go up. As interest rates come up, then those asset prices start to come down. And that's just from the risk reward return side. You also have just the way interest rates affect the economy, and in general, as interest rates are rising the economy slows. So then you get like this double whammy of lower asset prices plus a slowing economy because of interest rates, slowing down lending, slowing down investment.

And so you can get a double whammy, and they can cause your stocks to go down. And so just as a general rule, if interest rates are rising, that's not good for asset prices, and vice versa. But of course, it never follows a perfectly neat pattern like that. And these things are changing constantly.

But if you want to think long, just to give like our super long term perspective, interest rates, I think, really became a hot topic. When Paul Volcker was the Fed guy, back in the early 1980s, he had to break inflation. And so he did by driving the federal funds rate up to 20%, which is the short term interest rate. So interest rates spiked in 1982. And then they've been on a steady decrease in the 40 year period to follow that. And everything after the great financial crisis of Oh, a oh nine, had this period of ultra low interest rates. And starting in 2021, that trend has reversed and and obviously, we've all seen how the Fed has ratcheted up erase rates at such a fast and rapid and steep pace.

And so you know, it's possible maybe that might be shifting, falling rates isn't something we've always seen throughout the history of the United States, ever since the end of World War Two, we had interest rates increase from like, 1945, up until 1982. And that had a steady increase long term trend from there. So you know, I have no idea what interest rates will do the next 10 years and next 20 years. But the fact of the matter is, from call it even the 1990s 2000s interest rates were on a steady decline all throughout that period, all through the 2000s to 2000 10s.

And it's quite possible, we don't see that anymore. And so Howard Marks wonders if there's a sea change involved with that. And you have inflation at such high rates that we haven't seen before, because of so many different factors. And if that persists, then you have to have rates come up, because that's the way that the Fed manages inflation. So that would be I mean, until that comes down. And if inflation is persistent, then it's a sea change, because you can't, you can't come back from that the trend of globalization, which is all this free trade that goes between China and the United States and all these other

countries. And if that's starting to become more constricted, then that kind of definitely doesn't help inflation.

Let's just say that because China has a very deflationary effect to the world economy. And if they're severing their ties here in there, that is not good for inflation. And then, of course, conflict, armed conflict, like we've seen in Ukraine, that doesn't help inflation, destruction doesn't help inflation, geopolitical tensions can really flare up inflation. So those kinds of things, however long they persist, can make for whatever we saw 10 years ago, maybe being just a thing of the past and something we can't rely on in the next 10 years.

Dave

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So how do you think this relates to the idea that the way businesses make money today is different than it was 20 3040 years ago, and how we account for that and how we value those investments. And without getting into the nitty gritty of all the accounting gobbly gook, there's been a growing consensus on the internet that the way that we look at a company making business use example, Microsoft, the way that they make money is vastly different than the way that UnitedHealth does, or that even three M or GE does, and all the accounting is all the same. But the assets that Microsoft owns, are different than the assets that three M owns.

So the idea that using the same accounting standard for both, is maybe a little faulty. And so how do you connect that idea with the following interest rates, which caused companies like Microsoft or Microsoft, maybe not the best example but other companies like Google to be wildly valued versus a company like three M which isn't even though they may be producing great returns over the same period? The way that we account for the value of those a lot of people are arguing now that that needs to change and we have to Think about your subscription business is way different than a very capital heavy business. So I'm getting long here and my question, but how do you think that kind of all correlates with what Howard was talking about?

Andrew

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As soon as I hear the words growing consensus, I automatically disagree.

Dave

10:17

Because you are contrary.

Andrew

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So, you know, there is something to be said, obviously, Michael Mobizen, has done some great research on how so many more assets of businesses are intangible now versus tangible. And we can see that because obviously, the United States is no longer this industrial revolutionary economy. We're all working in factories, and all of this, and a lot of stuff's done on the internet.

Now, I think there can be some changes to GAAP accounting as far as how to deal with some of those things. But free cash flow, stock free cash flow. So the way I kind of have always seen that stuff is it's taken into account through the cash flow statement. I think what's interesting with that, that you bring it in, and kind of tying it into what Howard Marks was saying, is, I think we saw this unprecedented explosion in tech, that we, I think, a lot of Wall Street, and I feel like I've fallen victim to this mentality, too. I think we all assume that that's going to continue forever. And so we look at companies are like, you could say software, right? Software as a Service. So we all assume that businesses are just going to continue to invest infinitely and in getting all the latest technology for their firms and everything.

And you just wonder if that's really going to continue? Is technology going to be the best performing sector in the next 10 years as it was in the 2010s? And I'm not sure if that's the case? I mean, if interest rates are higher, it's going to be harder to start a business. So have we seen a lot of new businesses and a lot of new innovations? And is it just the fact of the matter we won't see as many in the next 10 years as the last 10 years? I don't know the answer to that. But if you have companies that serve those industries, that we're assuming those industries will continue growing forever, and they're not going to grow anymore Software as a Service maybe to pick on them, you know, are they gonna have the same demand in the next 10 years as the last 10 years?

Well, then you have to ask like, if interest rates aren't falling, like there were 10 years ago, and I look at like industry, like venture capital, or like Angel invest and those kinds of businesses. If you're a company in the stock market, and you serve those kinds of brand new businesses, are you going to have the same number of companies to serve in the next 10 years? If interest rates aren't that low? And I don't think a lot of the people investing in those companies are maybe thinking that way? And you really won't know, I guess until the numbers come out. But it's an interesting thought experiment to think, can you really rely on the tailwinds that you had in the previous decade? And I think for some industries, you can, and for others, you

can't. And I think where the danger is, is if you're blindly assuming that everything's gonna stay the same, then you're probably going to get knocked over.

Dave

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Yeah, the era of free money, or cheap money is over for now. And I think that probably spurred a lot of the tech advancements that you were talking about, there was so much money flowing into those kinds of areas of development and investment, partly because the money was so cheap, that it was easy to do.

And you saw quick turnarounds of returns, in a lot of cases, and especially during the pandemic, when a lot of this was accelerated. And it's kind of interesting to think about the sea change because the tide came in, during the pandemic, and there was all this money going into all these things. And we're all just wow, the the growing tech, boom, and then everything reversed to the tide went out. And now we're seeing who was swimming without a bathing suit in. I think, you know, Howard's idea of a sea change, I think is probably a great analogy for that.

And it's going to be interesting to watch over the next 1015 20 years, how this all changes and how we adapt to those things. And Howard is a great voice of reason, sometimes in the midst of a lot of chaos. And he's very smart. When I think of him. I don't know how you think of them. When I think of him. I kind of think of them as this friendly grandfather. That's very, very, very conservative. And I can't imagine him wearing anything with yellow because it's too bright for him. I think he's a great resource for people to read and to learn more about this. What did Howard think How did Howard think that we should behave during this coming sea change?

Andrew

14:58

That's what I kind of liked about them. demo and then feel like he gave you a prescription. He just kind of laid it out. And I, I felt like it was, it should be eye opening to people, if you haven't thought about this is, you know, how are you going to react to this? I mean, just based on our conversation today, how would you think about for beginner positioning of portfolio? How do they protect themselves from some of the pitfalls of maybe the excesses of the last decade,

Dave

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buying with a margin of safety, trying to find companies that are going to grow, but not, you know, trying to remove some of the irrational exuberance, especially though we experienced over the last few years. And I think trying to find, I hate to keep going back to this, but it's such a great phrase, you know, finding great companies that you that are trading for selling for a fair price. And I think if you do that over a long period of time, you'll do well. And try not to get caught up in the shiny object obsession that can happen a lot in the Wall Street. If you avoid some of the darlings, you may miss out on occasion that happens, but we don't have to swing at every pitch. And I think finding things that you think are going to be good companies over a long period of time, I think will do much better than the shiny objects.

Andrew

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Yeah, I agree. I would, the only thing I would add to that is I would be careful about sector concentrations. So if you've gotten really excited about all of the big tech over the last decade, and your portfolio is like 60% technology, I would take a look at that again and wonder, okay, that sounds like you know, is that very optimistic to assume that things are going to continue in a certain way forever? And it doesn't recognize what we can very well tangibly see are things that have changed. And it's not too hard to see that it has changed when you look around. Yeah, that's exactly right. Exactly. Right. All right. Well, with that, folks, we

Dave

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will wrap up our conversation for today. Please check out our website, investing for beginners.com. There's a great search bar at the top of the page. And there's lots of resources to help you find these kinds of companies that we're talking about as we go through a potential sea change. This is a great way to help you fortify yourself and protect yourself from the ocean going out and you're not swimming with a bathing suit. So finding great companies looking at different ratios. Those are all different things that you can find on our website on our search bar. So without any further ado, I'll go ahead and sign us off you guys go out there and invest with a margin of safety, emphasis on the safety. Have a great week and we'll talk to you all next week.

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