

Remember the 1979 song “[My Sharona](#)”? What about “[Who Let the Dogs Out](#)” from 2000? Sports fans may remember the 2002 season Jon Gruden led the Tampa Bay Buccaneers with Warren Sapp, Ronde Barber & Co. They beat Oakland to win the Super Bowl that year – the only Super Bowl Tampa Bay has ever played in since their incorporation in 1976. So many artists, teams, & businesses alike share the same trait as the ones mentioned here: “one hit wonders”. The fascinating thing about “one hit wonders” is how they reserve an iconic place in history that is reminisced upon for decades afterwards – while their creators fade into the distance. The 1970s rock band *The Knack*, the *Baha Men*, and the *Tampa Bay Buccaneers* tirelessly tried (& are still trying) to repeat their past success only to be met with disappointment.

Over one’s investing life, having a “one hit wonder” can undoubtedly be memorable. Staking a large amount of your portfolio to Google at its IPO and rolling with it over the years would have been life changing, for sure. But that same internet media investment could have very easily been AOL, TiVo, or Yahoo! (remember those?). This thought experiment renders two important questions:

- 1) How much skill, rather than luck, is involved in finding the “big hit”, sizing the investment right, and timing it well?
- 2) Is it a valid investment strategy to assume a multiple number of these hits throughout an investment life? If you hit or miss once, does it change the probability of success for the next one?

For #1, we believe a combination of skill and luck must be present, as there is certainly a skill to identifying a great long-term business and managing risk appropriately. However, it is ridiculous to believe that luck is not also present in getting all three aspects correct at the same time.

That’s like making a large bet in the summer of 2000 that a song by the Baha Men would win a Grammy. Or betting the Buccaneers would win the Super Bowl in 2002 coming off a 9-7 season with a new head coach. These are very low probability bets.

Believing we could do this multiple times over is the epitome of confidence-bias. Further, achieving this ‘trifecta’ (position, size, & time) once has no bearing on one’s ability to repeat it. Constantly chasing the “one hit wonders” of the investment world is a strategy destined to disappoint over time without having a ton of luck over and over again.

At Doxa Capital, we think about this a little differently by focusing our efforts on the process, not the outcome. This philosophy stems not from “*how do we win one Super Bowl?*” but rather “*how do we get to the playoffs every year?*” Too narrow a focus on an outcome reduces the likelihood that outcome can be repeated. Said another way, good outcomes originate from either a great process or good luck, and a great process is much more repeatable than good luck. **We see this as a critical viewpoint for achieving sustainable success over the investment life of our clients.**

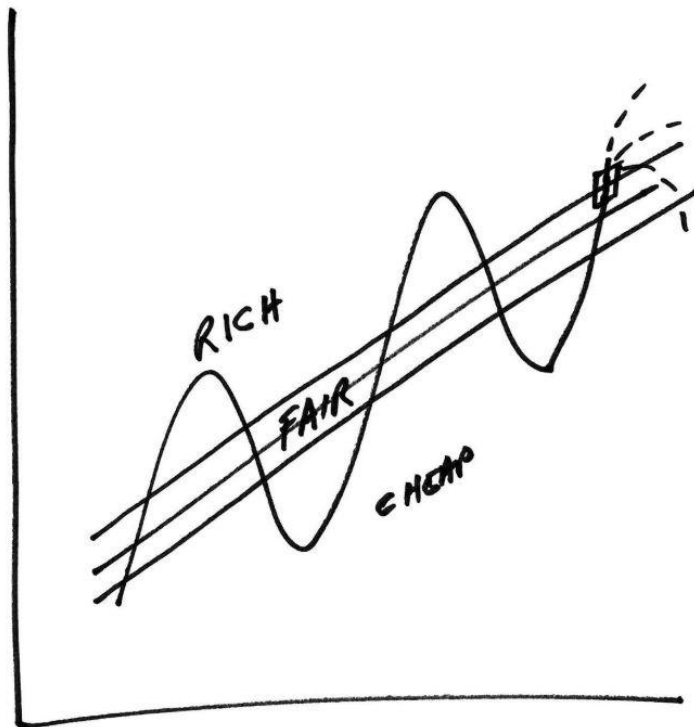
The Process

Investing is a game of probabilities. At the highest level, we want to position portfolios not for the biggest win, but for the highest probability of a win. At any given point in time, a decision must be made based on potential outcomes of future events. The shorter the time frame, the more luck (& less skill) is required – while on a longer time frame, more skill (& less luck) is required.

Think of it this way: which are you more likely to get correct – *name the top song of 1979, or name the top band of the 1970s.*¹ For sports: *who won the Super Bowl in 2002 versus who won the most Super Bowl's throughout the 2000s?*²

Investment decisions can be painted with the same brush. We cannot know what the immediate future holds, but we can

identify where we stand on a broader perspective. Take the simply drawn chart above¹: The next 6 or 12 months could render a number of different outcomes. However, using a historical 'rich, fair, or cheap' context of market cycles we can derive that a moderately defensive stance is not only prudent but required for proper risk management.



Many managers don't think this way. Finding some luck and hitting a huge home run quickly attracts a lot of capital; therefore, a much bigger bonus. Time frames are shorter than ever and "hot money" chases immediate returns like never before. It may feel great in the short time while momentum is good and luck is on your side, but the same problem persists throughout history – it ends swiftly, is never derived from a repeatable process, and focus is solely based on outcome. **At Doxa Capital, we do not rely on luck, momentum, or "hot money". We are entrusted to be good stewards of family savings and appreciate the irreplaceability of that capital.**

Sounds like some buzzword filled line in a big bank commercial, right? Then cut to a happy looking retired couple on their sailboat at sunrise.

To a large firm this probably is just good marketing, but to us it's a philosophy. I'll explain:

1. We fundamentally believe you cannot invest without an edge. Therefore we only invest in places where we can win (or have an advantage). This is where time frames come into play.
 - a. To be successful in the immediate term (less than 6 months), you need either a ton of luck or a ton of speed. Luck is fairly random and speed is determined by

¹ In the 1970's, top artists by record sales & Billboard charts 1-5 were: Led Zeppelin, Elton John, Pink Floyd, The Rolling Stones, & The Eagles.

² The New England Patriots with 3 Super Bowls. Pittsburgh Steelers won 2.

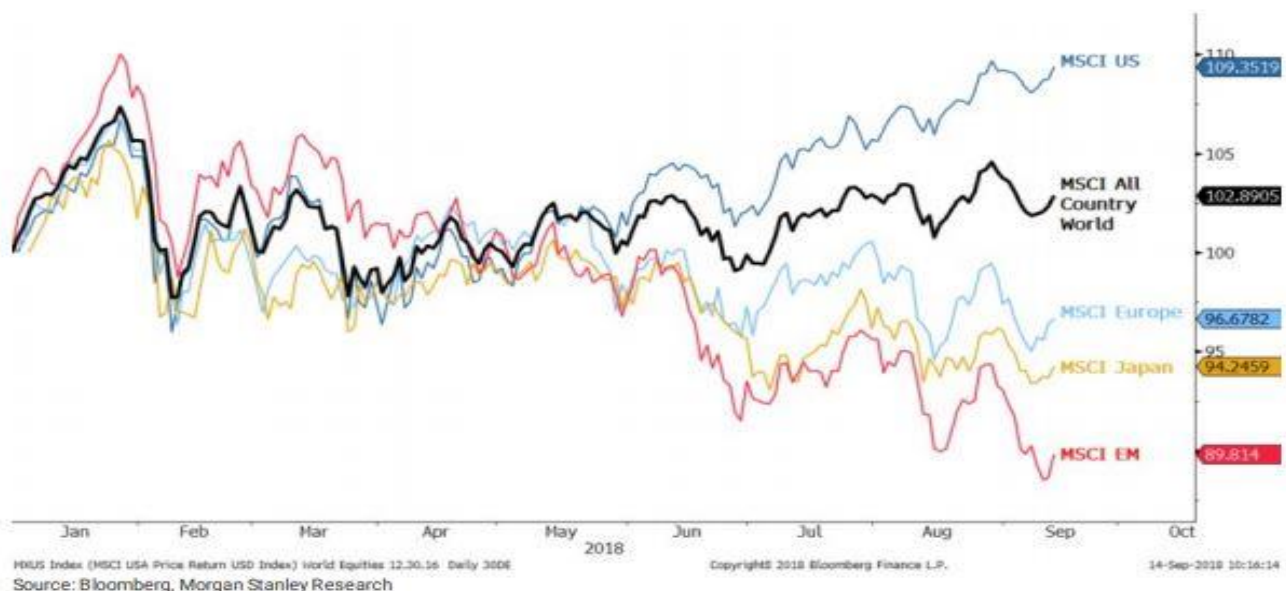
algorithms. It is rare to see either of these be successful through an entire market cycle.³

- b. The medium term (1-2yrs) is the most dangerous timeframe. Impatience is prevalent. Many investors who believe they're long-term capitulate in this environment, where emotion and volatility reign supreme. To succeed, consistent market timing would need to be near impeccable. Two years can provide a lot of different narratives around an investment. This forces investors to see the forest for the trees.
- c. **We live in the long term (3+ years).** Success here equates to having patience & discipline through a lot of noise. The minute to minute news cycle and chase for "hot stocks" has made true long term investing scarce. This provides a great opportunity for dynamic macro thinkers that can look through near term headwinds and position capital for the future.

All said another way – We focus on a robust, sustainable business model with a high return on capital + a macro tailwind at a price below our intrinsic value. We don't claim to have a ground-breaking algorithm nor can we repetitively time the market better than others. These strategies are the "graveyard of real money and the birthplace of false hope."⁴ **Our edge is to constantly think like a business owner, not a stock speculator. That's our way of consistently achieving success over the long run.**

Opportunities: "Buy what's on sale!"

The long preface outlining our process serves two purposes – it is a great reminder as "short term-ism" is contagious and it underscores how we are thinking about the opportunities in front of us. At the beginning of the year we outlined a 2018 checklist that we can now say is complete. Our new challenge is to determine the wide-ranging effects stemming from these events and how long they will persist. The most obvious effect seen year to date across global indices is



³ Renaissance Technologies is the immediate firm to come to mind, albeit other small shops may have success as well.

⁴ Our variation of a quote from Teresa Heinz.

2018 Checklist

- ✓ *We expect higher volatility and flat to low single digit returns in 2018. Market positioning is very one-sided with risk premia at record lows.*
 - This played out immediately in January as many “short vol” positions were unwound. Mid-January increasingly seems like peak euphoria across many markets, sectors, and stocks.
- ✓ *China & a weaker US dollar boosted global industrial production in 2017.*
 - China pulled some stimulus back and went tumbling in the first half of 2018. Global GDP growth peaked in Q1.
- ✓ *Wage inflation seems primed to impact corporate margins.*
 - Low-end wages, trade, transport, & energy are all impacting margins; this is slowly creeping through the system sector by sector. While many have already felt the brunt, others have not. Margin pressure will not abate until everyone is hit.
- ✓ *Global central banks are beginning to retract the liquidity underpinning markets.*
 - This can be seen in the currency markets. The effect of a dollar rally and rate rise was seen in the weakest links first: Turkish Lira, SA Rand, Argentine Peso, etc. This waterfall is not finished.

the wide divergence between the US and international markets, seen on the previous page.ⁱⁱ **We do not believe this unusual variance is sustainable.** At a high level, this gap has been created for two prime reasons: 1) global liquidity has been reduced, and 2) US fiscal stimulus masks late-cycle economics.

Getting right to the point: the events we outlined at the beginning of the year have created a great entry point into some of the world’s most attractive markets as well as great sector opportunities in the US. However, the lack of concern priced in the broader US indices calls for increased caution. **We believe it is prudent to view 2018 as a transition year – pare expensive domestic equities and build positions in quality international ones.**

As most of our 2018 themes are currently playing out, it’s time for a new theme we expect to be dominant over the coming year: **Deflation in things we want, inflation in things we need.** In other words, the necessary (or inelastic) things in your life like food, gas, daycare, etc. will cost more, taking money away from things you want (elastic), like home delivery, premium subscriptions, etc. However, we see many companies sacrificing price to retain business, meaning profit margins are due to disappoint. Let’s try to unpack this:

Avg. Y/Y Change	USD	Crude Oil	10-Yr Int.	U3
Q3 1996 - Q1 1997	4.94%	25.60%	8.63%	-5.94%
Q4 1999 - Q4 2000	2.24%	95.15%	18.22%	-6.96%
Q4 2005 - Q1 2006	4.61%	29.45%	6.96%	-9.36%
Q3 2013 - Q2 2014	2.33%	0.35%	49.80%	-12.96%
Q1 2017 - Q2 2017	2.65%	33.46%	28.71%	-8.16%
Q3 2018	4.14%	44.94%	33.93%	-11.63%

Source: FRED, Doxa Research

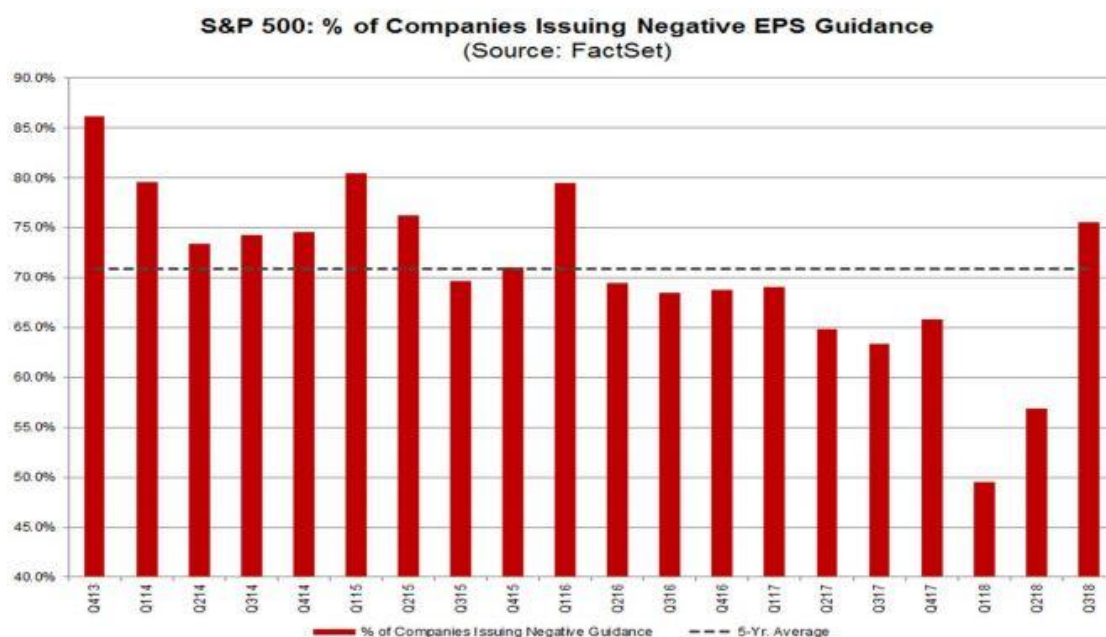
1. At the highest level, the lifeblood of US corporate profits can be boiled down to four variables: **the USD, oil, interest rates, and labor costs**. Over the past 30 years, all four of these have concurrently been higher year-over-year only 5 timesⁱⁱⁱ, seen in the table above, grouped together by business cycle.⁵

- a. The most obvious observation here is how this is a late cycle event. However, as we look closer between the late 90s and today, the similarities are striking. **Between 1997 – 2000 & 2014 – 2017, the price of oil declined 50%, interest rates declined 20%, unemployment went from 5.5% to 4%, and the dollar steadily climbed**. Two eras twenty years apart, same results. *Bonus: the outputs are similar as well – Emerging market underperformed + tech sector outperformed.*

History doesn't repeat, but it sure does rhyme.

2. To be clear, we are talking about corporate profits – not the general economy. The economy will certainly slow as the recent fiscal stimulus dissipates, but there is no “time bomb” or “financial meltdown” on the horizon, in our view. However, a general reset of financial markets seems very plausible, if not probable, as a higher cost of doing business becomes reality from the abnormally low cost environment experienced since 2008.

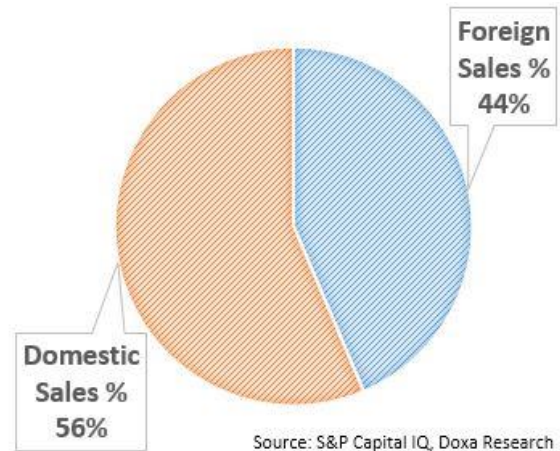
- a. A rise of energy (oil), the USD (trade), financing (interest rates), and labor costs (unemployment) literally affect every company in America. This translates into good demand but less profit, i.e. margin compression. The chart below shows these factors starting to weigh on company outlooks.



3. One thing we hear most often: *Aren't corporate earnings really great and market prices fair?* Yes and yes – but markets don't care about what happened in the past, only what is going to happen in the future. **In the future: consensus forecasted 2018 profit margin is 11.9%, 2019 is 12.5%, and 2020 is 13.2% - all being record highs.^{iv}** Apparently consensus didn't get the oil-dollar-rates-labor memo. This seems primed for disappointment.

⁵ In the previous chart, USD = US Dollar, 10-yr Int. = Interest rate on the US 10yr note, & U3 = unemployment rate.

- a. One thing we admittedly didn't expect is the markets inability to see through the one-time growth boost from corporate tax cuts. However, this is transitory and does not change the fundamentals that we monitor under the surface. **For example, a home improvement retailer will grow net profit 25% during 2018 – but profit before tax will grow around 6%.**^v *Narratives influence price but fundamentals always come through.*
4. To us, the current set-up looks a lot more like a ~2000 scenario than anything else, with a few key differences:
- The extreme valuation excesses are there, just not as broad as 2000. Money and information move much faster today than at the turn of the millennium, so assuming we will reach the same broad over-valuation as 2000 seems a little far-fetched. One look at cryptocurrencies, marijuana stocks, & “subscription-everything” valuations will show that excesses are very much present.⁶
 - The US market did not grow to \$25 trillion in size⁷ by being solely focused on our home market. Our companies rely heavily on international markets, as seen in the pie chart on the right (S&P 500 % of revenues). This diversification is what anchors our companies to global growth, not just US growth.
 - Energy, labor, trade – makes sense in terms of cost. But interest rates? Rates have been low for ten years and the **absolute** level of rates today is not alarming in the least. **But companies have extremely over-levered because borrowing money was cheap – 40% of all small company debt is floating rate.**^{vi} Higher rates equals higher debt service which equals lower margins. Liquidity also has a big effect – [more here](#).



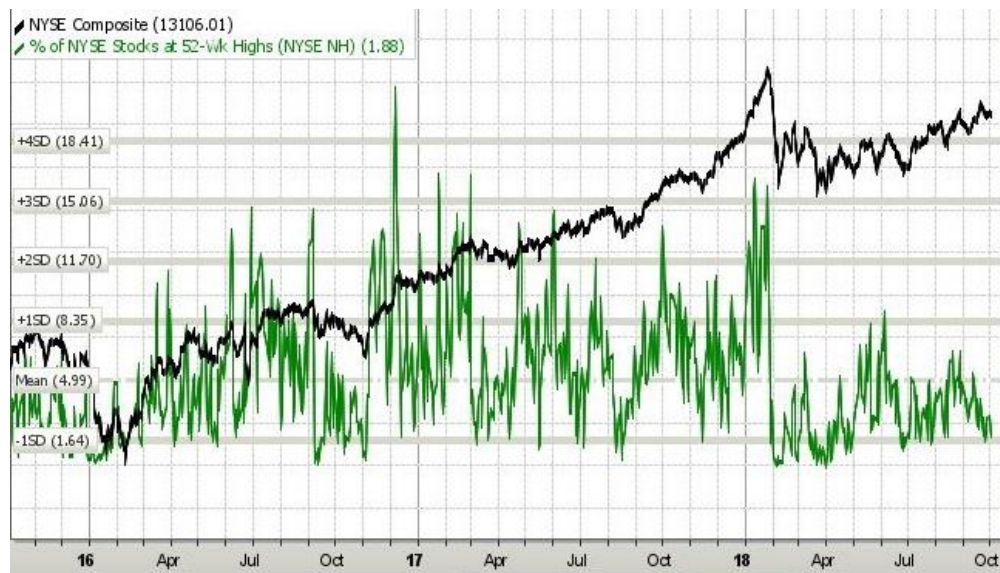
So where is the opportunity if the broader US market still needs to reset?

In January of this year, increasing costs = decreasing margins etc. was what we expected to happen ([2018 Outlook](#)). **Well we aren't expecting anymore, it has been unfolding all year.** Underneath the surface of the oft-quoted mega-company indices are many sectors that have repriced to this higher cost environment. These resets are slowly working through the sectors and will not stop until every corner is hit – even the market darlings of today.

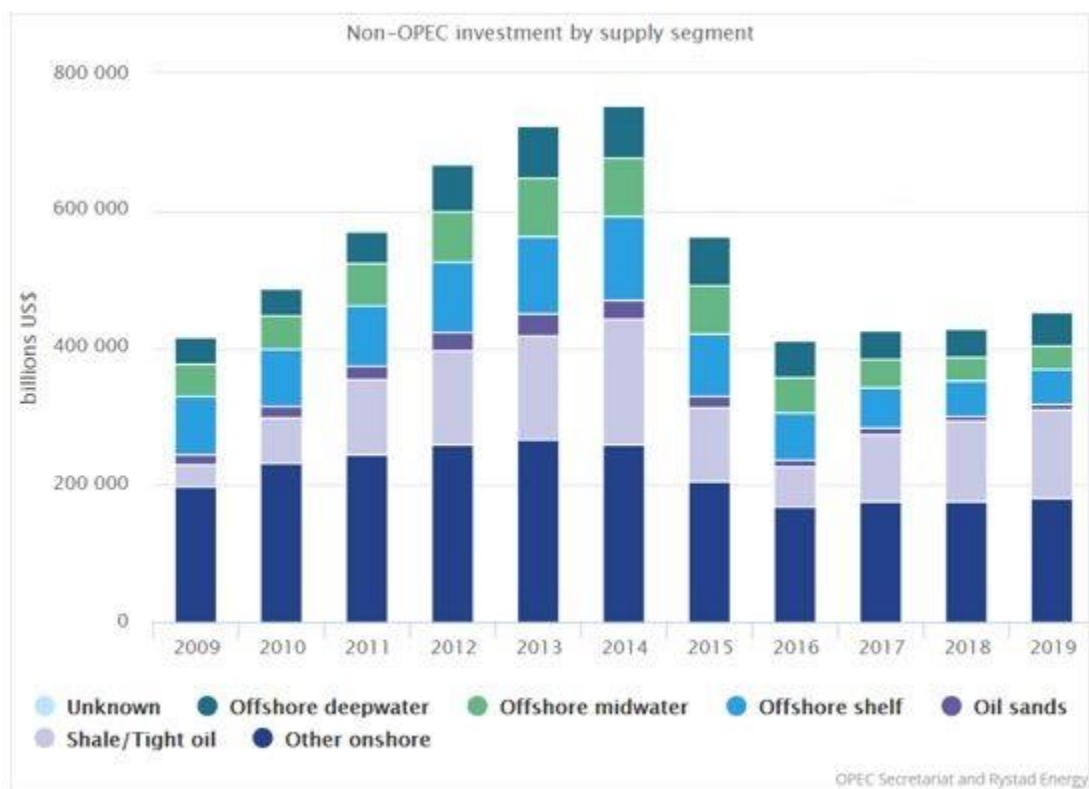
But we are more interested in what has already repriced – mainly companies that have pricing power to push these costs through to its customers. Building products, semiconductors, chemicals, industrials, staples – all of these sectors are filled with stocks down 25%+. Opportunities today are much more prevalent than at the beginning of the year. The chart below^{vii} shows the stark differences between the January market high and today.

⁶ Given we are in the top decile of general market valuation across nearly every metric.

⁷ Size as measured by total stock market capitalization.



Energy is an opportunity we continue to favor, as we've mentioned in prior notes. Supply/demand in oil markets is a long game, hence why it is a continued theme of ours.⁸ **At its core, current investment = future supply. Oil markets will get tighter going forward as the rate of investment has been very slow to recover post-2015 oil recession.** Oil services, integrated international majors, & multi-source production companies seem to be good risk/reward set-ups. Our only caution here is pure play US fracking companies.



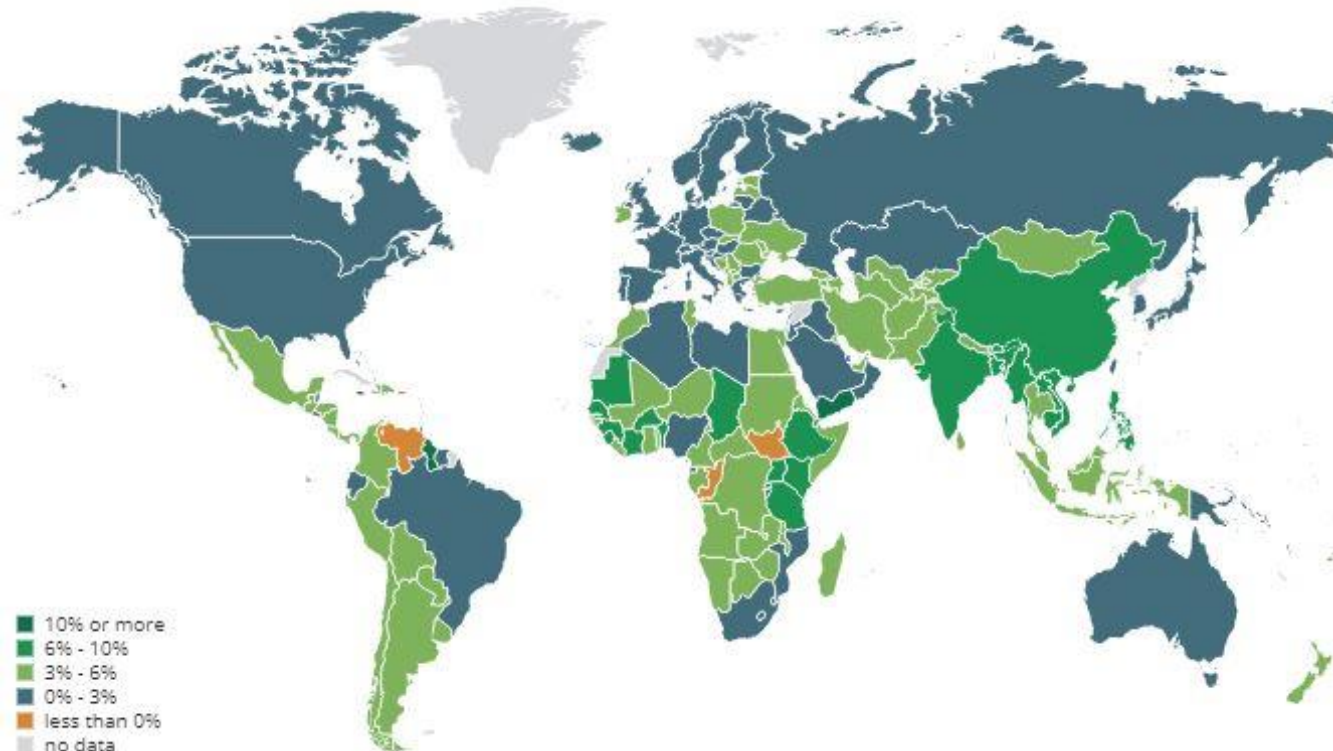
⁸ <https://www.iea.org/statistics/kwes/> << for more information.

The Long View

Emerging markets are extremely unloved right now, but we view this as a very attractive entry point to markets that can outperform over the next decade. In short, we believe the world has diminished its excess capacity – making EMs' shift to capital and Developed Markets' (DMs') shift to labor. **In other words, EMs' new focus will be on higher quality output & higher margins where DMs' new focus will be on labor from capital (declining margins).** In a broad sense, this swing explains a lot of the recent political change as well. EMs also have superior demographics and are now focused on capital deepening. This will produce better margins and profitability.

By taking a long time horizon, we can really step back and see the global picture as a whole. For simplicity's sake: let's say you're shopping for a new TV. Sony, Samsung, LG, etc. – all very nice 55" flat screens with a few different ancillary features here and there. If Samsung was 20% off, would you buy the full-priced LG? 30% off? At some price, those marginal differences matter less, right?

IMF 2020 projected Real GDP growth by Country



Think of global markets like those TVs – *of course there is much more nuance to it* – but largely business cycles, demographics, and rule of law (politics) drive markets over time. Wouldn't you rather buy the TV (market) on sale, rather than the ones full-priced? According to the IMF, projected 2020 GDP growth for all advanced economies is roughly 1.7%, while emerging economies projected 2020 GDP growth is around 5.1%.^{viii} **With a number of emerging markets down 15-20% year to date, investment opportunities have presented themselves throughout the asset class** - and as we here at Doxa Capital know; it just takes a little work to distinguish the quality TVs on sale from those that are just plain cheap.

Chase Lee

Director of Research

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ⁱ Drawing taken from Howard Marks, here: https://www.wsj.com/articles/you-can-time-the-market-just-not-all-the-time-1536922831?mod=hp_lead_pos8

ⁱⁱ Wilson, Michael, Weekly Warm Up: Global Reflation Still the Primary Narrative; Sticking with our Consolidation Call for 2018-2019, September 17, 2018

ⁱⁱⁱ Taken from FRED and EIA data going back to 1988 – as far as series allow.

^{iv} Bloomberg Consensus Estimates on the S&P 500 Index

^v Doxa Estimates & Company Data

^{vi} <https://www.barrons.com/articles/unseen-dangers-in-small-cap-stock-rally-1516419134>

^{vii} <http://www.indexindicators.com/charts/nyse-vs-nyse-stocks-new-highs-params-3y-x-x-x/>

^{viii} https://www.imf.org/external/datamapper/NGDP_RPCH@WEO/OEMDC/ADVEC/WEOWORLD

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