The Special Theory

112 years ago, Albert Einstein published his groundbreaking work on the *Special Theory of Relativity*. The two key postulates were:

- The laws of physics are invariant in all inertial systems.
- The speed of light in a vacuum is the same for all observers.

This theory led to the now-famous equation $E = mc^2$ and predicted that as an object approaches the speed of light it becomes shorter in the direction of travel, its mass increases, and time passes more slowly. All these predictions have been tested over the past 112 years and real-world data has consistently supported the theory. While I could delve into the elegance of the theory for pages, the key focus of this letter is to make an analogy between these postulates and the Sankala Group *Theory of Long-Term Investing:*

- **The laws of investment are invariant in all markets**
- **Risk is a function of valuation – *regardless of what we happen to be thinking today.***

Einstein wrote, “Gradually I despaired of the possibility of discovering the true laws by means of constructive efforts based on known facts. The longer and more desperately I tried, the more I came to the conviction that only the discovery of a universal formal principle could lead us to assured results.” This quest is the holy grail of physics. While this unifying equation hasn’t yet been derived, the postulates of the *Special Theory of Relativity* are very important components of the foundation. Similarly, while no final solution to financial markets has been discovered, we believe strongly that our postulates are equally fundamental.

The laws of investment are invariant in all markets means that certain principles of investing remain true regardless of the geographic location of the company. This is not to say that two companies in different locations are equal investment opportunities, it simply says that their prospects are governed by the same principles of risk and valuation.

Short-term thinking often tempts us to believe that governing investment laws no longer apply because, “things are different this time.” Plausible stories always arise to logically explain why something happened after it already happened. This bias, called hind-sight bias, makes us feel like we should have known what was going to occur. The truth is that market movements are nearly impossible to predict over shorter time scales. Movements in periods under five years are generally dictated by capricious human emotions and thus fall under the heading of speculation, not investment. Theories explaining speculative urges of mania and depression are fascinating, but are outside the scope of constant investment laws.

To illustrate how long-term investment laws are at play today, let’s look at U.S. markets versus emerging markets. A basket of companies located in emerging markets may have higher geopolitical risk than a basket of companies located in the United States, but these companies are not inherently a better or worse investment. That is determined by our second postulate, which says that regardless of those risks, if they are valued cheaply enough they are in fact overall less risky. When we look at returns for the last 89 years[1], we find that the higher risk basket of emerging market stocks has returned 12.5% annualized while the lower risk basket of US stocks has returned 9.4%. This result is driven by the fact that due to the inherent risks in emerging markets, valuations have consistently been lower – and thus companies have earned and returned more to shareholders per dollar invested.

If we look more closely we can see manias, depressions and speculation at work. For multiple periods, we see significant variations in returns. During the 10-year period from September 1, 1988 to August 31, 1998 a basket of emerging market stocks returned 9.9% annualized while a basket of US stocks returned 16.5% annualized. This 6.6% excess return in U.S. stocks tempted many to abandon the “obviously inferior” emerging market stocks. But, what happened in the

[1] We have historical market data from 1928 to today.

next 10-year period? From September 1, 1998 to August 31, 2008, emerging market stocks roared back with a return of 18.1% annualized while US stocks yielded only 4.6% annualized. Emerging market stocks beat US stocks by 13.5% per year. Then from September 1, 2008 through February 28, 2017, emerging market stocks returned only 2.7% annualized while U.S. stocks returned 9.8%. This 7.1% annualized US stock market excess return is once again tempting people to focus too much investment into U.S. stocks at a point where emerging market stocks are poised to produce superior returns given their lower valuations. We have arrived at a place where emerging markets are considered very risky due to 10 years of hindsight bias, while the actual driver of risk – valuation – is telling us exactly the opposite.

Another major implication of invariant investment laws is that valuation ratios can be used to compare investment opportunities across different markets**.** One of the most studied and predictive valuation ratios is the Price-to-Book Ratio.[2] Our research has shown that a basket of large capitalization stocks in developed markets has an average long-term Price-to-Book Ratio of 1.75. This ratio of 1.75 is a powerful benchmark against which to compare current market valuations to determine the relative over or under valuation of a market. Using this reference, we find that the S&P 500's current Price-to-Book Ratio of 2.75 is 57% higher than normal.

Does this mean the S&P 500 must crash immediately? Most definitely not; overvaluation can persist for many years (and currently has). But it does suggest that the S&P is less attractive now than it was for most of the last 9 decades. In fact, it has only had a higher Price-to-Book Ratio during 2 months in 1929 at the end of the roaring 20's, and for 4 years from 1998 to 2002 during the tech bubble.

At the other extreme, a basket of large capitalization emerging market value stocks currently has a Price-to-Book Ratio of 0.95. Because these stocks are higher risk due to their geopolitical risk and other business risks, we would not expect them to trade at the full 1.75 ratio. Our research has shown their average Price-to-Book ratio is 1.2. Emerging market value stocks don't follow fundamentally different investment laws, they are simply higher risk and must therefore carry lower valuation ratios over time. Thus, we can compare their current valuation ratio to their average valuation ratio and conclude that they are 21% undervalued relative to normal.

Does this mean that emerging market stocks will immediately have great performance? Absolutely not; undervaluation can persist for many years (and it has.) But it does suggest that emerging market stocks are a significantly better value than usual. Perhaps that was part of what we saw playing out in Q1 as the MSCI Emerging Markets Index more than doubled the performance of the S&P 500 despite the anti-trade rhetoric in Washington. We can't get into

[2] Price-to-Book Ratio = (Stock Price) / (Total Assets – Intangible Assets and Liabilities). The Price-to-Book Ratio is not a perfect valuation metric, but it is conservative and less volatile than procyclical valuation metrics such as the more famous Price-to-Earnings Ratio.

the game of trying to predict these speculative movements, but we can say that we weren't surprised to see this divergence even under these otherwise seemingly weak conditions for foreign investment. Speculation can only push back on the laws of long-term investing for so long.

In a world clouded by noise and contradictory investment ideas, it is more important than ever to remain grounded in unchanging investment laws. We cannot keep switching ideas, looking for what is different this time, and moving from one speculative trend to the next. That approach will not benefit our account balances or our mental balance. Instead, we must keep investing using the laws we know work over time, and endure speculative phases with as much grace and humor as we can. We are very confident that value analysis will stand the test of time – just as certainly as we know the speed of light is the same for all observers.

Best,

Thomas M. Denkenberger

Thomas M. Denkenberger
Sankala Group LLC
T: (720) 549-3355

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