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OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

Once upon a time, companies operated under the principle that they had to make money. Going public was a reward for earning a profit, and investors wanted to share in that profit. It was a version of the American dream. Apparently that dream has changed. There now seems to be a contest of who can grow the fastest while losing the most money, and investors don't seem to care. The latest company on deck is WeWork. The company leases buildings remodels them into contemporary spaces, and then subleases them to individuals or companies looking for an open workspace.

This is not exactly a high-tech product, but it does appeal to the high-tech mindset. There are few barriers to entry, renting property has been around forever. Currently, it seems to have become very trendy to rent a desk to an entrepreneur who also wants to play ping-pong and drink beer while working. There does seem to be a mystery to the business plan of WeWork. This is ultimately just about renting space for more than what WeWork pays for it, otherwise known as a profit. WeWork is preparing to go public, and growth of 101% to $1.54 billion in the last six-months is fuel for a public offering. Let's just forget about the first six-months of losses totaling $1.37 billion, these guys are growing fast. This trend has been the same for the last few years - high growth, bigger losses. The dream is always the same, high growth will eventually convert into high profit. Let us examine a different tune, but the same lyrics, only here there is no hope for a happy profitable ending.

Germany's 30-year bonds are at -.22%. Just contemplate that one for a minute – evidently, no one else is. For the next 30 years you earn …nothing. In Britain a 50-year bond pays .94%. Even the miracle of compounding doesn't help much, since $1 will turn into $1.60 in 50 years at .94%. Compounding only adds an extra $.13 over a lot of years. These returns are not investable, they have become outright speculation. In the last three months the 100-year Austrian 1.1% bond has gone up by 50%. Does anyone want to just collect their interest payments and wait 64 years to only earn 50%? If something goes up by 50% in three months, that is what most people call high risk. Maybe even higher risk than the stock market. However, the headlines do say: "There is a flight to quality, and: This is risk off." All it takes is interest rates moving up a few percentage points sometime in the next decade and there will be blood everywhere in these safe government bonds.

Compounding has been described as one of the wonders of the world. We currently have half of the world's bond market that has interest rates that are so low, compounding has no or very little effect on the investments' long-term value. That by itself is a good reason to stay away from bonds that fall under this scenario. Even the 30-year Treasury bond is now approaching 2%. After taxes, that means you can never have inflation running higher than 1.5% or you start to lose money. Who really thinks inflation will stay below 1.5% for the next 30 years? At 2%, it takes more than 30 years to double your money. Compounding should be an investors friend, but the problem is that compounding takes time, and it takes something to compound to experience it's wonder. Most European bonds and currently WeWork have nothing to compound.

Compounding does effect risk. The S&P 500 has had a dividend that has grown consistently over the last 90 years by a little more than 5% per year. The dividend of the S&P 500 currently yields about the same 2% as a 30-year Treasury. But unlike the Treasury bond, which stays at 2% for its life, the dividend of the S&P 500 will double to 4% in 15 years. By the end of 30 years, you are at 8%, if the last 90 years are any indication of the future.

Smith Barney, one of the major brokerage firms of the 80's, had a commercial that is a message that we need to remind ourselves of. It was the opposite of our current day trading mindset. "Smith Barney knows that old fashioned hard work is often the difference between getting stung or getting a taste of the honey. They make money the old fashion way, they earn it." Compounding appears to be the old fashion way, but it still works.