A Client Memorandum from Rockstreet Partners

When the Unexpected Happens

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ROCKSTREET PARTNERS

In this Issue

Rockstreet discusses some lessons from 2016

The founder of Isreal, David Ben-Gurion, is credited with saying:

> *"All experts are experts on things that did happen. There are no experts for things that may happen."*

We can think of no better way to sum up 2016. For that matter, we can think of no better words for investors to bear in mind as we enter the 8th year of the current market cycle.

The Year of Surprises

Let's start with the November election. For months, we heard Hilary Clinton was a shoe-in to be the 45th President of the United States. *The New York Times* gave Mrs. Clinton a 91% chance of winning, the Prince-ton Election Consortium a 97% chance. The notion that Florida, Mich-igan, Ohio, Pennsylvania and Wisconsin would all go to Donald Trump was declared "insane". The list of distinguished people who confidently proclaimed that Mr. Trump would lose included just about every pollster and pundit who has ever graced the public airways, written an article, or sent a tweet.

The skepticism was not without cause. Donald Trump's candidacy defied virtually every norm of modern presidential politics. By the examples of the recent past, he should not have secured the GOP nomination, much less won the general election. But Mr. Trump's election, like the Chicago Cubs winning the World Series, was a stark deviation from the immediate past. Something shifted, the unexpected happened.

The unexpected also happened elsewhere. In June, the United Kingdom voted to leave the EU. The pre-referendum polls had "remain" with a solid lead. On election day, betting markets priced an 85% likelihood

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that Britain would remain in the EU. In the end, 52% of Britons voted to leave.

The unexpected also happened in monetary policy. At the start of 2016, most forecasters saw the Federal Reserve aggressively raising interest rates. But then weak data intervened in the spring, and Brexit came over the summer. Come the fall, Donald Trump was a nominee for President. Whether you agree with these decisions or not, the Fed ultimately played it safe, raising benchmark rates only once, and only after the election was over.

In each of these events, the unexpected destroyed the forecasts. Britons rejected the counsel of their leaders, then Donald Trump won Florida, Michigan, Ohio, Pennsylvania and Wisconsin. Many have claimed their errors do not constitute an indictment on their methodology, because 2016 was the "hundred-year flood"—a very rare seismic shift in public opinion that isn't fully appreciated until it manifests. While the excuse is understandable, it ultimately cannot stand because it ignores (or better, rationalizes away) the very reason for the failure. In the end, the failure itself and the rationale both beg the question: what is forecasting worth if it's reliable only when the unexpected doesn't happen?

The forecasting errors would be harmless but for the fact that people rely on them. In the months since the election we have witnessed many in a state of shock. These people have taken to the streets and social media to ask the question: How could this happen? It's a question that has far broader application than just the election.

What to do When the Facts Change?

Twice a year since 1946, the Federal Reserve Bank of Philadelphia publishes a survey summarizing the forecasts of around 30 prominent economists drawn from academia, business and government. Known as the Livingston Survey, its panelists opine on the direction of a range of economic indicators, from GDP to stock prices. Despite their long training, this distinguished group has a poor record of foreseeing shifts in economic growth. In fact, they have failed to predict each of the last two recessions! On the eve of the 2000 recession, their one- and two-year forecasts for unemployment, GDP growth and the level of the S&P 500 were far off the mark. The survey's forecasters did not improve with time. In mid-2007, mere months before the start of the Great Recession, the survey reported that "the panelists think that real GDP will grow 3.0% annually over the next 10 years." The actual result is closer to 1.4%.

This simple example holds an even simpler truth: predictions are often right when the future resembles the past, but wrong when it doesn't. In both the 2000 and 2007 examples, most of the survey's predictions were little changed from the recent trends. If GDP had been growing at roughly 3%, then the panelist saw it rising at a very similar rate. Similarly, stock markets had generally been performing well when the economists made their guesses, so most saw them continuing to head in the same direction. Soon after making these predictions, however, something shifted, the unexpected happened, and their estimates now look abysmal.

Forecasters continually fail to predict when breaks in continuity occur. Now, this is not so much an indictment on forecasting as it is an indictment on those of us who choose to rely on them. Even the most well-trained experts cannot predict when—and just as often, what—will happen to upend the status quo. The problem with forecasting isn't so much that it is often wrong, but that people rely on this flawed method when making decisions.

Take the housing bubble. Before the crash, home prices had not fallen nationwide in any single year since the Great Depression, and virtually no forecast predicted that they would. The assumption that home prices would rise indefinitely fanned the bubble's flames: regulators saw no need to intervene, mortgage lenders expanded the pool of loans, investment bankers packaged them into mortgage-backed securities, ratings agencies bestowed the AAA imprimatur as investors kept adding them to their portfolios. At the root of everything was the comfort drawn from a single prediction that assumed continuity with the past.

Intelligentsia vs. Humble Observer

We are not the first to point out forecasting's blind spot. To be sure, many people smarter than us have made the same case. What we find interesting is that the insight tends to beget one of two responses.

The first of these responses is the "*I am Smarter*" variety—the Intelligentsia. These people focus on what the forecasters got wrong. They generally benefit from the clarity of hindsight, while at the same time creating the impression that they themselves were not among the fooled. (We are excluding people whose clairvoyance was backed up by risk-taking. ***See*** John Paulson in 2008.) The Intelligentsia do not necessarily argue the futility of forecasting; instead, they tend to emphasize points of data that would have given the insight had people only been willing to take note. In other words, <u>the Intelligentsia focuses on market systems—the quality of information available, risk controls in place, etc.—that can reduce risk</u>. As a class, they tend to be people who benefit from maintaining the illusion that risk can be controlled, such as politicians, regulators or any economist writing a book.

As a cautionary exercise geared for understanding, this approach is useful. Society's processes are an accumulation of our experiences, and we are right to learn from our mistakes. The danger, however, comes when we think that the knowledge we glean can be applied in a manner that can prevent the unexpected from happening again. Consider:

- After the accounting scandals at Enron and Worldcom, Congress in 2002 passed the Sarbanes-Oxley Act to prevent fraudulent accounting activities by public companies. Within six years of its passage, the magnitude of ineptitude (we will be polite and refrain from using the word fraud) committed by mortgage companies, investment banks and rating agencies, the worst offenders of which were all publicly traded, was revealed to have happened on SOX's watch.

- Congress responded in 2009 by passing Dodd-Frank. This ambitious legislation affected the oversight and supervision of financial institutions, created a new agency responsible for implementing and enforcing compliance with consumer financial laws, introduced more stringent regulatory capital requirements, effected significant changes in the regulation of over the counter derivatives, reformed the regulation of credit rating agencies, implemented changes to corporate governance and executive compensation practices, incorporated the Volcker Rule, required registration of advisers to certain private funds, and effected significant changes in the securitization market.

Being concerned with systems, the Intelligentsia believe that knowledge and understanding of what caused the last crisis can somehow prevent the next. They do not make much allowance for people—just processes. How confident are we that their analysis and changes can prevent mistakes? Ask yourself: While the unexpected is yet to intervene, does anyone doubt that whatever happens will slip right through Dodd-Frank's net?

All too often we tend to act as if our humanness can be eliminated from finance and investment. Yes, reform surely has a place in creating a better functioning system, but it cannot eliminate the effects of people making poor decisions. <u>All the insight, knowledge and well-tailored regulations cannot undue the fact that we are an emotional being, living in a complex world, just trying to make our way. No amount of knowledge can save us from ourselves.</u> Economic activity is not (usually) conducted by two computers speaking to each other, but two people. So long as this process retains its humanity, then we will continue to see failures and mistakes.

Which leads us to the second category of response, which we call the "*Humble Observers*". Unlike their counterparts, the second perspective takes a market cycle view of risk that assumes it will be increasing the longer a market cycle lasts. Humble Observers do not try to claim that they can see the future. Their contribution is of a more timeless, even spiritual, variety. The Humble Observers know that the fault for these errors lies within our own natures; risk is part of the human

experience and about the only thing we can predict is that the unexpected will happen. They focus on market cycles, not systems.

Don't Compromise Standards

At Rockstreet, we do our best to be Humble Observers. We don't formulate our investment plans based on expected movements in the economy, interest rates or the market at-large—the things that, as the Livingston Survey shows, even the most distinguished routinely get wrong at the worst possible moments. Nor do we chart our course based on broadly-accepted rationales. To do otherwise would have justified an aggressive posture in 2007 and a very defensive one in 2009. To do so now would mean buying assets on razor-thin spreads, or building new assets at record costs—acts that could only be justified by accepting several of today's most well-worn mantras.

Sticking to this principal requires Rockstreet to look beyond conventional wisdom. Many consensus beliefs turn out to be right, and most that are wrong will be harmless. But some will be very wrong, very harmful. In those situations, the skeptic can profit—and it is those skeptics, who question the conventional wisdom and act accordingly, who have the best odds of outperforming. Occasionally the skeptic outperforms by locating the blind spot; but more often it is because the skeptic refused to compromise his standards.

Compromised investment standards are the investment manager's gateway to disaster. Pressure to deliver returns is the most common cause for abandoned principles. If you don't constantly remind yourself to be a Humble Observer, then the competition can drive you to cut a few corners. If one decides to take the turn he will find many enablers: management teams who readily accept your equity, lenders willing to get "creative" with debt, and investors looking to get in on the action. Eight years of record low interest rates can cause people to do things they will eventually regret.

For better or worse, Rockstreet will always chart its course based solely on the risk-return characteristics of the deals we investigate, review and underwrite. Real estate investment is highly localized and information is often fragmentary. Each of the opportunities Rockstreet considers helps fill in the gaps between the others. They provide street-level information that paints a far more accurate portrait of an asset's strengths and weaknesses than any macro predictions or market truisms. It takes patience to uncover and vet these situations, but the knowledge advantage we gain is well worth the time and effort.

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Former Speaker of the House Tip O'Neill famously said "All politics is local." Like any good real estate investor who focuses foremost on the local market factors, the successful politician must pay close attention to how government actions impact his constituency. The adage is a near constant in political circles; yet, the pollsters and pundits who confidently called Michigan, Pennsylvania and Wisconsin for Mrs. Clinton appear to have neglected the point when reaching their own conclusions. They seem to have drawn comfort that 2016 was not to be the first time since 1988 that Michigan or Pennsylvania would go Red. Wisconsin had been Blue since 1984, and they didn't see it changing for Donald Trump. The local facts in those places where changing, but most pundits didn't see fit to change their minds or methods. Instead, they drew comfort from history.

And therein lies the real lesson of 2016. We cannot draw comfort from history. Trends exist until they don't. Rationales work until they change. They are useful tools for the investor for time, but do not hold too tightly. Be willing to question the assumptions supporting your own forecasts. Be willing to remember the saying of John Maynard Keynes: "When the facts change, I change my mind. What do you do sir?"

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