



April 4, 2018

Dear Clients and Friends:

As many of us recently celebrated Easter, a pure expression of faith, I had an admittedly off the wall thought....are the stock and bond markets faith based? Let us first assume that faith is a belief in something for which there is no empirical evidence. A variety of factors may be responsible for that faith, but in the context of financial markets, I posit fear and greed as predominant drivers. Fear in the traditional sense would be fear of substantial or even total loss, and nothing gets the attention of investors like losing money. Feeding into something almost primal, fear is visceral and can be paralyzing, causing irrational decisions. We saw this in the 2008 financial crisis when investors made completely absurd assumptions, which had almost no chance of occurring. Investors who relied on facts, rather than faith, to make their decisions were mostly well rewarded. This is, of course, much harder than it sounds, for as they say, there are no atheists in foxholes.

A more subtle type of fear is what is referred to as FOMO or fear of missing out. Typically seen toward the end of long bull markets, this emotion requires investors to either ignore what they know to be true or make assumptions about the future that are simply fanciful. It is exacerbated by unrealistic return expectations (think massively underfunded pension obligations). It seems that FOMO peaked at the end of January 2018, with the last two months showing a slight retreat in our informal FOMO gauge. The ability of investors to earn a relatively risk free rate of around 3% for the first time in almost a decade, along with a sizable increase in the volatility of the equity market, may have banked FOMO for now. As a result, some of the more absurd assumptions with respect to growth in the overall economy and earnings have receded. The FOMO-driven market can be particularly challenging, as it tends to last longer and will test the investor, like Reams Asset Management, who relies on reason.

Turning toward the other driver, greed, the examples are simply legion. In a macro sense, greed is closely but not inextricably linked to FOMO. Yet it is in the micro world of individual stocks where it really shines. Let us take a look at a company known as Tesla. There is no need to discuss the efficacy of electric vehicles, which is without question very high. However, I believe an investor in Tesla must set aside reasonable assumptions about what is economically possible in the future. Tesla has not yet sold 300,000 vehicles in total while GM sells 9.6 million per year.* Despite enormous U.S. government subsidies, Tesla has posted massive losses at the company level and on each vehicle sold. It has also engaged in questionable accounting practices, guzzled cash, and developed no significant proprietary technology. Yet it recently had a market valuation that exceeded both Ford and GM. How is this possible? Faith - the belief in something for which there is no empirical evidence and, in this case, overwhelming evidence to the contrary. The desire to be part of something transformational causes investors to ignore the facts as well as revere a CEO who

plays fast and loose with facts and channels P.T. Barnum almost daily. Greed can inevitably lead to irrational behavior, but it can be treacherous to invest against. Just ask those who have shorted Netflix or Tesla in the last year or so. Usually it is best to step aside and pick through the detritus left after the crash. In full disclosure, I am personally short the stock of Netflix.

We believe markets at times do exhibit qualities of faith-based investing, and knowledge of the drivers can be very useful. I am not sure that belief in the Federal Reserve to get it right or have any idea what the future may hold qualifies, but it is worth a discussion. Certainly, the belief that they have a unique ability to discern the future is not supported by any evidence.

For now, we will try and focus on high probability outcomes such as available and stable 3% nominal returns or close to 1% real returns. The transition from a FOMO market to one more interesting may or may not be underway, but it is without question long overdue.

Sincerely,

A handwritten signature in black ink, appearing to read 'M. Egan', with a long horizontal flourish extending to the right.

Mark M. Egan, CFA
Managing Director

*Data obtained from Bloomberg Terminal, accessed 4/3/2018.

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