

Artemis Vega Fund LP



THE INCREDIBLE SHRINKING STOCK MARKET

"We frontloaded a tremendous market rally to create a wealth effect ... The Federal Reserve is a giant weapon that has no ammunition left."

Former Dallas Fed Governor Robert Fischer (January 2016)



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Monetary Stimulus

Fed Keeps Rates Low ↓
Maybe negative rates too!



1

The Incredible Shrinking Stock Market

Low fundamental growth

Revenues flat
No reinvestment
No hiring or wage pressure



Corporations issue debt

Yield hungry investors buy debt at rich valuations



Corporate CEOs
Meet EPS Targets
and get Fat Bonuses

Stock Market ↑

Valuation with P/S, EV to EBITDA, Tobins Q, Shiller PE near crash levels (1928, 2000, 2007)

Volatility ↓

Share buy backs ↑

Shares ↓
Earnings Flat
Earnings Per Share ↑
P/E Ratios ↓

1. *The Incredible Shrinking Man.* Dir. Jack Arnold. Perf. Grant Williams. Universal Studios, 1957. Images

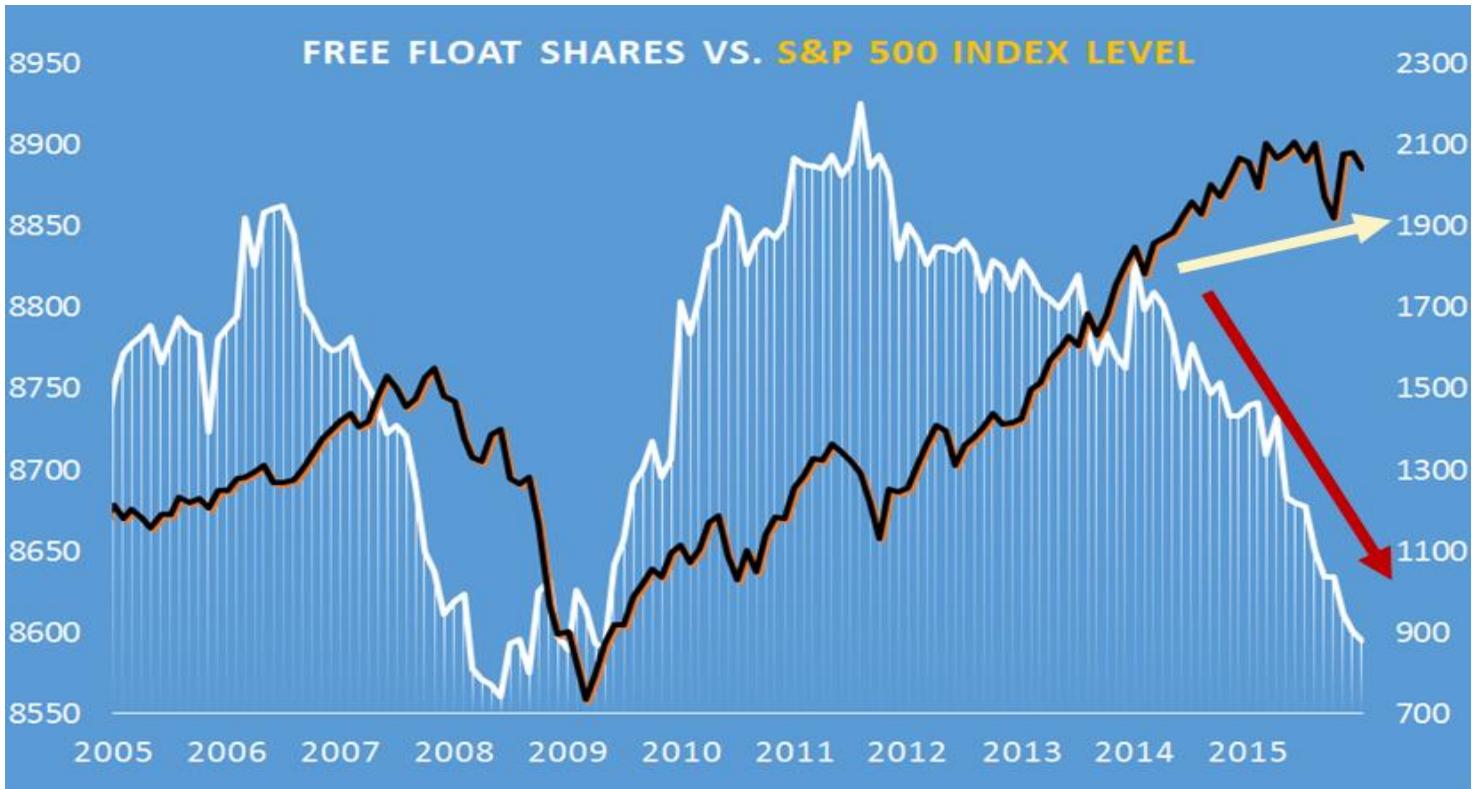
2. *Mr. Monopoly.* Monopoly. Parker Brothers (Hasbro).

The stock market is shrinking... literally. Since 2009, US companies have spent over \$2 trillion buying back their own stocks with the majority of those purchases financed by debt issuance. Large capitalization companies are issuing historically high levels of corporate debt at ultra-low rates, and instead of hiring workers or investing in R&D, they are using the capital to buy back their own shares. Share buybacks do nothing to help fundamental growth rates of businesses; however, they do reduce the number of shares outstanding, artificially boosting earnings per share, and hence reducing price-to-earnings ratios, and therefore helping to boost share prices. A majority of S&P 500 companies use EPS growth targets (rather than sales or operating growth) as a means to evaluate executives for the purposes of stock option payouts. As a result, there is ample incentive for managers to use buy-backs to manufacture EPS growth rates, even if the company

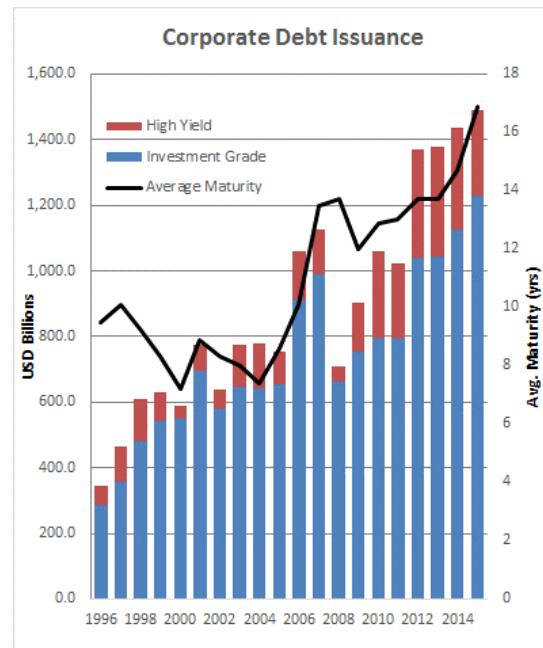


isn't actually growing its core business. For the first time in history, companies in the S&P 500 index spent more than their entire annual operating earnings on share buybacks and dividends.

The buyback craze generates a floor underneath markets, artificially supports earnings, lowers volatility, and represents a wealth transfer from investors to the corporate elite. Empirically, share buybacks have had a tangible effect in shaping the dominant mean reversion characteristics of the current volatility regime.



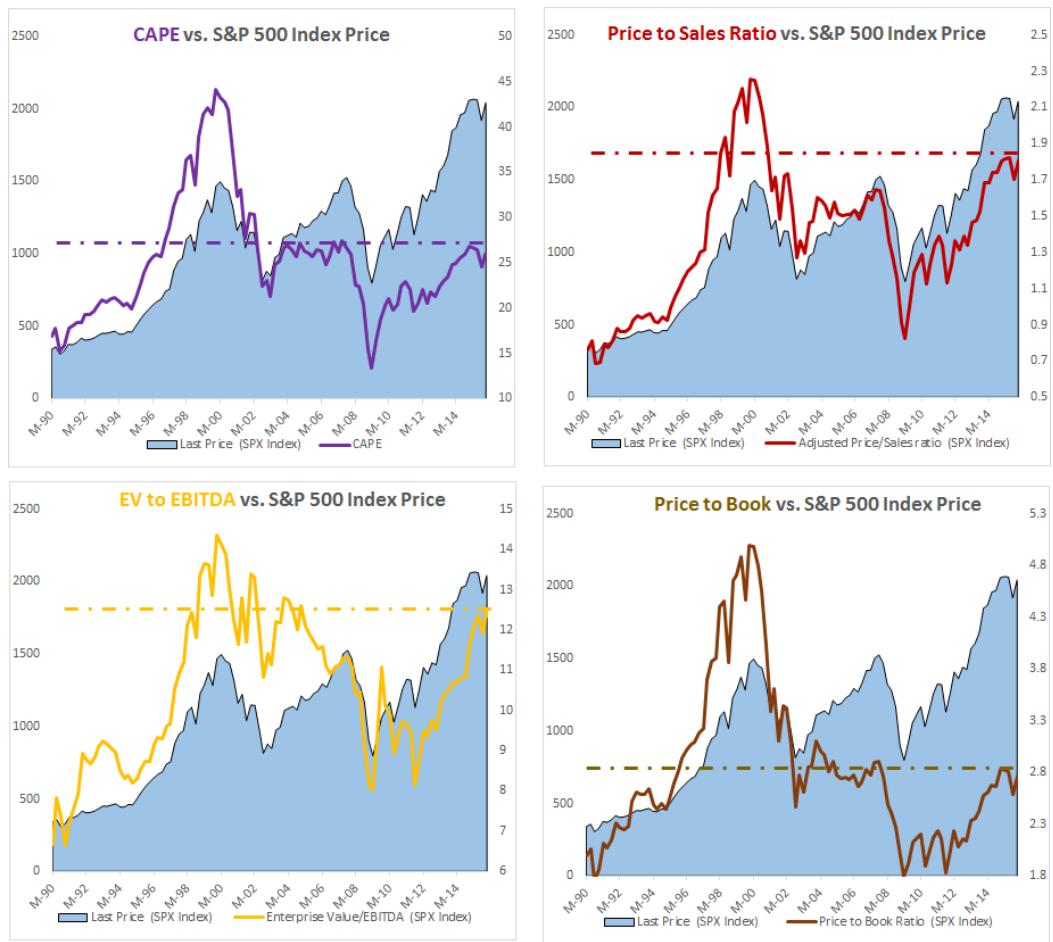
Share buybacks, in and of themselves, are only a tool and are neither good nor bad. When used correctly they are an effective method for management to add shareholder value by purchasing shares below their intrinsic value. "Below intrinsic value" are the operative words, because if a company is buying back shares at above the intrinsic value of the business it is against the interests of long-term investors. Today, ultra-low interest rates have enabled managers to game the system by using leveraged share repurchasing programs to engineer higher earnings to get fat bonuses regardless of intrinsic value. Unable to generate organic revenue growth by running their core business, corporate CEOs have turned to financial engineering to ensure their bonus triggering EPS targets are met. This was not the intended purpose of low interest rates. In the current bull market, share buybacks have dwarfed the amount of corporate monies spent on research and development, property plants and equipment, and new hires. Instead of contributing to the intrinsic growth of a business, this form of financial engineering is merely a means of 'gaming' valuations. It is a wealth transfer from long-term investors to corporate executives... and the net result is a bubble in both equity prices and corporate debt.



The later stages of the 2009-2015 bull market are arguably a valuation illusion built on artificially engineered EPS growth. For evidence, consider that RBC Capital Markets concluded that buybacks accounted for 25% of annual S&P 500 earnings growth between 2012 and 2014 and close to 50% of the EPS growth in 2015. According to a Deutsche Bank study, absent share buybacks, the S&P 500 would have experienced negative EPS growth in 2015. Historically buybacks peak right before market crashes, and prior to today's peak, 2007 represented their former all-time high.

Share buybacks financed by debt issuance create the illusion of value. When a corporation issues debt to buy back shares it artificially engineers higher earnings per share by removing the number of shares outstanding. The technique optically reduces the price-to-earnings multiple ("P/E Ratio"), and makes the corporation riskier by adding debt, but does nothing to promote the organic growth of the business. Naïve investors, seeing only a lower P/E ratio, bid up the remaining shares resulting in price appreciation. Keep in mind, share buybacks only add value to shareholders if a company is below its intrinsic value, but this becomes a self-fulfilling prophecy if investors narrowly define "value" by P/E ratios, which are depressed by the practice. The buyback phenomenon explains why the stock market can look fairly valued by the popular P/E ratio (below), while appearing dramatically overvalued by many other more nuanced metrics (above). Valuation metrics that are not as easily manipulated by share buybacks (e.g. EV/EBITDA, P/S, P/B) are near or above levels achieved before market crashes in 1928, 2000, and 2007.

If share buybacks were actually good for long-term shareholder value, why would so many insiders be selling? According to TrimTabs, insiders sold \$7.6 billion of shares in November 2015 representing the fourth highest monthly level on record. Consider the fact that buying back overvalued shares of a company using debt only benefits those who are out the door first, and today that means insiders and activists. This is not about shareholder value; quite simply this is a form of theft. Corporate executives and activists are using ultra-accommodative monetary policy and leveraged share-buybacks as a wealth transfer tool at the expense of long-term shareholders (aka, Pension systems and mutual funds representing the middle class). Investors will eventually wake up to the fact that you cannot rely on leverage and financial engineering indefinitely in the absence of intrinsic growth.



Share buybacks have an adverse effect on stock market volatility. Mean reversion is artificially incentivized when large swaths of price insensitive buyers are constantly seeking to buy on dips. The period to watch is the two to three weeks during and after earnings announcements, when the SEC mandated share buyback blackout period officially ends. In the past two years this period has encompassed three of the top ten “supernormal” volatility drawdowns in history. This includes the largest drawdown in the VIX in history, the 10 day and 42% decline that ended in October 2015. **It will be interesting to see if buybacks can drive another relief rally into earnings season in late January 2016.**

Share buybacks have had definitive effects on shaping the psychology of volatility short sellers into expecting mean reversion. Fundamentally, they also decrease volatility by smoothing out the EPS growth profile of corporations. The volatility of S&P 500 earnings per share is directly linked to the volatility of the stock market, so smoother EPS, manipulated or not, will reduce equity volatility (see chart). Empirically share buybacks have helped drive the highly mean reverting volatility environment. The next part of my letter will focus on the factors that influence and/or may cause an end to the buyback mania and mean reversion regime.

Excessive Leverage

Corporate balance sheets are in much better shape than before the financial crisis, so higher debt loads are an unlikely reason for share buybacks to stop. At the same time, the risks of the corporate debt boom may be masked by accounting shenanigans. US corporations keep a tremendous amount of cash overseas to dodge US taxes. Two thirds of S&P 500 index cash totals are held offshore, but it is the US operations that borrow to pay for share buybacks. Total debt to equity ratios include the overseas cash, which can't be accessed without paying expensive taxes. In a liquidity crunch, some corporations could experience problems if domestic cash totals are not sufficient to pay for debt issued to fund buybacks. In addition, in the event of a global stock market crash, debt-to-equity ratios can rapidly increase. Nonetheless, debt burden is not a great reason to expect the buyback regime to end anytime soon

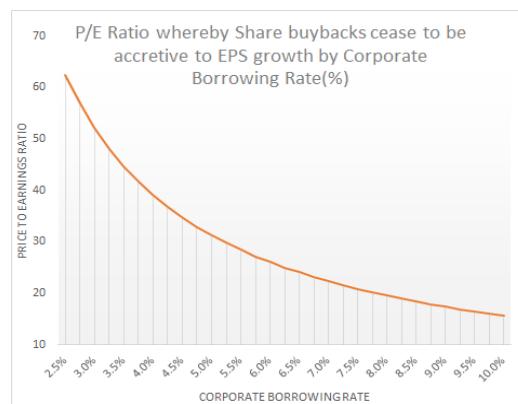
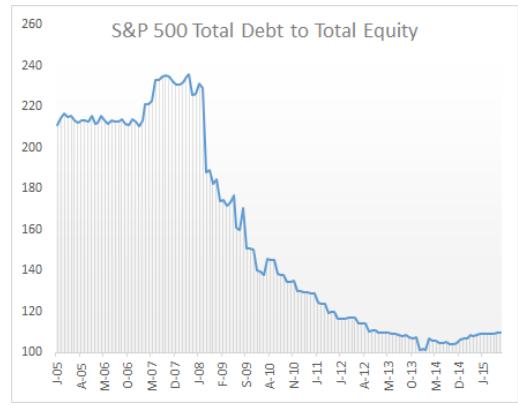
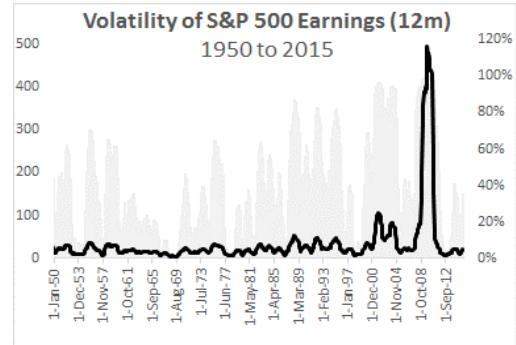
Rising Rates

Now that the Fed is raising interest rates will this cause the buyback boom to come to an end? Very unlikely. The chart to the right shows the maximum P/E ratio by corporate borrowing rate for share buybacks to cease being accretive to earnings. At the market's current P/E ratio, corporate borrowing rates would have to rise to nearly 8% for share buybacks to cease helping earnings. With the average S&P 500 index corporation borrowing around 3.4%, the process of share buybacks can be supported up until a P/E ratio of 46! Even 4 rate hikes this year would be unlikely to get us to the point where share buybacks cease to be accretive to EPS. Interesting to note, if the Fed followed the Taylor rule, rates would be 2.75% higher and share buybacks would look much less appealing. Slightly higher rates won't dent buybacks now.

Regulatory Changes

In 1982 the Securities and Exchange Commission adopted Rule 10b-18 which holds corporations harmless for potential EPS and stock price manipulation through share buybacks. If this rule was repealed, the share buyback boom would end overnight. This is very unlikely anywhere to the right of a Bernie Sanders presidency and liberal congress.

Is there no end in sight! Why can't buyback schemes send the S&P 500 to 4,000! In fact, there are many reasons to believe that the regime of mean reversion and low volatility may be cracking at the seams.



Investor revolting against poor quality earnings

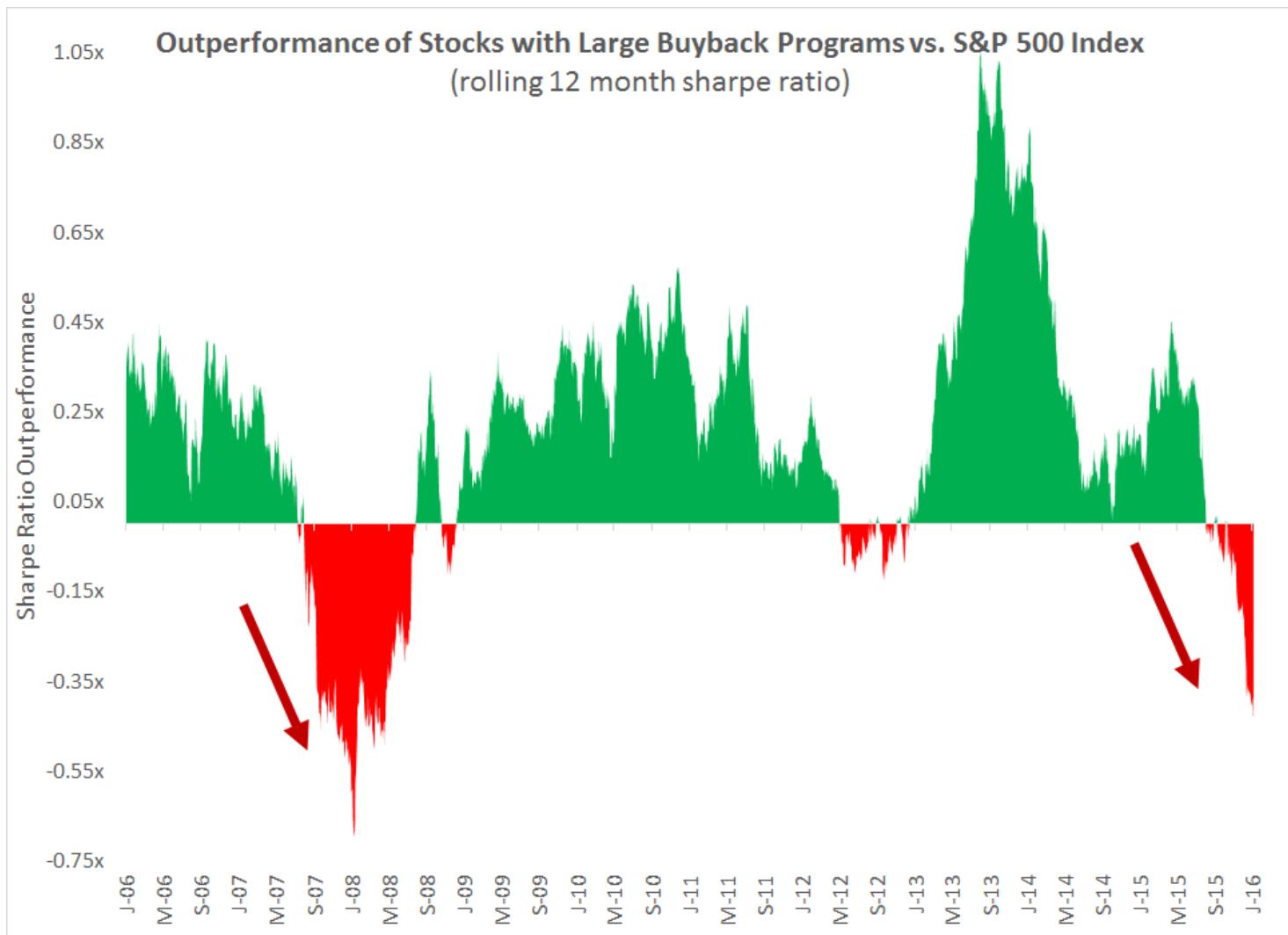
Finally, sleepy institutional investors are waking up to realize that corporate America is effectively robbing them. For the first time since just before the financial crisis, the corporations with the largest share buyback programs are significantly underperforming the S&P 500 index on a rolling annual Sharpe Ratio (return per unit of volatility). At the peak of the bull-market in late 2013 and early 2014, large cap stocks with significant buyback programs were realizing twice the rate of return per unit of volatility when compared against the overall market. Today, those same heavy buyback dependent stocks have begun to dramatically underperform the market at the greatest pace since early 2008, a telling sign of internal weakness and regime change. The illusion of growth can only go so far.

Let's go back to this quote:

"We frontloaded a tremendous market rally to create a wealth effect."

Former Dallas Fed Governor Robert Fischer (January 2016)

Wow... what candor. This quote essentially admits that the Fed intentionally set up a market for the next greater fool.



Global recession turn price insensitive buyers into sellers



A global recession or geopolitical shock could lead to serious trouble for this late stage bull-market. Late 2015 experienced the largest drawdown in world currency reserves since 2008 indicating that many **price insensitive buyers** are about to become **price insensitive sellers** of a wide array of assets.

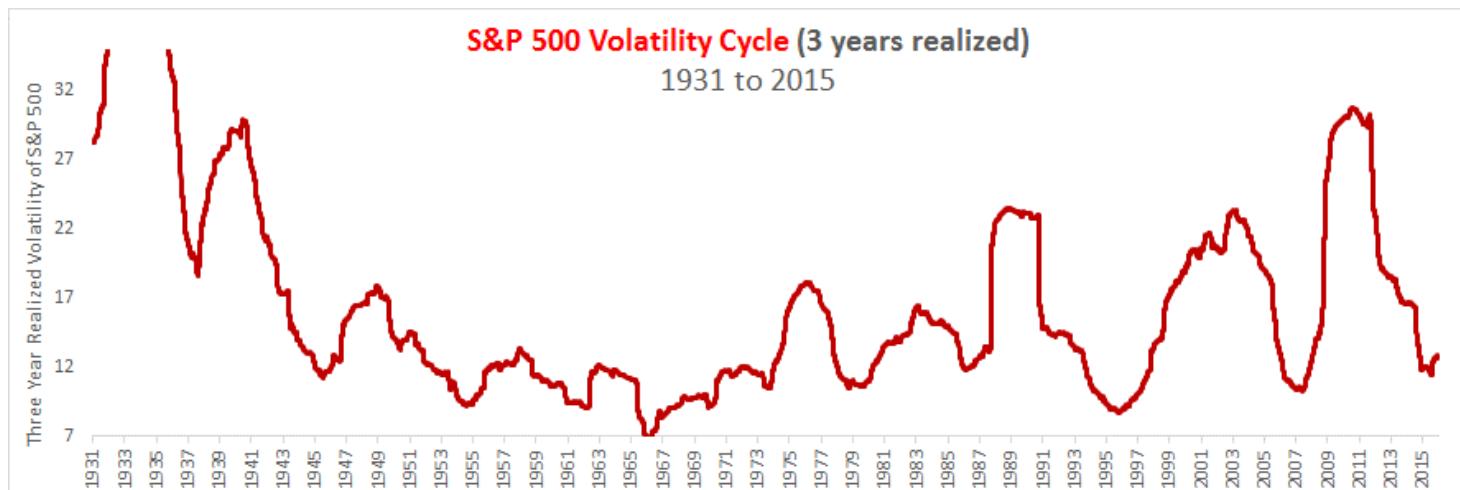
The Federal Reserve has signaled raising rates at-least four times this year against a backdrop of slowing global growth. The IMF recently downgraded its expectations for global GDP amid negative trends in developing nations like China and Brazil. A China hard landing and potential emerging market contagion recalls the falling domino effect that Asia and Russia had on domestic markets between 1997 and 1998. A more hawkish stance on US rates has put downward pressure on emerging markets and upward pressure on the USD. Commodities remain detached from financial assets, as oil has fallen to \$31 a barrel to start 2016 putting pressure on sovereigns ranging from Saudi Arabia, Brazil, Norway, and Russia. As global central banks, sovereigns, and foreign corporations seek to mend their own problems, this means pulling liquidity away from US assets.

Loss of central bank credibility

Something very strange happened in the fourth quarter of 2015 ---- markets actually began to react negatively to central bank intervention. The S&P 500 index sold off violently in September in response to Yellen's discombobulated press conference explaining the FOMC's decision not to raise rates. The macro hedge fund community was caught off guard when Mario Draghi failed to match rhetoric with definitive ECB action sending the Euro through the roof in December. The Japanese are losing faith in Abenomics, with Abe's approval ratings dropping to 36% amid flat inflation and declines in household spending. China's policy makers have made a sham of themselves trying to prop up their equity markets, spending what is estimated to be up to 10-20% of GDP in addition to a series of devaluations, botched circuit breakers, and intimidation of short sellers. The western press now openly mentions the existence of the 'Chinese National Team', a collection of state controlled entities that not so mysteriously buy large cap stocks to ensure the market closes in the green when needed. The Fed now owns 20% of the entire US treasury market, the BOJ owns over one third of Japan's sovereign debt market, and the Chinese 'national team' owns an estimated 6-10% of their entire stock market. These markets have already become saturated by government interventionism and it's hard to argue for higher asset prices absent real economic growth, regardless of aggressive policy.



With commodities, credit, and international equities experiencing rapid deterioration, historically a bear market and higher volatility in domestic equities has not been far behind. More to the point, the financial cocaine of share buybacks appears to be losing its luster as investors are beginning to see through blatant manipulation of earnings in the absence of top of the line revenue growth.



I recently watched the Oscar nominated film adaptation of the “Big Short” by Michael Lewis (I loved the book). It’s easy to forget each of those managers faced large losses, outright investor revolts, and even lawsuits over a contrarian thesis that made their clients millions. There is an inherent social need for human beings to follow what is perceived as being normal – even if normal is completely insane. Convexity is the tipping point between those realities: when yesterday’s fool becomes tomorrow’s Guru. Today’s normal is madness by any standard of financial history.

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ARTEMIS
CAPITAL MANAGEMENT

- (1) CBOE Long Volatility Hedge Fund Index August performance based on 66% of respondents. Artemis Vega Fund LP is a member of the index
 - (2) VIX forward prediction errors are measured as the sum of squared errors for a current day VIX future price to the eventual forward price of the spot-VIX at the maturity date of the future. Error factors averaged among the seven sample VIX futures daily.
- Data Sources: Artemis Capital Management LP proprietary models, Bloomberg, GI



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