TRENDS & TAIL RISKS

a Capital Wealth Advisors publication

BY LEWIS JOHNSON & SAM HASSAN >> MAY 9, 2018

SPECIAL EDITION:

Introducing Sam Hassan, Managing Director

NOTE FROM LEWIS

Hi! It's Lewis Johnson. I am pleased to share with you a new resource in the form of today's guest author, Sam Hassan. Sam is our firm's Managing Director of Investment Management. Sam has been one of my good friends for more than a dozen years since we worked together at a large Connecticut-based hedge fund. We were thrilled to coax him back stateside to our Naples office from his prior postings in Dubai and Abu Dhabi, where for the last decade Sam worked at some of the region's largest sovereign wealth funds and investment firms.

Sam will be writing monthly to share his views on important market topics. His publication will go by the name of "Market Caviar," for which today's research is the introduction. I will continue to publish "Trends and Tail Risks" every other Wednesday just as I have for years. We are excited about the addition of Sam's talent to our research team, and hope you find his insights as helpful as we do.

-Lewis

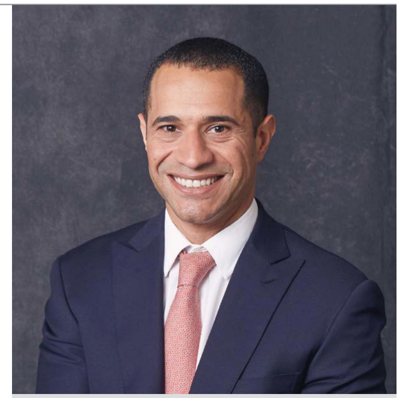
My name is Sam Hassan. I recently joined Capital Wealth Advisors as Managing Director of Investment Management. Thank you for reading the first edition of Market Caviar. The goal of Market Caviar is to bring to light some of the things we consider important when making capital allocation decisions.

Original, independent and outside the box thinking is the goal. I hope after reading these pages and future editions, you walk away with a different or new perspective. In this week's edition, I'll share some observations on index investing and bring to light an area that I believe is misunderstood and overlooked.

Market Caviar: First Edition

Index Investors Beware of the Sucker Punch

I've always been fascinated with boxing. Two highly trained people get into a ring and



Sameh Hassan
Managing Director
Capital Wealth Advisors

As Managing Director of Investment Management at Capital Wealth Advisors, Sameh (Sam) oversees Portfolio Management, builds client relationships and adds to our global research effort. Sam has a track record of successfully building/managing funds and portfolios globally across various asset classes and geographies.

Sam brings nearly 20 years of experience and began his career in NY with Scudder Investments small-cap team in 1999 as a generalist. Subsequently, he joined Pequot Capital, a leading hedge fund, as a generalist with a focus on the consumer for the firm's flagship fund until 2007. He then moved to Dubai where he built and managed regional and frontier hedge funds for Shuaa Capital, Duet (FIM partners) and Fortress Investment Group where he served as Managing Director.

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Funds Sam was responsible for were awarded "Fund of the Year" and "New Product of the Year" from MENA FM Magazine. From 2014-2017 Sam was Principal for Abu Dhabi Investment Council's Global Special Situations group where he was directly responsible for all publicly traded securities globally in addition to private investments in technology, healthcare, and regulatory capital transactions.

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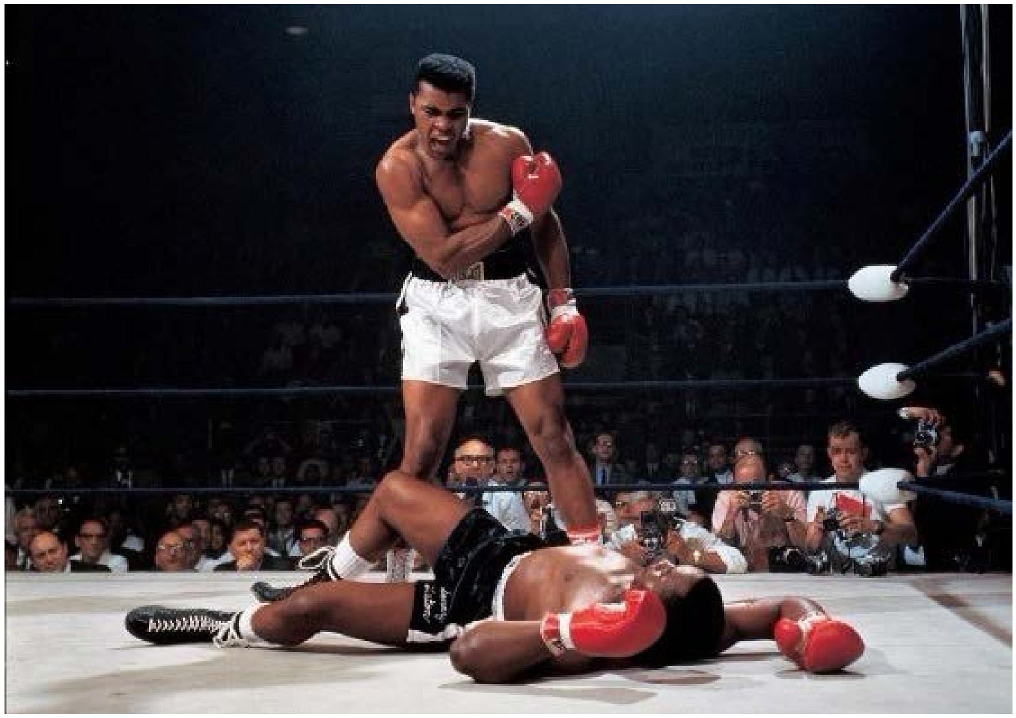
duke it out until someone gets knocked out. On any given day, anyone can win. In boxing, like the markets, it is often the punch you don't see coming that puts you on your back. The most skilled knockout artists aren't the hardest punchers, rather they are the ones that lure their opponents into complacency then hit them with a punch they do not see coming. I worry that index investors have been lulled to sleep and could awaken flat on their backs to a very different reality from what was originally expected.



Muhammad Ali after first-round knockout of Sonny Liston - May 1965
Source: *http://www.latimes.com/projects/la-me-muhammad-ali-obit/*

Index investors claimed a victory in 2017 with handsome returns following a decent year in 2016. Not all that shines is solid gold. **Underneath these numbers you will find that a mere 5 stocks contributed around 20% of the overall return.** They call them the "FAANG" stocks represented by Facebook, Amazon, Apple, Netflix and Google. In my opinion, these companies siphoned lots of excess return from the market and disrupted several large industries along the way.

By owning the index, investors had ample exposure to these names and the end result was a handsome return. These publicly traded FAANG stocks post their results quarterly, telegraph their execution plans and announce to the world how they intend to continue to deliver for their shareholders. These companies' gains likely came at the expense of another. As of May 4th, these companies accounted for 27% of the Nasdaq's market capitalization!

In September 2003, Forbes posted an **article** comparing Amazon.com to Barnes & Noble. In conclusion the article noted, "Barnes & Noble has the best of both worlds since it also owns barnesandnoble.com." For those keeping score, Amazon shares went from approximately $47 to $1,600 while Barnes & Noble went from approximately $12 to $5 from the time of publication. In the end, the overall index did fine because gains in one more than offset losses in the other. I believe Amazon's beginnings as a disruptor are very similar to the new crop of companies in the background, however I also believe the major difference is that today's batch remain privately held.

I believe that going forward, the index is not going to benefit from today's disruptors because they are not publicly traded and may remain private for longer than in previous cycles. This new crop has been training hard and does not publicly post financials, updates, annual reports, business plans, milestones, successes or failures. **Worst of all, so long as they remain private, the index will not benefit from their successes in the public market but index investors will still be exposed to the companies that get disrupted.** I believe this new generation is bigger and bolder than it's FAANG grandparents. Staying private may give them the advantage of surprise.

Recently these private companies were given the nickname "Unicorns." I find the name ironic as my daughter loves to draw unicorns and thinks they are so innocent and cute. A unicorn is defined as a private company with a market capitalization of $1bn or more. In terms of numbers, there are currently approximately 170 unicorns up from about 45 in 2014. Do not let the name fool you, as these companies are not start-ups! They boast private market capitalizations ranging between $1- $70 bn compared to Amazon's IPO market capitalization of less than $500m or Netflix which went public closer to $300m.

You may have heard of these companies and maybe even used some of their products. Uber, Lyft, Airbnb, SpaceX and Pinterest are just a few. These companies are well capitalized, and their ambitions appear to be way beyond delivering books to your home. I had the opportunity to meet with many many Unicorns while working for a large Sovereign Wealth Fund in the United Arab Emirates. I believe these Unicorns have ambitions bigger than their market caps. They say things like "we want to make car ownership obsolete" or "people don't need central bank currency anymore." Think about all of the industries and companies that are represented in the index here that could be negatively impacted. Fewer cars on the road means less auto loans, insurance premiums, parts, components and on and on. This is just one example.

My biggest concern is that **the longer they remain private, the greater the likelihood they detract from the performance of publicly traded companies in the index.** Amazon went public with a market capitalization of under $500m. Yet Uber, in the private market, is valued at around $70bn. Today, Amazon's market cap is $775bn! That's over 1,500 times its original size. **All of those gains were captured by the public market which I believe more than offset the losses on companies disrupted along the way.** How much value creation and return will be extracted before these companies go public? Based on current valuations relative to Amazon, the returns generated in Uber from $500m to $70bn are already gone. In Spotify's case, their direct listing started at close to $30bn where I believe most of the easy money was already made.

When we look back 5-10 years from now, some of these Unicorns will likely have changed capital markets permanently. It is my belief that they have remained in the private markets for longer already and may yet remain private for longer still. **Capital is still flowing into the private market with alternative investors providing fresh dry powder to support these companies.** Spotify's recent listing is an example of how these unicorns are even changing the process of debuting shares on the market. Rather than issue new shares through an Initial Public Offering (IPO), the company chose to do a direct listing where shares were sold by private market owners. In this process, there was no lockup placed on the owners and there was no underwriter.

These are some of the reasons we own individual stocks and bonds when constructing portfolios. We strive to have eyes wide open and act when there is enough cushion to protect against what we can see and what we can't see. Investors who choose to get their market exposure through an index should also be aware of the changing capital market structure that they might not see.

Remember this Index investors: when you step into the ring, keep an eye on the left! Focus, the left is coming, do you see it? DING! DING! What happened? What round is it? Is it over? Yes, it's over…straight right. Did you see it coming?

Thank you for taking the time to get to know Sam and hear a little bit about his ideas. I hope you come to enjoy Sam's writing and find it as useful as I have.

Please keep an eye out next month for Sam's new monthly publication "Market Caviar." We look forward to sharing his insights with you.

-Lewis

Questions? Comments? Criticism?
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