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Caterpillar: the truth about "they."

Most of us spend a good deal of time feeling worried, troubled or downright alarmed about *something* in our lives . . . quite a few things, more likely. So naturally we find it easy to feel that other people—"they"—are smarter, richer, happier, healthier or luckier that we are. Setting aside the "richer" people (which is an unmistakable fact) we mostly find over the years, as we learn more about them, that "they" are seldom *actually* smarter, happier, healthier etc. than we are. Quite the opposite, pretty often. As investors, we are particularly prone to the feeling that "they" are smarter than we are; that "they" know more, earn more and win almost always.

In fact, they're not, and they don't.

Hedge funds used to be everyone's favorite "they" some years ago, with daily reports on their mind-boggling track records from an admiring media. There've been enough spectacular hedge fund meltdowns to tarnish that glittering reputation, these past several years. No matter—soon there will be another brilliant "they" for us to envy for a time. Meanwhile, though, let's glance at the recent history of Caterpillar—long-time Outlook core investment—for a reminder that "they" are never as smart as their reputations.

Blue is the 10-year stock price. Orange is quarterly sales. That sales line has taken quite a hammering since 2013, hasn't it? So did CAT stock, of course, falling from $110 to $60 or so. Now let's look just a little closer at 2016. Down and down went sales, riding an accelerating plunge since 2014. Now let's pick one of everyone's favorite "theys:" short sellers—of which hedge funds make up a big part of the crowd.

> ***"After half a decade of weak demand, short interest in Caterpillar Inc. (CAT) averaged $3.3 billion in 2016, thefirst time short interest averaged over $3 billion in its history," said Ihor Dusaniwsky, head of research at S3 (a financial analytics firm) in a new report. Short sellers figured the heavy machinery maker's persistent weak world-wide sales would sink the stock, but that bet turned out to be wrong. Instead, it rallied 36.5%***

in 2016, creating an aggregate $968.4 million of losses on short positions. Short interest in the stock peaked at $3.7 billion in October.

It's OK to say "Wow!" to this. As Mr. Dusaniwsky noted, those clever people made the biggest bet in Caterpillar's history after 4 years of falling sales . . . after 4 years. They proceeded, immediately, to get their smarter heads handed to them, next to one billion dollars in losses on their short positions.

There's nothing wrong with being smart. There's quite often something wrong with trying to be clever . . . which is at the heart of any short-seller's mentality. As Outlook has often noted, cycles are a permanent, profound, fundamental part of economic life. Cycles endure, and keep acting the same decade after decade (and century after century) because they're built from normal human behavior. Things get very bad for a while, then they get a lot better, because so many people never quit fighting to fix any problem they have. Caterpillar's sales slumped for 4 years as its thousands of customers fought to handle plunging energy and commodity prices, stubborn economic stagnation in Europe, distinct slowdowns in China, and so on. Those short sellers can't possibly have looked at this kind of chart, can they? Surely if they had, they'd have thought, "Things do always seem to turn up after an economic hurricane, don't they? Maybe we're a bit late to be shorting this stock. Maybe, just possibly, we should (dare we think it?) "Buy low," not "Sell low."

Ah well . . . they didn't and they paid for it. Outlook, instead, kept buying more shares on their way down—because free markets fix themselves, so cycles turn up after plunging. We think we'll be doing the "earning" now, for quite a while.

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