Pecaut & Company

Our Mission: To Be Our Clients' Most Trusted Financial Advisor

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August 2013

EXECUTIVE SUMMARY

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Market Update

Helped in no small part by massive Fed stimulus, the S&P 500 has rebounded about 150% from its bear-market low in 2009. Earnings have roughly doubled over the same period, so the gains have been somewhat larger than the earnings improvements. The S&P 500 now trades at about 15 times estimated earnings which is about its long term average valuation.

Ongoing fears are stimulated by the easing of the Fed's QE program, troubles in China, unrest in the Middle East, and unresolved sovereign debt issues worldwide. Here's stats from a B. of A. Merrill Lynch report on what six years of central-bank medicine have wrought: 520 rate cuts across the globe, $33 trillion in fiscal and monetary stimulus, $66 trillion in global government bonds yielding less than 1% and the lowest US government bond yields in 220 years.

This massive stimulus must be wound down. Talk of the Fed tapering its $85 billion in monthly bond purchases has made for increased volatility, especially in the bond market. The 10-year Treasury has jumped from 1.6% to 2.85% over the past four months. As we guesstimated in our June client letter, the proper 10-year Treasury rate would be about 3.1%. We came to this number from Bob Rodriguez's observation that the historical 10-year Treasury rate has been 2% plus the rate of inflation. In a world with 1.1% inflation then, 3.1% would be an appropriate 10-year rate, so we're getting there. Rather than a cause for fear and panic, this process should be seen as welcome and completely necessary if we are ever to wean ourselves off of massive stimulus.

While stocks are less cheap with the rally of the past 3 years, the valuation gap between stocks and bonds remain significant. A 3% 10-year Treasury suggests a market PE of over 20 under normal circumstances. Of course, circumstances are never normal.

Caution is, as always, in order with the sovereign debt crisis still slowly unfolding, China slowing down (leading to softer commodity prices), and the U.S. still unable to form intelligent fiscal policy. Insider selling has been high – as of early August insiders sold $524 billion worth of shares and bought less than $15 billion, according to Thomson Reuters. That sell-to-buy ratio of 36 is higher than the typical range between 12 and 20. (The ratio was in the single digits in March 2009 when insiders were buying in earnest.) Margin debt relative to per capita GDP has returned to historically high levels.

There are many positives are as well. Improvements in auto and housing are real. America's new position as the world's low-cost energy producer is driving investment in energy infrastructure, transportation, and manufacturing. The banking system has clearly recovered and is significantly better capitalized than any other in the world. We like that sentiment remains muted - recently investors withdrew $14.3 billion from U.S. stock funds. The latest sentiment survey showed bearish hordes jumping to 42.9% from 28.2% and increasing for the sixth straight week.

We've seen different numbers but according to Barron's since May, some $75 billion has flowed out of bond funds. This is significant change after 5 years of steady and massive inflows. Meanwhile some $11 billion flowed into equity funds. While flowing in rather than out is a shift, the degree of investment is surprisingly small for so spectacular a rally. We are encouraged. If investors are still lukewarm, this rally may still have a long way to go.

States from Florida to California are starting to see unexpected budget surpluses. Americans' debt obligations as a percentage of their disposable income has eased from 14.1% in 2007 to 10.4% recently, and household net worth has surpassed its 2007 peak to reach $70.3 trillion. Consumer confidence is at the highest level since 2008.

All in all, stocks continue to remain a much better value than bonds or cash.

<u>Summer Reading</u>

"That Mayo Smith (the manager) is not a very good man to pitch for. The last guy to pitch a good game is his man, and he overuses him and neglects everybody else. There are three or four pitchers on the club he doesn't even talk to."

- Jim Bouton, <u>Ball Four</u>,

Corey threw the <u>Bullpen Gospels</u> on my desk for some summer reading. It was a hoot. That got me going on baseball books. I like Michael Lewis but hadn't gotten around to reading <u>Moneyball</u>, so I covered that one. I also re-read <u>Ball Four</u> by Jim Bouton, the ground-breaking diary of his 1969 season with the Seattle Pilots, their one and only season (they then moved to Milwaukee and became the Brewers). The books are full of examples of how we can be prisoners of the tyranny of dead ideas. Old baseball maxims are held up, examined, and found hilarious in all three books. In general, they depict baseball as an old boys' network run on gut feel with hard-headed resistance to change. Asking insightful questions, using statistics and probabilities, a commitment to best practices, and clear communication were not part of the program.

I especially enjoyed the above quote from Bouton's book. To pitch one man and neglect the rest of the team sounded just like my Little League coach! I owe him an apology. All these years I thought he was an idiot. Now I see that he was simply implementing Major League thinking!

Bouton also expressed great frustration with second-guessing, especially from his pitching coach. If he threw a fastball on a 3-2 pitch and gave up a homer, the pitching coach would yell, "What are you doing throwing a fastball on a 3-2 pitch!" If he threw a knuckleball on a 3-2 pitch and gave up a walk, the pitching coach would yell, "You should of thrown your fastball. You never throw a knuckleball on a 3-2 pitch. What were you thinking!"

What Bouton was thinking in 1969 was that he could extend his career by learning the knuckleball, which is far easier on the arm than any other pitch. He accepted that some days the knuckler wouldn't knuckle, and he'd get hit like a batting practice machine. But he had to keep throwing it to master the pitch. The constant second-guessing was hilarious. Eventually Bouton determined that he'd stick to the knuckleball all the way, despite the noise from the dugout. Later in the season, he got some redemption when he retired the Oriole's mighty hitters, Frank Robinson, Boog Powell, and Brooks Robinson, 1-2-3, all on knuckleballs.

Investors would do well to follow Bouton's lead. Focus on what makes sense versus blindly following conventional wisdom. How many track records are mired in mediocrity, doing only what everyone else is doing so as not to get criticized or second-guessed?

One inflation note: At one point Bouton negotiates his salary from $18,000 to $22,000. Today, the average salary for a major leaguer is $3.2 million. The minimum salary then was $10,000. Today the MLB minimum is nearly $500,000. A 50-fold increase in 44 years! How times have changed.

<u>Second-Guessing versus First Thoughts</u>

"What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework."

- Benjamin Graham, <u>The Intelligent Investor</u>

The second-guessing that frustrated our baseball protagonists is not uncommon in the financial world as well. The media obsesses about "the market" and whether it will go up or down. Each quarterly earnings "miss" can be met with double digit downdrafts in the stock price. A "make" can be met with a similar updraft. Expectations unmet are harshly treated. Expectations exceeded are celebrated. It's all a bit emotional and manic/depressive. That is to say, not so intelligent.

If Bouton's pitching coach were our client, we can just hear what he might say. "The market's going down, why didn't you get me out?" "This stock just had a good quarter, maybe we should buy it." "The market's going up, why did you sell my shares in XYZ?" Day to day, there are a million things to second-guess in the financial world.

Graham offers a way out of this madness. Begin with a sound intellectual framework. Then rigorously defend it from the strong emotional impulses that can derail it. Value investing is just such an operation. First, it takes our intellectual framework to the long term. If we take the mindset that we are buying ownership in a company when we buy a stock, that immediately gets us thinking over years rather than days or months. We wouldn't buy the corner drugstore looking to flip it in 3 months. By restricting purchases to only those companies selling well below intrinsic value, one mitigates the risk of permanent capital loss and eases the tension of day-to-day ups and downs. By buying a whole portfolio of such companies, one mitigates loss for the overall portfolio. Much like an insurance underwriter with thousands of homogeneous units, an operation like this puts the laws of large numbers and probabilities to work on its behalf.

For example, we predict the media will do extensive hand-wringing should Congress wrangle over the debt ceiling. In the long term, it's a blip on the screen. In the short term, there could be some extreme emotions… just the sort of emotions that can corrode one's investment framework.

Meanwhile, we'll take comfort knowing that AAA-rated Nestle's continues to grow world-wide as the globe's largest branded food company. Wells Fargo continues to grow and expand market share as the nation's largest mortgage banker. And Berkshire Hathaway's industry-leading subsidiaries continue to grow and invest to expand their competitive moats.

The next time someone asks you where the market is going, try this answer: the stock market has risen at a 6% average rate over the last century. So where is the market going in a mostly free enterprise sort of world? Over the very long term, the answer is up.

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