Pecaut & Company

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

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EXECUTIVE SUMMARY

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Market Update - Climbing a Wall of Worry

Investor disenchantment is high after the lost decade of 2000-2010…...We could easily imagine a buying panic from performance-oriented mangers followed by a surge of return-hungry investors re-entering the market. Stampede out. Stampede in. It's happened before. With a shortage of shares, it could be quite dramatic.

- *Pecaut Newsletter*, January 2012

The S&P 500 is up for 24% for the year versus a gain of 12% for the MSCI World ex-US Index, a 1% loss in emerging markets, and a 2% decline for the Barclays U.S. Aggregate Bond Index. No doubt about it, U.S. equities have been the place to be. With slow but steady improvement in energy, rails, autos, housing, and financials, America has been on the mend. Yet the headlines have been filled with worry. The sovereign debt crisis. China slowing. Unrest in the Middle East. Stubbornly high unemployment. Congress, the Gang that Can't Shoot Straight, playing a game of chicken with America's creditworthiness (*a record of trust that has been 237 years in the making* as Warren Buffett put it). The "sugar" high in asset prices due to massive Fed stimulus. Budget wrangling and Fed tapering that have merely been postponed, not settled. Yes, there is much to worry about. So how can the market go up?

Back in the 1980's, my dad and Uncle Jack often yodeled during a bull market that it was "climbing a wall of worry". It took me some years to understand what they were so pleased about. In time, I got that what they were saying was that it's natural for a stock to go up on good news. That's to be expected. What is really good, however, is for stocks to go up on *bad news*. This suggests that all the investors who were scared or disappointed have long ago left the building. The next action in the stock is for new investors, bargain hunters, to come in sensing a deal and a shift in fortunes. Going up on bad news was a sure sign this dynamic was under way. Pretty cool insight.

This insight applies to entire markets as well. In our current case, we have written at length about the remarkable stampede into income funds over the last 5 years (over $1 trillion) and the simultaneous stampede out of equity funds (over $500 billion). It has been an absolutely massive migration. While the sting of the 2008-09 subprime crash was completely understandable, fleeing stocks for the "safety" of bonds in a zero-based interest rate world had its own risk profile; particularly if interest rates or inflation rose in any material way.

In any case, we see a change in sentiment. Funds are flowing back into equities in earnest. According to *Trimtabs*, $54.2 billion went into equity funds and ETFs in October. After five years of massive outflows from equity funds, investors are finally returning to the stock market in some size. Given that the outflow into bond funds totaled over $1 trillion, this new trend back to stocks could have a ways to run

Not that we haven't run quite a ways already. It's remarkable to consider that the S&P 500 could be up 150% from its 2009 lows and only now we are talking about things heating up. By a few measures, we are returning to levels of excitement last seen in 2007. Here are some of the things we track:

Margin Debt – Margin debt is approaching $400 billion, levels last seen in 2007. Generally speaking, the higher the debt the greater the speculative nature of the market.

Insider Selling – Surprisingly, insider buying has been picking up according to *Vicker's Weekly Insider Report,* whose most recent "total sell/buy ratio" is 5.87. To put that in perspective, the lower the Vicker's ratio, the more selling the insiders are doing and vice versa. The ratio was 3.0 in December, 2012, rose to about 6.5 in March (a good buying point), trended steadily down to 4.0 by October (reflecting increased selling into a rising market – just what we'd expect to see). To jump back up to 5.87 at this point suggests a sudden spurt of bullishness on the part of business executives. We'll see where this one goes.

Valuations – With the general market selling at about 16 times earnings, the market is in the middle range of valuation. However, with a number of industries running at record operating margins, some reversion to the mean should be expected, suggesting that current earnings in some cases are not as good as they look.

IPOs – Heating up. In an article entitled "Investors Return to IPOs in Force", a recent *Wall Street Journal* reports: *"Investors are stampeding into initial public offerings at the fastest clip since the financial crisis, fueling a frenzy in the shares of newly listed companies that echoes the technology-stocks craze of the late 1990s. October was the busiest month for U.S.-listed IPOs since 2007, with 33 companies raising more than $12 billion."* We recall the IPO of Facebook, which raised $16 billion in May 2012, and how it was met with caution and then disappointment. Contrast that mood with today, as the financial media is all abuzz for Twitter's estimated $1.6 billion offering. There's much more excitement.

Hot Concept Stocks – Valuations afforded new world darlings are approaching those of the old dot.com Internet bubble years. This from the dry wit of *Grant's Interest Rate Observer*: *"At $20 billion, Tesla's market cap is two-fifths that of General Motors' $49.9 billion, though GM owns a slight lead over the technological interloper in vehicles sold (9.5 million vs. 14,962 over the past 12 months)."* Similar things could be said for shares of a number of IPOs and new age stars like Netflix (PE 400), LinkedIn (PE 700), and Amazon (PE 1200).

In general, we see the "No Earnings Economy" stocks outperforming the "Earnings Economy" stocks by a wide margin. Ironically, we note that the "Old Economy" now includes former "New Economy" stalwarts such as Microsoft and Intel. Even Apple has gone from rock star to old news in just the past year.

Overall, we seem to be breaking into two markets: the "Old Economy" which continues to feature reasonably priced, steadily improving companies in well established businesses and the "New Economy" which is led by fast-growing businesses (in revenues anyway – earnings may or may not be forthcoming) with lots of media hype and enthusiasm. The steady economic improvement we have been tracking over the last several years appear to be solid and ongoing. Buying the "Old Economy" stocks trading at low PE's with solid balance sheets and sound capital allocation strategies seems like a perfectly sensible way to continue to preserve and grow wealth. However, investors should be aware that the froth of the "New Economy" stocks is creating a more speculative market environment.

<u>Taking the Temperature of the Market</u>

As difficult as it is to know the future, it's really not that hard to understand the present. What we need to do is "take the market's temperature."

- <u>The Most Important Thing</u> , Howard Marks

As value investors we seek to grow wealth through a long term, value-oriented process of buying companies (via shares of stock) at discounts to their underlying value. We agree with Howard Marks that taking the market's temperature is a very valuable aid in deciding how to structure one's portfolio. To be clear, *this is not about making market predictions*. Rather, we see "taking the temperature" as an exercise in gauging market sentiment. That in turn tells us how cautious or aggressive we may wish to be in buying shares of quality businesses.

In general, the greater the fear, the higher the caution, the cheaper the pricing - the higher the quality and potential return of opportunities in the stock market. This makes for a most compelling environment for investing. After the 2008-09 market crash, *the market had all of these factors running in our favor*. Of course, fear was so high after the subprime mortgage debacle it was difficult for many to act, even if they understood the opportunity. At the opposite end of the spectrum, the higher the greed, the higher the speculation, the richer the valuations - the lower the quality and potential return of opportunities in the stock market. Obviously, this makes for a more dangerous and less compelling environment for investing. Yet, despite such observations being "obvious", only now – and *only after a 150% rally* over the past five years - are investors *moving back into equity funds*.

We find investor sentiment, fund flows, margin debt, and other thermometers of the public investment temperature helpful in gauging just how aggressive or cautious to be over time. Here are some select quotes from the *Pecaut Newsletter* since 2009, reflecting our "temperature taking" approach. Note how this process helped us lean *away* from the conventional mood and thinking of the moment and *toward* acting in a rational, business-like manner.

March, 2009 – *"…we see all the seeds of an enormous rally: extreme fear, enormous cash positions, insiders buying at record levels (and, of course, they've been dead wrong so far), universal negativity, and low valuations. What will turn the tide? It could be something as simple as job losses are 400,000 instead of 600,000"*

February, 2010 – "*One friend was wistfully remembering the Clinton years back when we had low unemployment and a budget surplus…we were quick to point out that all that good news was in the price, and the market subsequently went nowhere over the next 10 years. A* *good economy does not mean a good investment environment. High investment returns require a low price. Low prices come with the baggage of fear and uncertainty. We have a good share of both today."*

March, 2011 – "*our favorite theme for the past decade has been to invest in the growth of the emerging world….for far-sighted global brands we see wonderful years ahead. …Many people think of the stock market as a place to go try and "make money". We see the stock market as a place to become part owners of exceptional businesses that can grow and preserve purchasing power."*

January, 2012 – "*While much could go wrong, much of that is in the price. What isn't in the price is things going right."*

May, 2012 – "*This is our time in a nutshell. For those looking to headlines, it is a time to flock to cash and bonds. For those looking to buy value, there is much to do in the world of business."*

February 2013 – "*The real key for investors in our minds is capital allocation. In a world flush with liquidity, how excess capital gets allocated will be a major determinant in investor returns. Though stocks are less cheap with the recent rally, for the patient and value-oriented, there remains plenty of opportunity."*

Make Your Charitable Gifts Now

With the market up handsomely, now is a great time to consider making charitable gifts of appreciated stock. It's a win/win/win. The charity of your choice gets much needed funds, you get a deduction for the value of the gift and you side-step capital gains taxes on the appreciation.

Let us know what you're thinking of doing and we'll guide you on the best way to go about your gift. Doing this in November assures we get things done well before year-end deadlines.

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