Pecaut & Company

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

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EXECUTIVE SUMMARY

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Market Update

We are at a most interesting point in this 5-year rally. On the one hand, stocks are clearly less cheap. On the other, sentiment is surprisingly cautious this far into such a rally. Fueled by massive monetary stimulus, more than $15 trillion has been added to U.S. equity values as the S&P 500 has roughly tripled from its subprime mortgage crash low in 2009, Market growth has exceeded growth in earnings, so there's been some multiple expansion as well as economic expansion. The S&P 500 recently topped 2000 for the first time, trading at 16.7 times projected earnings. To put that in perspective, note that the S&P 500 traded at 1350 back in September of 1999. That's a blistering 15-year return of 2.7% compounded (not including dividends). We believe some, but not all, economic improvement is in the price. In preview, we believe the market is most likely in a middle phase, not a top, and that the mass media, politicians, and general public are most likely fighting the last war.

Scanning

It was probably 20 years ago, but I well remember a leadership training where the speaker had us all look around the room and silently note all of the ***red*** items we could see. After a minute he asked us to close our eyes, still remembering what we had just seen. I distinctly recall that I was picturing in my mind's eye quite a number of red items. And then, with our eyes still closed, he asked us to name out loud all of the ***blue*** items in the room. I couldn't think of one! What a great exercise. By focusing only on red items, which is indeed a lovely and eye-catching color, I found that I had totally missed "seeing" anything else. What he was teaching us is that ***we see what we scan for.*** In a sense, we create our own reality by what we selectively (consciously or unconsciously) choose to see.

What the mass media scans for is eye-catching drama and excitement. Duly influenced, politicians and the general public look and talk about the same subjects. Less eye-catching but more substantial events are thus often undervalued or missed entirely. It can be very valuable to step back and reflect on what it is the media is scanning for and on what may be missed. What some pundits are scanning for is the next bear market.

We have never (yes, never) seen the mass media get these things right. So we take heart from a recent *New York Times* article warning investors that "From Stocks to Farmland, All's Booming, or Bubbling: Prices for Nearly All Assets around World Are High, Bringing Economic Risks." Such articles were nowhere to be seen in 2007 at the top of the subprime boom. Another contrarian indicator we follow is the world of institutional management. We are encouraged that the average U.S. college endowment had only 18% of its investments in U.S. stocks as of 6/30/13 versus 32% in 2003 according to a poll of 835 schools by Commonfund. Our view is that many institutions, the media, the politicians, and much of the general public are fighting the last war in looking for the next crash. Yes, the 2009 Crash was a doozy. It is totally human to feel traumatized and want to never have that happen again. However, the group psychology is such that all that is "seen" is colored through the lens of that last great event. Only a fool would not be hunkered down for the inevitable fall to come!

Scanning for Major Improvement

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

- Pecaut Newsletter, January 2012

It's remarkable how much has gone right since we penned those words. Our view continues to be the slow and grinding recovery of the last 5 years is quietly building a solid foundation for a decade of growth. With the rally of the last three years, certainly a portion of these improvements is in the price. However, if everyone is looking for what could go wrong, and everyone responds accordingly, this makes for a safer world! So what is going right?

QE is ending. Remember May of 2013 when the Fed began to address the eventual unwinding of QE? There was a tremor of panic as the 10-year Treasury leapt from 1.8% to 2.8% overnight. Now the Fed is on track to complete the unwinding late this year. Rather than celebrate, fears have turned to when and how much interest rates may be raised.

Employment is growing. Remember in 2009, when people were so worried with unemployment shooting over 10% and fears of another great depression were swirling? Today the unemployment rate is down to 6.1%.

America is nearly energy independent, satisfying 84% of internal demand last year. We remember reading a decade ago, on the 30th anniversary of the OPEC oil embargo, shaming articles on just how badly America missed on developing a sound energy policy. Thanks to developments in technology America is rather suddenly on track to be the world's largest energy producer. Pretty amazing, that one.

The "on-shoring" manufacturing renaissance is well under-way. Remember when we worried about the "off-shoring of America" as plants moved overseas to access cheaper labor? This has reversed. Higher labor costs abroad combined with low cost U.S. energy is driving a manufacturing resurgence on American soil. Locally, as noted in past letters, CF Industries is completing a $1.7 billion plant expansion. Low cost natural gas and a location in the cornfields make this THE PLACE to build such a plant.

The banking industry is the best capitalized it has been in a half century. Remember the fear as the entire banking system seized up in 2008? The psychology here is perfect for a sustained multi-year rally. The banks are still cast as villains, yet the fundamentals are dramatically better. With net interest margins at their lowest level in 30 years, few industries stand to be bigger *beneficiaries of a rise in interest rates* than the banking industry.

The housing recovery is well underway and has a long ways to go. After peaking at 2 million starts in 2007, plummeting to 450, 000 starts at the low, we are at 900,000 plus starts now. 1.2 million starts is about equilibrium.

You get the idea. Not just improvement, *major improvement*, grindingly better over a 5 year period.

Just because these events lack sizzle does not make them irrelevant. In fact, we think they are highly relevant. While the market is certainly not as cheap as it was several years ago, the economic backdrop is dramatically improved and trending better as we go. We think we can improve our investment odds still further by owning shares of great companies at reasonable prices and owning shares of capital allocation enterprises run by shrewd investors. Ultimately when you buy a stock you buy a business. Buying good businesses with smart owner/managers at discounts to future value: that's what we scan for.

Notes of Caution

All of this is not to say that there aren't increased risk factors in the market. This is why we say "middle innings". For example, while we normally have a 10% correction every year or two, we are three years without one in this bull market. We're due on that front. And such a correction would present an opportunity to buy more of our favorites.

Our primary concern continues to be the propensity of central banks to create more debt. Central bankers took actions between 2007 and 2013 that enlarged sovereign debt as a percentage of estimated global GDP from 62% to 79%. These actions reduce the margin of safety in the global system. We have no one great idea to offset the possible messy unwinding of this morass. However, if you pay off your debts, hold a couple years' worth of cash for emergencies, and own good businesses that generate cash and have pricing power to pass through inflation, we believe we'll be in decent shape for whatever comes.

We agree that valuations are no longer particularly cheap. *Grant's Interest Rate Observer* notes that on a price-to-sales basis, the S&P 500 is quoted at 170% vs. a post-1980 average of 106%. On the basis of total equity capitalization as a percentage of GDP, America markets stand today at 117% vs. a post-1980 average of 76%.

The yield-chasers are hard at it. Cyprus issued 4.625% notes due 2020 to yield 4.71%; the very same security that changed hands at 50.49, a price to yield 16.47% in the depths of the 2009 panic according to *Grant's*. Italian 10-year paper was priced to yield 2.8%. Spain's 10-year yield hovers just over 2%, the lowest in its history.

Animal spirits are running noticeably hotter. More than $1.1 trillion worth of takeovers have been announced this year, exceeding the total of 2013. In addition, there were a record 28 spin-offs in the first half of 2014 with many more coming.

Middle Innings

Warren Buffett – "*Great businesses are first liens against the passage of time.*"

This is our current position. Valuations are reasonable, not cheap. However, the hands of some companies are so strong, we are quite willing to be patient and just let the quarters roll by and see the earnings and intrinsic values grow. By the way, Buffett was referring to Coke and Washington Post at the 1990 annual meeting when we jotted down this quote. How times change! Both of these businesses are not what they once were. In particular, with the decimation of the newspaper biz by the Internet, Washington Post doesn't even have the same name (now called Graham Holdings). So we must pay attention.

Two examples:

Wells Fargo (51) – Back in 2012, trading around 30, Wells' pre-tax, pre-provision earnings suggested $4 per share of earning power in a more normal environment. At 12-13 times those earnings, Wells would trade around $50. Today, Wells is now reporting those $4 per share earnings and the stock is trading at 51. The earnings recovery trade is complete. What's next? With momentum in housing, underwriting quality, technology, market share, and business stickiness, the Wells moat is growing. We see Wells earnings $6-7 per share within 5 years. At a PE of 12, the stock would trade near 80. With some multiple expansion the stock could go to the 80-100 range. This is why we say "middle innings". The scariest part is over, yet the world still has a "show me" attitude with bank stocks. Wells has already shown us what they can do in the biggest banking crisis ever. Now we're ready to see what they can do under more normal conditions.

Leucadia National (26) – Ian Cumming and Joseph Steinberg graduated together in the Harvard Business School class of 1970. Nine years later, they formed Leucadia National from the remnants of a bankrupt factoring company called Talcott National. The duo went on to create one of the great investment track records of the last three decades. With Cumming retiring, Steinberg assured succession by merging Leucadia with Jeffries Corp. and handing the operational reins over to Rich Handler CEO (the longest tenured CEO on Wall Street) and Brian Friedman, President, of Jeffries. Essentially Leucadia is now a merchant bank with investment banking, about $3 billion of liquidity, and targeted investments in real estate, energy, meat-packing, and finance. Selling below book value of $28/sh., Leucadia looks well run, opportunistic, and cheap.

Note that both of these valuations are undemanding and a far cry from paying $10 billion for Snapchat. These are the sorts of things that have us in a "middle innings" frame of mind. Going forward, knowing what you own may become more important than simply being in or out of the market.

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