Pecaut & Company

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

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EXECUTIVE SUMMARY

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MARKET UPDATE

Stock markets around the world are a shade lower for the year with continuing concerns about the global economy, especially around the issue of the credit worthiness of sovereign debt from Dubai to the PIIGS (Portugal, Italy, Ireland, Greece, and Spain). All of which simply says that the de-leveraging of the world economy is still underway and will take a long time. And because the stimulus actions taken have been so extreme and unprecedented, investors must be prepared for a wide range of outcomes.

We are still amazed at the degree to which the massive stimulus from governments around the world has worked. The world economy has rebounded from the brink of disaster. So now what? It's clear that ultra-low interest rates have goosed investment returns in nearly all asset classes. So some caution is in order there. And what happens when stimulus is reduced? How viable are our financial institutions? Will the economy tank and will unemployment persist in the double digits? There's another element of caution for sure. In addition, it's hard to see how a highly leveraged government seeking a program of higher taxes, increased regulation, expanded government, and the very real possibility of higher interest rates down the road can be a recipe for sustained economic growth. Yet how do we reduce a $1.6 trillion deficit (which amounts to a Greece-like 10.6% of GDP) without increasing taxes? Are we not in what Bill Gross has called the "new normal" of very slow growth for many years to come?

On the other hand, over $500 billion of stimulus money has yet to be spent and mortgages are being underwritten on more solid terms every day. (In rough terms, out of some 80 million mortgages nationwide, 25 million have no mortgage and another 4.5 million are turning over annually on much sounder terms). Consumers and corporations collectively now have some $10 trillion in liquid assets, so those two sectors of society have gotten onto firmer footing. The contrarian in us notes that U.S. equity funds have been mostly in net redemption over the past year, so is it possible U.S. stocks are setting up to be the surprise winner in the years to come? In particular, we see a sweet spot in the market where investors can buy very high quality, global giants at low double digit PE's with decent dividend yields. In the very long run, we see continued global growth as the ace in the hole for the world economy, and these companies are sure to participate. We like the idea of getting some yield AND getting a call on global growth.

One friend was wistfully remembering the Clinton years, back when we had low unemployment and a budget *surplus*. Ah, those were the days. And, as the grizzled investors we are, 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. And low prices come with the baggage of fear and uncertainty. We have a good share of both today, though less now than we had a year ago at this time.

Up with Volker

"The only useful banking innovation was the invention of the ATM."

- Paul Volker, Fed Chairman 1979-87, current head of President's Economic Recovery Advisory Board

Paul Volker is back! We are most pleased. This ATM quote is typical. We've enjoyed quoting the acerbic Volker over the years and he was early in seeing the potential disaster brewing in the mushrooming use of derivatives. After being shunned by the Obama administration for much of the past year, Volker appeared with President Obama on Jan. 21, 2010 when the President proposed some new bank regulations dubbed "The Volker Rule". The proposed rules would prevent commercial banks from owning and investing in hedge funds and private equity and limit trading for their own accounts.

We totally agree. The solution needs to be *systems based*, not people based. As devotees of Spinoza, the father of the social sciences, we believe in regulating from a place of taking people as they **are**, not as we wish they would be. And what people are at times – often at the most critical of times – is greedy, dishonest, and foolish. Rather than regulate that, we favor Volker's idea of simply disallowing banks to invest on their own account. Remove the moral hazard. Bring back some form of Glass-Steagall lite. Then make it clear to the rest of the system that there are no more government bail-outs. Let the risk-takers succeed and fail on their own merits.

The idea of a global bank risk czar was a non-starter in our book. Especially so after reading Too Big to Fail by Andrew Ross Sorkin which recounts the frantic days in late 2008 when the U.S. financial system was on the brink. While we have a jaded view of Wall Street, we were still amazed at how ideas of sound stewardship or what was good for the system or good for the society simply had no place in the thinking of the CEO's of our investment banks. It's a world of sharks and those with nobler ideas get weeded out long before the executive suite. Finding any one human being to see clearly what is going on for the whole system is a long shot. Then to do so in a position under such extreme political, economic, and social pressure is nearly certain to fail. Change the system.

Bamboozlement

"The client world pays up precisely in proportion to how bamboozled it is by unnecessary complexity and this, among other negatives, is what the fancy new instruments were offering: confusion, doubt, and bamboozlement."

- Jeremy Grantham, Chairman of Grantham Mayo Van Otterloo

Grantham has a great way with words. We so enjoyed his explanation of derivatives, we thought we'd pass it along to you.

The Worst Did the Best

As we have noted, the worst did the best in 2009. According to Bespoke Group, the 50 biggest stocks in the S&P 500 rose 22% while the smallest 50 gained 113%. Those that paid no dividends outperformed those that do by better than 2 to 1. Those that earned no money did far better than those that had profits.

And it is this market behavior that has left us value investors a very nice anomaly – some of the highest quality companies in the world are selling at very reasonable prices with very nice yields.

And the Best was Worst

Which brings us to one of our most interesting factoids of the day: the decade's best performing U.S. diversified stock mutual fund had the *worst* dollar-weighted returns! Ken Heebner's $3.7 billion CGM Focus Fund rose more than 18% annually for the last decade, outperforming its closest rival by more than three percentage points. Spectacular stuff considering the S&P 500 lost money for the decade. Incredibly, Morningstar, Inc. reports that on a dollar-weighted return basis, *the typical CGM Focus Fund investor lost 11% annually for the 10 years ending Nov. 30*. This is really stunning. Not only did the typical investor not share in the double digit returns Heebner put together for the decade, the average investor lost money at a double digit rate!

How to account for this mammoth disparity? Volatility. Heebner runs a focus fund, meaning he owns fewer than 25 stocks, so the fund can and does move up and down dramatically. For example, in 2007 the fund surged 80% so investors poured $2.6 billion (buying high) into the fund only to see it sink 48% in 2008. Investors then yanked more than $750 million from the fund in 2009 (selling low).

We got on to the idea of dollar-weighted returns back in the 1980's when we reported that the legendary Peter Lynch said that most people had ***lost*** money in his Fidelity Magellan Fund, despite his world-beating returns. That was because mutual fund investors so consistently bought high and sold low. Typically, money would cascade into the fund after Lynch had a great year and was featured on the cover of financial magazines. Then, after a lackluster year or two, investors would leave in droves for other, more promising fare, missing out Lynch's next big up-move.

I remember getting calls, challenging the veracity of the quote. However, I was in the audience taking notes and had no doubt what Lynch had said. What Lynch was pointing out was the difference between a mutual fund's stated annual percentage returns and its "dollar-weighted returns", which includes the effects of cash flowing in and out of the fund.

We have returned to this topic often over the years. In 2000, we cited the likely doomed fate of Internet fund shareholders who stampeded into those funds after a couple years of eye-popping returns, getting in just as those funds were about to plummet. In our fourth quarter letter for 2009, we noted our caution toward bonds because bond funds have received an avalanche of funds ($380 billion of net inflows) after their stellar returns last year. And in this letter, we have optimism for U.S. stocks in part because U.S. stock funds have been in net redemption for the past two years.

Lessons Learned

Of course, Heebner was not alone in the 2008-09 market debacle. Many equity fund managers were hit with redemptions as shell-shocked investors sold low.

Our age-old lesson in all of this begins with **knowing what you own**. A real investor in Heebner's fund would know that he's extremely focused which generates extreme volatility. This is not a fund to own it if you're not up for the wild ride.

The debacle illustrated the value of one of the key principles of value investing: **look for companies with staying power**. Buying "stocks as businesses" keeps one's focus on the staying power of both the balance sheet and the business model. Companies that go bankrupt cannot rebound (and this list is a long one for the recent crisis from Countrywide to Freddie and Fannie to Lehman to Wachovia…). As they say at the Indy 500, to finish first you must first finish.

The debacle also illustrated the value of insuring **the investor's staying power.** Know yourself emotionally. How much volatility is too much? Fortify your own balance sheet. Consider paying off your debts. Debt free investors are never forced to sell and therefore have maximum staying power.

Working on the Railroad

While many have been building cash, Warren Buffett has been investing it by the billions. Remarkably, Warren Buffett, approaching age 80, is just hitting his prime. From double digit loans with equity kickers to distressed acquisitions to mega-deals, Berkshire Hathaway has allocated more capital in less time than at any point in its history. Corey estimates that Berkshire added roughly $25 billion of value in 2009. Yet the market treated Berkshire to just a 2.6% market price advance while the S&P 500 rose over 26% last year. Berkshire's stock price is making up some of that difference in 2010, gaining 15% to date versus a 2% decline for the S&P.

Stimulating some of that run has been a 50-1 split in the Berkshire B shares to accommodate Berkshire's $44 billion buy-out of Burlington Northern (Warren's "all-in wager on the U.S. economy"). The increased float from those extra shares led to Berkshire being newly added to the S&P 500 Index. The forced buying by S&P index funds was a factor in Berkshire's run up.

While the purchase of one of the nation's largest railroads would be enough action for most mortals, Buffett also recently inked a $1.3 billion deal reinsuring a closed block of U.S. term-life insurance business from Swiss Re. Insurance, of course, is in Buffett's wheelhouse so the odds are good that he knows what he's doing here. Buffett was quoted on CNBC saying that he believes that this is the largest insurance contract in history and that he expects Berkshire to get something like $50 billion in premium from the deal over time. Isn't that something? The largest insurance contract in history and yet we're guessing this is the first you've heard of it. Some 80 year-olds are just moving too fast for the media to keep up.

By the way, this is Berkshire's umpteenth bite at the Swiss Re apple. In the past two years, Berkshire bought a 3% stake in the world's number two reinsurance company, took on a five year 20% quota share arrangement with Swiss Re's property casualty business, and provided capital to Swiss Re during the crisis via a sweet 12% convertible note with a strike price that is half of Swiss Re's current price. When some people hear "Swiss" they think of "chocolate". We'd guess that when Buffett hears "Swiss" he's thinking "money".

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