Pecaut & Company

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

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MARKET UPDATE

We've come full circle. The rally in stocks has taken the S&P 500 back to where it stood in August of 2008 just before the plunge ignited by the Lehman Brothers collapse. A combination of restored confidence (though still fragile), massive government stimulus, and improving corporate profits has encouraged the market to regain some $7 trillion in market value. From the March 2009 low of 676, the S&P 500 has rocketed up about 90% to a recent level of 1285.

So now what? The global economic situation still appears fragile with Ireland being the latest bailout poster child. Significantly, China publicly admitted to taking steps to help some EU members counter the sovereign-debt crisis. The message to us is that we live in a global economy and, to a degree never before seen, all trading countries realize they are in this together. As long as those that have capital continue to assist those that have credit troubles, we just may muddle through this mess over the next few years.

Meanwhile, corporate profits have been strong (see below). Corporate America's ability to manage costs, inventory, and restructure balance sheets through the crisis has been really impressive. With such tightly managed cost structures, going forward it appears a small amount of revenue increase may result in a large increase in profits.

We have been pounding the table for months about how attractive the very largest corporations appear. While such stocks have rallied a bit with the market rebound, we continue to see global branded companies as the sweet spot of this market, offering modest valuations, great balance sheets, and handsome dividend yields.

Tale of Two Worlds

As we mull the coming investment year, two primary thoughts shape our thinking. One is that developed world government balance sheets are in terrible shape. The other is that, in aggregate, corporate America's balance sheet is in stellar condition. What a wide and curious disparity!

The balance sheets of the developed world governments are in terrible shape. The U.S., many of the nations of Europe, and Japan drank the Kool-aid. Central Bankers became infatuated with the idea of solving a problem of having borrowed too much money by….borrowing more money.

In the book <u>This Time is Different: Eight Centuries of Financial Folly</u>, Carmen Reinhart and Ken Rogoff analyze a number of financial crises through history. One pattern they note is that when a country's debt begins to exceed 100% of its GDP, the debt and debt service requirements can begin growing faster than the country's ability to repay. Then it's just a matter of time before there is some sort of financial calamity. Dangerously, the U.S. is on track to have a record deficit of $1.3 trillion for 2011 and debt of some $13 trillion, over 90% of GDP. Worse, Congress has shown little initiative in dealing with the issue, choosing instead to continue its stimulus and pork barrel policies. Europe has similar debt issues, though the idea of initiating austerity measures is catching on there. (By the way, Iceland committed the heresy of letting its banking system fail a couple years ago and, after a very painful period, is on the road to recovery.) The aggregate amounts to be borrowed and refinanced in the coming year are in the trillions. And we are not even including the financial mess brewing at the state government level. This process will be painful, reap feverish headlines and take years to muddle through.

As if they existed on an entirely different planet, U.S. large company balance sheets are in terrific shape. U.S. corporations hold cash equivalents equal to nearly $2 trillion or 7% of total corporate assets, the highest percentage since 1963. In 2010, U.S. corporations refinanced over $3 trillion of debt at generation-low interest rates. In addition, U.S. corporations posted record third quarter profits of $1.7 trillion, *the highest quarterly result in history*. In short, U.S. corporations have shown remarkable agility in adapting to the debt crisis of 2008-2009. Equally remarkable, despite proving their resilience through the greatest collapse since the Great Depression, U.S. global corporations continue to sell at the lowest valuations relative to the market in a half-century.

The Hidden in Plain Sight Market

So why are these stocks so cheap? Where's the love? In part, the fears about the government financial issues have given many folks a heightened sense of caution about financial assets of all sorts. For another, the general investment public has been burned by the stock market, so there is some making amends in order. At year-end 1998, the S&P 500 stood at 1225. As of Dec. 31, 2010, *twelve years later*, the S&P 500 stood at 1258 for an average annual gain of 0.2% for the period (not including dividends). After a performance like that, you can see where people may have lost some enthusiasm for stocks. In addition, there was the matter of the Internet Bubble and collapse in 2000-2002 followed by the 2008-2009 credit collapse where the market dropped a bone-jarring 57% from its 2007 high. Despite rallying dramatically since March of 2009, equity mutual funds have been in net redemption for the past couple years and only received some net inflows in the past few months. While stocks are no longer in revulsion, it is reasonable to say that stocks are not yet at the pinnacle of popularity.

In our book, however, it's time to give corporate America a little credit. The flexibility and adaptability displayed during the world's greatest financial disaster since the Great Depression has been most impressive. Management shrank balance sheets, reduced inventory, refinanced debt, sold assets, and maneuvered mightily to keep their businesses breathing in the suffocating collapse spawned by the subprime mortgage debacle. And, yes, the government played a huge role in keeping the financial system afloat.

As value investors we want value and a margin of safety. We too are concerned about what happens when major governments are too profligate for too long. On many levels, these companies provide some offset for these concerns. Worried about lending? These companies are self-financing. Worried about currencies? These companies are a natural hedge, doing business all over the globe. Worried about regulation? These companies are used to handling it while smaller competitors may be overwhelmed. Worried about inflation? These companies have pricing power and/or low capital requirements to offset the corrosive effects of inflation. Worried about a double dip? These companies are proven survivors. Need income? A number of these companies offer better-than-bond dividend yields.

A Decade of Inflation

The government tells us that inflation has been very quiet for the past decade and continues to be moderate despite its massive economic stimulus in recent years. Corey has complained long and loud (at least around the office) that we've had significant inflation for years. And the rest of us are not arguing with him! Food costs, energy, healthcare, education. They all have gone up significantly. However, the way the U.S. government measures core inflation leaves out many of these basic elements that consumers consume (in particular, energy and food). Our thanks to a recent issue of *Barron's*, quoting the *King Report*, on how much some of these costs have gone up in the last decade. Homeowners' insurance is up 108%. Taxes on real estate climbed 77%. A gallon of heating oil costs 150% more. The average electricity bill is 50% higher. Gasoline doubled. Monthly Medicare part B premiums have climbed 143%. A potato goes for 67% more and an egg costs 93% more. The price of a loaf of plain old white bread is up 50%. All this and the government reports there is little inflation. It's enough to give one indigestion.

We Don't Know Nuttin'

"We don't know one millionth of one percent about anything."

- Thomas Edison

On a recent version of the CBS show *60 minutes*, Ben Bernanke said he was "100% confident" that he could act quickly to stop inflation from getting out of control. We suppose that public humility and public office are simply mutually exclusive. However, it is rather stunning to hear a quote like that after the gargantuan missteps by all parties leading up to the sub-prime mortgage debacle. Clearly, something less than 100% certainty is called for.

While we're guessing that Edison was exaggerating to make a point, the old inventor was eerily and remarkably accurate with his remark. According to the movie, *What the Bleep Do We Know*, scientists estimate that the incredibly sensitive sensory organism we call the human body receives *400 billion bits of data per second*. That's a mind blowing amount (and we note that we have no idea how such a number was derived). Even more incredible, to manage that data flood, scientists estimate that *the human mind filters out all but 2000 bits of data* with which it then interprets the world. This perspective challenges commonly held notions of perception and what counts as "objective reality" or "truth".

We can easily test this notion about filtering in small ways. For example, if we played a game where we gave you 30 seconds to make a mental note of every red object in the room, you'd quickly scan the room using your "red" filter. You no doubt would notice the red holiday decorations, the red in the painting, the red poinsettia, the red cup, etc. If we then asked you to close your eyes and tell us about every *blue* item in the room, you might be hard-pressed to think of any blue objects. This is the essential point: our minds filter data. What we "see" in the world depends (whether consciously or unconsciously) on what we are looking for. Thus, to say I "know" something and believe that it is a final, objective and complete truth is an illusion. What I "see" is entirely conditioned by what my mind has been trained to scan or filter for. And the volume of data bits that I don't "see" outnumbers the few that I do by the billions. Humbling thought, yes?

To review: 400 billion bits per second of data in, all but 2000 bits filtered out by the human mind. If our math is correct, that means *we actually use only 5 ten millionths of one percent* of the data we receive in our cognitive processes. In terms of modern science, Edison was incredibly accurate! For us, we immediately become humbled for all that we don't know, and we feel compelled to tred lightly when we are tempted to say we do "know" something.

With the colors red and blue, so with the concept of "inflation". As we noted above, the rate of inflation clearly depends upon where you look for it. The government CPI filters out some of those basic living costs that are going up the most. And that's the point of this philosophical ramble. Let us stop and think critically about comments of the sort where Ben Bernanke said he was "100% confident" that he could act quickly to stop inflation from getting out of control. (What does he even mean by the word "inflation"?) Clearly, something far, far less than 100% certainty is called for. In fact, to paraphrase Edison, *"we don't know even 5 ten millionths of one percent about anything."*

Global Advantages

A decade ago, Goldman Sachs coined the term BRICs to refer to the four largest emerging economies of Brazil, Russia, India and China. Goldman built computer models to project when the size of these economies might surpass that of the G7 nations. Well now it's happening.. Last year, China surpassed Germany as the world's largest exporter and surpassed Japan as the world's second largest economy. India's economy is expected to surpass that of Japan's in 2011. Clearly the "emerging markets" in many ways have already emerged. Those companies that can participate in the "Rise of the Rest", as Fareed Zakaria has dubbed these emerging economies, should have a strong tailwind for years to come.

In fact, as value investors, we "filter" for those global companies that are working diligently to build sustainable growth and product advantages in these markets. These are the day in, day out sorts of things that generally go unnoticed by the CNBC crowd of investors. For example, we noted in a recent newsletter that Coca Cola held market share at a time when many consumers were trading down in other brand categories. We felt that was huge in demonstrating how strong the Coke brand was and something only a major economic crunch could show us. In addition, Coca Cola has been able to expand significantly in Russia as competitors struggle with financing and logistics.

Another company working hard to grow in emerging markets is Proctor & Gamble, which gets a third of its revenues from developing regions, up from 20% in 2000. CEO Robert McDonald wants to raise that percentage to 50% by 2020. In China, which P&G entered in 1988 through a joint venture with Hutchison Whampoa, per capita spending on P&G products is just $3 a year versus nearly $100 in the U.S. In addition, as reported in a recent *Fortune* story, P&G is actively researching the "$2 a day" consumer in emerging markets, hoping to add 800 million new customers in the decades ahead. One of the surprising things they are finding: poor customers care about beauty – just like everyone else. Such consumers are not merely looking for the cheapest and most practical items.

P&G is intent on growing its competitive advantages, investing some $2 billion a year in research with 25 R&D centers around the world. So not only is China a major market of the future for P&G, it is fast becoming a research center as well. In fact, P&G has become an employer of choice, one of the top three choices among Chinese university graduates looking for jobs. All these new, creative people are generating new products coming out of China. The *Fortune* article notes that Crest Pro Health toothpaste, a premium brand whose main researcher, Wang Xiaoli, cracked a 50-year chemistry problem by finding a way for stannous fluoride to stabilize in water. Wang, who won a companywide innovation award, says she came to P&G because "I didn't want what I learned to be published in 100 years."

How many companies have the products, focus, and resources to take such a long view towards developing these markets? What is the future value of being one of the three most sought after job providers for Chinese university students? While these sorts of things will not interest the fast money crowd, growth in sustainable, long-term business advantage quickens the pulse of us value investors.

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