Pecaut & Company

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

401 Douglas St., Suite 415
Sioux City, Iowa 51101

www.pecautandcompany.com

Telephone: (712) 252-3268
(800) 779-7326

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EXECUTIVE SUMMARY

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Market Update

Our thoughts and prayers go out to our neighbors that have been affected by the Missouri River flooding. This is one for the record books and adds another twist to a year filled with natural disasters.

As for un-natural disasters, the sovereign debt crisis in Western nations continues to fester. The Euro-zone is currently grabbing the headlines with Greece, Ireland and Portugal appearing destined to default. This is a huge mess. The debt Supercycle was three decades in the making so it will take more than a couple years to sort through the hangover.

But we are working it out. Unlike 2007, when the world was happy and complacent, today there is extensive attention being brought to bear. We are cautiously optimistic that as the developing world emerges and consumes more goods and services the Western nations will "muddle through". For those willing to look out a few years, it seems clear that the developing markets will increasingly be the engine of global growth. For a reminder to be patient, we turn to 1975:

"*Stock market fluctuations are of little importance to us – except as they may provide buying opportunities – but business performance is of major importance. On this score we have been delighted with the progress made by practically all of the companies in which we now have significant investments*"

- Berkshire Hathaway Inc. 1975 Chairman's Letter

As was the case then, today's markets are fearful and volatile. That does not bother us, except as such volatility may provide buying opportunities. Meanwhile, we are very pleased with the ***business*** performance of our favorite companies. We continue to find it remarkable that, for the most part, our favorite companies still sell at modest valuations even as they provide better-than-treasury yields, offer a hedge for currency and inflation risks, carry fortress-like balance sheets, and continue to capitalize on global growth.

This Can't Be Happening

Under the direction of the Army Corps of engineers, we continue to try to control floods by the brute force of levees and dams in the lowlands rather than by reforesting the distant highlands where floods are generated. Levees, like cocaine, are addictive: building them increases the craving for more. Raise the levees and you raise the bed of the river as more silt is deposited. This in turn requires the levees to be raised still further, thus increasing the damage done whenever, after many such cycles, the river finally breaks free of man-made controls. St. Louis and New Orleans are living on borrowed time, and all because the simple-minded policy of controlling floods by building levees and dams has not been challenged with the ecolate question, "And then what?"

- Filters Against Folly –1985 - Garrett Hardin, Professor Emeritus of Human Ecology at the University of California, Santa Barbara. – p.76

Along the Missouri River there has been disastrous flooding. The amount of rain and snowmelt up north has simply overwhelmed the system. Our hearts go out to all those affected. What a mess.

Some in the media have suggested this is a 100-year or 500-year event. However, as Garrett Hardin noted some three decades ago, this massive and massively damaging flooding was not an unlucky accident but an *inevitable outcome* of Army Corps policies. Each levee, while sensible in isolation, added to a collective whole that made the river run faster and higher. As the dams silted in over the years, their carrying capacity was steadily diminished. As civilization expanded, less and less marshes and forests were available to sponge up excess rain and snowmelt. As farmers added tiling to drain their fields, ever more run-off was funneled into the waterways. All the while, there was no one to ask the ecolate question, *"And then what?"* Decision by sensible decision, we slowly built a collective disaster waiting to happen. And now it has. A *Des Moines Register* cartoon captured it perfectly. It shows a farmer with a pitchfork with water up to his nose and an Army Corps engineer with water up to his neck looking at his manual. The caption: "*According to our models, this can't be happening.*"

"And then what?" Hardin hits the nail of proper risk management squarely on the head. One must look beyond conventional thought to thinking hard about what could go wrong. It begins with what has gone wrong historically, but moves beyond that to considering how the future could be different from the past. It cannot simply be read from a manual. If anything, manuals are dangerous to the extent that they inhibit thinking, because, hey, the thinking has already been done. It's in the manual.

The flood provides an apt metaphor for the subprime mortgage meltdown. The conventional thinking said "home prices never go down". This mantra rationalized poor underwriting standards which devolved to virtually ***no*** underwriting standards, which worked as long as housing prices kept rising. Washington was pleased as U.S. home ownership hit record highs. Regulators were instructed to keep the happy days rolling. Ever more poor underwriting decisions were followed by the slicing and dicing of mortgages into packages of derivatives, which were aided and abetted by AAA ratings from Moody's and S&P. Like cocaine, bonus-driven investment bankers sought to out "innovate" each other by engineering ever more exotic mortgage-related derivatives. They in turn relied on the buyers of this financial detritus to suspend their own common sense and allow themselves to be seduced by AAA ratings and high yields. All driven by the "manual" that said housing prices never go down - after all, they hadn't for decades. Until they did.

<u>We Got Problems</u>

If you went to the moon for the last decade and just returned, the headline issues would appear mind-boggling. U.S. deficits equal to 28% of GDP (we were running a ***surplus*** when you left.) Total U.S. government debt approaching 100% of GDP. Congress and the Executive Office dithering as a U.S. debt ceiling deadline approaches, playing loose with America's triple-A debt rating. How did we get into such a mess? The Euro-zone is in a debt crisis of its own with Greece, Ireland, Portugal lurching toward default. According to Sean Egan of Egan-Jones Ratings the European Central Bank has 303 billion euros in assets, 113 billion in deposits of local banks and 150 billion in sovereign debt supported by a thin sliver of 10 billion euros of equity. He asks, "Will Europe, worn down by bailout after bailout, finally be forced to bail out the bailer, the ECB?" A big mess to be sure.

At this point, you might be thinking you should have hung out on the moon for another decade. The fact is that the debt Supercycle of 1980 to 2008 left us with a monster hangover. We are still only part-way in the process of reconciling all that debt to the realities of our global economy. We see three primary event risks on the horizon: U.S. losing triple-A status (the world's largest economy), a disorderly default in the Euro-zone, and an unexpected adverse event in China (the world's second largest economy). As if that weren't enough, there are also the impacts of Japan's disasters on global growth, unrest in the Middle East, fear of a double-dip recession, currency debasement and inflation risks to consider.

This is where our long-held advice to be debt free comes into play. To the extent you owe no one, then *you will keep what you own, regardless of how the debt reconciliation process unfolds*. Have at least 6 months worth of expenses in liquid accounts for emergencies. Keep another couple years worth in short term, liquid securities to supplement your living expenses. With the balance you have the luxury of taking a longer view. And for those with a longer view, we see opportunity.

<u>We Got Opportunity</u>

If you went to the moon for the last decade and just returned, the opportunities in large cap stocks would appear mind-boggling. When you left, large cap companies were market darlings, selling at PE's of 30, 40, and up. Everyone agreed that these were great investments. Such companies deserved their rich premiums because they had economies of scale, access to capital, and an unmatched ability to profit from global growth for decades to come. Sounded great but the prices were, well, over the moon.

Imagine your shock and delight to find these same companies selling at record low valuations, with far stronger balance sheets, far higher earnings, able to refinance at ultra-low interest rates, and having proven their ability to prosper from the "rise of the rest". The whole global growth story is really happening and these stocks are as cheap as they've ever been.

You can hardly contain your excitement as you consider these data points:

40% of S&P 500 revenues now come from international sales. The S&P hasn't really been a "U.S." index for years. No one seems to have noticed yet.

Emerging markets collectively now account for more of global GDP than the U.S. China is now the world's second largest economy. India is likely to pass Japan for the #3 slot soon. In beleaguered Africa, there are now more cell phones than in the U.S. Meanwhile, U.S. investors continue to obsess over the domestic economy.

McKinsey estimates the world's middle class will double over the next decade from 20% to 40% of the world's population. The study also estimates middle class spending will *triple* over the decade from $7 trillion to $20 trillion.

McKinsey also notes that brand advantages can last for years. Looking at the number one and two consumer products in 17 categories in 1925 in America, McKinsey found *that the U.S market leader remained the number one or two player in the category for the rest of the century.*

Hmm…. investing in global growth sounds like an even better idea than it was in the year 2000. So investors must be piling into these stocks, yes?

No, investors have been piling into bonds funds. Since year-end 2008, over $650 billion has flowed into bond funds. U.S. large cap stock funds were in net redemption for the period.

Meanwhile, in complete contrast to what small fund investors are doing, the manager of the world's largest bond empire, Bill Gross of Pimco, sold all U.S. treasuries in his fund. Instead, he's recommending buying quality global stocks like Proctor and Gamble.

Check out this quote: "*Corporate profits – one of the few areas of strength in the limp U.S. recovery – appear to be weathering the economy's soft patch. But the gains in many cases have come from international operations, particularly in emerging markets*."

- *Wall Street Journal*, 7/25/11

Why the "but"? Of course gains are coming from emerging markets. That's where the growth is.

We agree. In addition, for the first time since the 1950's, Corporate America is issuing debt at rates cheaper than the yields available on the common shares. In fact, Corporate America has been issuing debt at rates *below those of sovereign nations.* Microsoft was able to issue medium term notes at rates as low as 1%. Meanwhile shares of Microsoft trade for just 11 times earnings and yield 2.3%. Johnson and Johnson also issued 1% notes while JNJ shares trade for 15 times earnings and yield 3.5%.

As we've noted in past newsletters, these companies offer a hedge for much of what many are worried about. A credit crisis? These companies are self-financing. A currency crisis? These companies deal in currencies all over the world. Inflation? These companies generally have low capital costs and better-than-average ability to pass through cost increases. Unanticipated problems? These companies have proven their ability to adapt to change.

<u>Fighting the Last War</u>

"If a weak currency made you competitive, Zimbabwe would be a manufacturing powerhouse."

- Joe Rosenberg, Chief Investment Strategist, Loews Corp.

No question the 2008-2009 crash was a doozy. We believe that sharp drop traumatized many investors and that a number will never return to the markets. Thus, we believe the question driving many of today's investment decisions is *"What if we have another 2008-2009 crash?"* Most likely, it is this question that is driving the stampede into bonds. Investors, fearful of another market swoon, are loading up on guaranteed, fixed-dollar contracts from treasuries, to CD's, to annuities, to bonds. Capital preservation is the goal. And these are indeed the products designed to deliver capital preservation (as long as the issuer offering the product remains solvent!).

We believe investors are fighting the last war. Joe Rosenberg suggests weak currencies are the issue, and the governments of the west are currently engaged in a race to the bottom. (As Mohamed El-Erian, CEO of Pimco, cleverly describes the dollar: "the U.S. has the cleanest dirty shirt in the laundry".) Investors need to ask Hardin's ecolate question, *"And then what?"* In a time of worldwide currency debasement, we would submit that *purchasing power destruction* may well be the big issue in years to come. As currencies are debased, it seems highly possible that inflation will accelerate (and already has in many parts of the economy) and interest rates will rise. In such a world, what guaranteed, fixed-dollar contracts really will offer is a guaranteed loss of purchasing power.

Thinking long term, we believe the real issue will be protecting purchasing power. As detailed in past letters, "safety" in a world of currency debasement really amounts to preserving purchasing power. In 1930, the year my father was born, a Coke cost 6 cents. Today it costs $1. If you locked that 6 cents away in 1930 so it would it be "safe" and not fluctuate, today you would have your 6 cents. Though, capital was preserved, you incurred a 94% loss in purchasing power. That's the risk.

<u>What If We Have Another 2008-2009 Crash?</u>

First answer: We will. It's not a matter of "if". It's a matter of "when". Markets go up over time and have downturns along the way. That's simply the way the world works. Since 1900, the U.S. stock market has had on average a 10% correction every year or two and a 20+% correction every 3 to 5 years. If you are not prepared to accept this aspect of reality, then keep your money at the bank.

Second answer: If you own great *businesses*, why worry so much? Nestle's has been around for 150 years. 2008-2009 is already just a blip on the chart. The stock went from 50 to 30. Now it trades at 63. Coca Cola has been around since 1886. 2008-2009 the stock went from 64 to 39. Now it trades at 69. At no point did people stop drinking Cokes or munching on Nestle chocolates. At no point did Coke's AA rating or Nestle's AAA ratings come into question. At no point was Nestle's dividend, which has risen seven-fold from 26 cents to $1.85 per share since 1995, in danger of not being paid. If anything, both companies expanded their reach and dominance during the crisis. As reported in this newsletter, Coke made huge inroads into Russia as local beverage vendors suffered from lack of financing.

Third answer: If you're in for the long run, these are buying opportunities. From Africa to Asia to South America, peoples of all sorts of cultures are embracing trade and open markets. Of course, there will be set-backs. That's how it works. Read Matt Ridley's <u>The Rational Optimist</u>. After several books on genetics, Ridley suggests in his most recent work that the evolution of civilization is driven by the DNA of ideas. The more "sex" ideas have, the faster we evolve. And with today's communications and technology, we are evolving as never before.

Value Creation

One last note. While the long term appreciation in shares rides on primarily the growth of the underlying business, investors seem to forget that publicly traded companies can create (and destroy!) value in other ways as well. Some of the ways that corporations are creating value currently include:

Selling bonds – Companies are taking full advantage of generational low interest rates to refinance.

Repurchasing shares – While buyback programs are often abused, a number of companies are buying in shares well below intrinsic value. For example, White Mountains, an insurance company selling well below book value, is buying shares in at the rate of 10% a year. At this rate, the company will be private within a decade!

Buyouts - Mergers and acquisition have picked up this year. White Mountains may accelerate its buyback program after selling its Esurance division to Allstate for $1 billion. Berkshire Hathaway has hit a homerun with its purchase of Burlington Northern Santa Fe, partially financed with debt issued at ultra low rates.

Spin-offs, reorgs, restructurings – Sometimes companies seeking to maximize efficiency and value may reorganize operations. For example, Conoco Phillips stock has appreciated as management changed focus from empire building to creating shareholder value. COP recently announced a tax free spin off its refinery operations to shareholders.

The point is that businesses can create value for shareholders, regardless of whether the market is up or down that day. In the long run, that's what counts.

Dan Pecaut Corey Wrenn