401 Douglas St., Suite 415
Sioux City, Iowa 51101
www.pecautandcompany.com
Telephone: (712) 252-3268
(800) 779-7326

December 2012

EXECUTIVE SUMMARY

- **Market Update**
- **How Bad Is It?**
- **Happy Holidays**
- **Appendix - The Age of Capital Allocation**

MARKET UPDATE

We do not lack for things to worry about. The sovereign debt mess, the fiscal cliff, a slowing of economic activity in China…. One of our top concerns continues to be central bankers who have been on a borrowing binge trying to solve a problem of too much borrowed money by borrowing even more. This tactic is akin to the old joke, "the floggings will continue until morale improves." In a world awash with liquidity, more liquidity is not the answer. Economic growth and sound fiscal policy are the answer. The former will take time. As for the latter, well, we're still waiting.

Yet, in the face of all these worries, the stock market is up this year. How can this be? Well, for one thing, a portion of this return is a "sugar high" from the massive stimulus measures taken by governments, inflating the value of nearly all assets. For another, earnings matter and aggregate corporate earnings hit a record high in the third quarter. (In fact LPL Financial's Jeff Kleintop reports that since the first quarter of 2009, as the recession troughed, *the S&P 500 Index is up about 83% as are earnings per share, uncharacteristically accounting for nearly all of the rise in the stock market.*)

For those companies selling too cheap, there have been value-creating actions – including substantial share buybacks, spin-offs, acquisitions, dividend increases – increasing *per share* business value.

In fact, we see the decade to come as "the age of capital allocation". In a slow-growth, zero-based interest rate world, with corporations sitting on $1.7 trillion in cash and generating record cash flows, *how excess capital gets allocated* will be a major component of the value created (or destroyed) over time. For this reason, we will take a closer look at capital allocation in the appendix of this newsletter. (We're ok if you put this letter aside so you can get to your next holiday party. However, we hope you'll read it eventually as these thoughts are central to our thinking going forward.)

By the way, this is a key reason why we continue to like shares of global brands. Not only do they offer great balance sheets, handsome dividends, and a call on global expansion; they can reinvest future cash flows for decades to come at attractive rates of return. In the financial industry, we see many companies selling at huge discounts to book value, valuation gaps that could be closed by huge stock buybacks or deals. Furthermore, we see the natural gas boom driving a renaissance in American manufacturing.

For long term investors, we suggest thinking less about the headlines and more about buying value. For the value-oriented, there is opportunity.

HOW BAD IS IT?

The crush of negative media has simply been suffocating. So our top recommendation for 2013 is **TURN OFF YOUR TV**. The political campaigns certainly contributed to the dark tone. Much of this negativity has been reflected in investment behavior. We note in particular a bull market in fear:

The Bull Market in Fear:

1. $980 billion into bond funds, $440 billion out of US equity funds since Jan. 2008.
2. Negative short term interest rates in Denmark, Switzerland and Germany.
3. Record demand for US Treasuries.
4. A rush into annuities.
5. Bearish strategists – In 30 years, Wall Street strategists have not been, in aggregate, as bearish on equities as they are today. They're recommending an equity allocation of about 44%, where the benchmark has been roughly between 60% and 70% over the last few decades.

People are flocking to "safety", though how safe bonds, annuities, and other fixed-dollar investments will be if we evolve to a world of rising interest rates and accelerating inflation remains to be seen. (We note that from 1926 through 2011, U.S. long-term Treasury bonds had 22 losing years, compared with 24 losing years for stocks. After a 30-year bull market in bonds, people may have forgotten that bonds can go down as well as up.)

Furthermore, the S&P 500 hit 1550 in 2000. It returned to that level in 2007. And currently sits at around 1440. During this infamous "no return" twelve years, U.S. GDP has increased 50% and global GDP has doubled. In addition, many stocks are much cheaper and better financed today. Lots of growth and lower prices make stocks a better deal. This is the paradox and the why of why value investing works so well. In the same nation that has shoppers clamoring for bargains on Black Friday, we have investors shunning bargains in the stock market. The probabilities are high that stocks will significantly outperform bonds over the next ten years.

Meanwhile, corporate America has been working hard to adjust to the ebb and flows of economic fortune. People seem to forget that businesses are dynamic, not static. And we see a number of bright trends that investors are largely ignoring:

Getting better:

1. **Corporate balance sheets** - $1.7 trillion in cash and refinancing debt at ultra low rates.
2. **Banking capital** - Most conservatively capitalized in 50 years.
3. **Auto and housing** - Recovering at the same time for first time in 20 years.
4. **U.S. energy** - Suddenly a low cost producer with breakthroughs in drilling shale deposits
5. **U.S. Household wealth** - Rose to $62.7 trillion as of June 30 from $51.2 trillion in early 2009 according to the Federal Reserve.

The truth is that the U.S. economy is in a better position than most other major economic powers. Corporations have great balance sheets and cash flows. The U.S. banking system is far stronger. Auto and housing are rebounding. Cheap energy is fueling a renaissance in American manufacturing. Pent-up consumer demand is substantial. (For example, the average car in America is 11 years old, the oldest since records have been kept.) Yes, there are major global issues in the balance. But the American economy is better situated and better prepared for what may come than many investors may realize.

As for the fiscal cliff, Simpson-Bowles had it right in December 2010 – increase revenues and reduce spending in gradual, sensible ways to get our budget back in line. The good news today is that nearly everyone finally agrees this is what must happen. Now comes the next step – doing it.

WHAT TO DO?

We continue our age-old wisdom: pay off your debts and live within your means. Then, *no matter what happens, you can keep what you have*. Keep emergency funds and a couple years' worth of living expenses in safe liquid investments. You'll earn microscopic rates of return but the money will be there when you need it.

With the balance, you can think and invest longer term. Think opportunity cost – where can I get the best return for the least risk with each dollar? As you look at this wider opportunity set, think about what is safe and cheap in real terms versus following the herd. While "bonds" sound safe, we think quality stocks of companies with pricing power and economic tailwinds offer some protection from inflation and currency debasement and continue to offer significantly better growth and value.

The investment industry has seen dramatic growth in fancy financial planning and new products in recent years. As never before, people are diversifying into hedge funds, complex annuities (with 110-page contracts!), alternative investments, private equity, timber, and other exotic strategies. While recent returns may have been good, often the fees are stiff, the contract terms are onerous, liquidity severely limited, and you don't really know what you got until (if) you get your money back.

At Pecaut & Company, we prefer to stick to our knitting. Perhaps we are simply prisoners of history. For the Pecaut clan, paying off your debts, living within your means, saving and investing for the long term in well chosen, value-oriented equities has seen us through the Great Depression, several wars, a period of double digit inflation, and, more recently, the Internet Bubble and the Subprime Mortgage Debacle. We choose to continue to do what works.

HAPPY HOLIDAYS

We close 2012 with great gratitude. To love the people you work with and feel like the work makes a difference, what could be better than that? So thanks for being our clients and our friends.

We hope that you can hold your loved ones close this holiday season. All the wealth in the world means little without loved ones with which to share it.

May you and yours have a wonderful holiday and may we all have a healthy and prosperous New Year.

Dan Pecaut   Corey Wrenn

APPENDIX – For those who are gluttons for more, you may read on…..

THE AGE OF CAPITAL ALLOCATION

Here we are going to expand upon some thoughts from our last client letter. With corporations sitting on $1.7 trillion in cash, refinancing debt at ultra low rates, and record profits rolling in, corporate America has seldom been more liquid. How that liquidity gets invested over the next decade will have a major impact on investment returns.

There are essentially 5 things public corporations can do with a dollar earned: reinvest in the business, acquire other businesses or assets, pay down debt, pay dividends, and/or buy in shares.

Deciding how much to allocate to each of these five areas ideally is driven by "opportunity cost". In other words, each extra dollar should go where it gets the best risk-adjusted return over the long run compared to all other competing opportunities. As we shall see, this is infrequently the case. Just as emotionally-wired individual investors invest their dollars in the wrong place at the wrong time, so do corporate managers. And sometimes they are just unlucky.

Part 1 – Reinvesting in the Business

Investing in one's own business, if it's a good one, is generally a great way to go. Invest in what you know. Reinvestment is ideal when the business has a large economic moat, a long open field of growth, and earns high returns on that invested capital. This is one of the reasons we like global brands so much. With the globalization of the world economy, several billion new consumers are joining the global market. Companies like Coca Cola and Nestle can invest billions of future dollars for years to come serving these new customers. (Ed: It's quite remarkable to recall that these companies were considered mature as growth stocks in the late 1980's. That was before the fall of the Berlin Wall!)

Unfortunately, hundreds of businesses have problematic reinvestment issues due to competition, regulation, obsolescence, etc. If you run a newspaper, surely you're not looking to plow a lot of money into printing presses! If you're in retailing, do you reinvest in the face of the fierce competition and momentum of online shopping? You get the idea.

A reinvestment boom is underway in the U.S. fertilizer industry. CF Industries recently announced a $1.7 billion fertilizer plant expansion near Sioux City, the largest capital investment ever for the state of Iowa. Natural gas is a key factor in fertilizer production. With cheap and abundant natural gas – one of those positives we mentioned - CF is reinvesting major dollars into its core business. CF is not alone. By our count, *over a dozen new fertilizer plants* are on the drawing boards.

By the way, we see a renaissance of American manufacturing driven in large part by the natural gas boom. This will be a significant boon to the U.S. economy for the decade to come. Numerous companies are announcing new plants in America. Utilities are rapidly converting from coal to cleaner-burning natural gas. We are actually surprised more has not been written about it to date.

That's not to say all these plants will work out well. We loved this story from the Dec. 10 issue of *Forbes*, which had a feature on Richard Kinder and how he built his gas pipeline empire. Kinder Morgan led a $6.8 billion, 1,700-mile pipeline project designed to bring cheap Colorado gas to the Eastern Seaboard, the most expensive gas market in the country at the time. This was before the Marcellus Shale formation and horizontal drilling exploded east coast gas reserves. John Edwards of Credit Suisse nailed the punch-line: "Now the pipeline is like bringing sand to the beach."

Overall, each business has its own reinvestment dynamics to consider. Companies that can reinvest large amounts of capital into their core business at high returns are always valuable. In a slow growth, deleveraging world, they are probably much more valuable than most investors realize.

Part 2 – Buying Other Companies or Assets

Buying other companies/assets cheap is great. We're all about buying value. However, all too often we see acquisitions done with a sense of greed or fear. What John Maynard Keynes called "animal spirits" can run high in the acquisitions game.

In our March 2000 Pecaut newsletter we made mention of the value destroying $164 billion mega-merger of AOL and Time Warner, which was fearful of being left behind in the Internet age. We understand the old "don't just sit there do something" impulse, but the purchase price virtually guaranteed a massive destruction of capital. The deal put the combined value of the companies at about $300 billion. Today the value would be about half that, destroying nearly every dollar invested.

Likewise Hewlett Packard recently took a $8.8 billion write-down on its 2011 acquisition of Autonomy, in effect admitting that the company was worth an astonishing *79% less than H.P. had paid for it just last year*. What a stunning and irreparable destruction of shareholder value. The deal was driven by then CEO, Leo Apotheker, who assured analysts "we feel that we paid a very fair price for Autonomy. And it will give a great return to our shareholders." Mr. Apotheker was fired by HP less than a month after the announcement.

By the way, this is one of the primary reasons we focus on businesses with high integrity **owner/managers**. If CEO Apotheker had to live forever with that decision, would he have made it? Like the Roman engineers who were made to stand under the bridges they built as the army crossed over them, owner/managers think more carefully about investing corporate cash because they think of it as *their corporation and their cash!*

This is one of the reasons we have owned large positions in insider-owned conglomerates over the years like Berkshire Hathaway and Leucadia National (which currently is in the process of acquiring Jeffries Corp.) and companies owned and run by the founders like PriceSmart. The insiders think very long term and invest like it's their money….because it is.

With many managers flush with cash and prone to the "don't just sit there, do something" virus, we look for a great many follies to occur in this area in the years ahead. Investors who focus on companies run by high integrity owner/managers will significantly mitigate this risk.

Part 3 – Paying Down Debt

Less debt on a corporate balance sheet generally means more staying power in tough times and more financial flexibility in good ones. As always the key question is opportunity cost – how does the return on paying down debt compare to all other capital allocation alternatives?

During the debt expansion of 1990-2007, it became unfashionable to be seen with too much cash lying around. Corporate raiders and leveraged buyouts contributed to this mindset. As a result, the number of AAA rated companies in America dwindled to just four (ADP, Exxon, J&J, Microsoft). However, there was an abrupt about face in attitudes after the 2008-09 subprime debacle. Conservatism is back in fashion. According to Bloomberg, US debt has shrunk to a six-year low relative to the size of the economy. Private-sector borrowing is down by $4 trillion to $40.2 trillion since 2006.

However, the really big move in this arena over the last four years has been *debt refinancing at ultra low rates.* Microsoft recently issued $2.25 billion of 5-year bonds at a yield of 0.875%, just 0.27% above the comparable Treasuries. According to a 11/7/12 *Wall Street Journal* article, Exxon Mobil and J&J debt traded at a small premium to similarly short-dated Treasuries. Bonds of Exxon coming due in 13 months were quoted at 0.01 percentage point less than the comparable Treasuries. Amazing.

The value added on refinancing has been significant for many companies. For example, Exxon has seen its average interest coupon payment fall to 6.1 percent from 7.8 percent at the end of 2009. Meanwhile, Exxon's profit margin rose to 9.3 percent from 7.7 percent in the same period. A portion of Exxon's margin expansion was simply the fruit of refinancing. Likewise Disney's average coupon rate fell to 3.3% from 5.7% in 2009. Similar things could be said of numerous S&P 500 companies.

The plus is that corporate balance sheets are in phenomenal shape. The negative is that profit margin expansion from refinancing is now largely over. Look for margins to narrow on this point in the years ahead.

Part 4 – Paying Dividends.

Returning cash to shareholders through dividends is another allocation option. Dividends are coming back into style. 403 of the S&P 500 companies pay dividends, the most since 1999. Payouts as a percentage of earnings are somewhat modest at an average of one-third of earnings versus a historical average of closer to half. The plus is that many companies have room to increase dividends if they choose.

The most interesting recent development here is that more than 150 companies have announced special dividends totaling about $20 billion this quarter to avoid anticipated tax increases in 2013, according to Bloomberg. Costco knocked it out of the park, announcing a dividend of about $3 billion, exceeding a whopper $2.3 billion payment from Las Vegas Sands. For similar reasons, Wal-Mart will pay its first quarter 2013 dividend in December 2012. These are companies paying attention to shareholders.

Overall, we continue to find it remarkable that many high quality stocks offer dividends that exceed their bond coupons. We have not seen this phenomenon since the 1950's. J&J, for example, yields 3.4% versus a 2% yield on its 10-year debt. J&J has been growing for over 100 years. The debt has no growth possibilities. How can this be? Basically, it is another symptom of the bull market in fear.

Part 5 – Buying in Stock

In our January 2012 newsletter we mentioned Sir John Templeton's "shortage of shares" scenario. On those rare occasions where the net issuance of stock turned negative, Templeton saw that often presaged a significant rally in stocks. We suggested at the time that we may well be heading into one of those times with investors abandoning equity funds and corporations buying in shares. And it turns out we are.

On the issuance side, the bungled Facebook IPO threw a big old wet towel on companies going public. The perception of increasing regulation for public companies has probably added to low enthusiasm for going public as well.

Meanwhile American companies bought back $274 billion more shares than they issued through September according to Yardeni Research. There it is – the shrinkage of shares! And the share buybacks (more shrinkage) are continuing to mount. GE announced a $10 billion buyback over the next 3 years. Boeing - $2 billion. Dupont - $1 billion. United Technologies – another $1 billion.

IBM has one of the biggest buyback plans on the planet and we believe this is a key reason Warren Buffett likes IBM so much. (Berkshire Hathaway owns $14 billion of IBM stock, making it one of its largest equity positions.) Capital allocation plans are clear and clearly will increase per share business value over time. IBM plans to buy back $50 billion of stock by 2015 and has bought in 4.9% of its shares this year alone. In addition the company plans to pay out $20 billion in dividends over the five year period. IBM also continues to invest in R&D and acquire smaller software companies as well. Now that's an allocation plan!

Buybacks can be especially effective value enhancers for companies with deeply discounted stock prices and excess cash. White Mountain Insurance was a nice winner for us, not because the business grew, but because it sold its Esurance division, realizing its hidden value, and bought in a ton of shares well below book value. In a similar vein, General Motors is spending $5.5 billion to buy back 200 million shares of its stock held by the U.S. Treasury, cutting the Treasury's stake from 26.5% to 19%.

AIG, selling at 60% of book is a current favorite of ours. CEO Robert Benmoshe has done a terrific job of shucking assets and paring AIG back down to its original life and P&C businesses, shrinking AIG from $130 billion to $30 billion of assets since the crash. If AIG's stock price simply returns to book value, that's a 65% gain at some point. Grow that book value with steady, mundane earnings and steadily buy in shares at such cheap prices, and this is the sort of investment that can double over the next 5 years.

In sum, companies with large, intelligent buyback plans can be a major investment return enhancer over the next decade. Those companies that get it and execute well offer extra return potential over and above the unfolding of the general stock market and economy.

5 Point Allocation Scorecard

To test-drive our 5-point capital allocation scorecard, let's take a short look at Nestle. Dan started following this stock in the mid-1980's (he liked the chocolate and he liked the conservative Swiss accounting). The steady evolution of Nestle into the world's largest branded food company and a shareholder wealth-building powerhouse has been a thing of beauty. In our book, we note that Nestle scores high in all areas of allocation:

Part 1 – Reinvesting in the Business - Nestle reinvests continuously in its brands, global growth and research and now features 29 different $1 billion brands. It's a wonderful record of commitment and success. And with billions of oncoming consumers, there's years of growth ahead.

Part 2 – Buying Other Companies or Assets - Nestle has a solid record of sensible acquisitions over the years, from its home-run with Alcon (sold to Novartis), buying Gerber Foods, stealing Dijiorno pizza from Kraft, and, most recently, buying Pfizer's infant nutrition business - with 85% of sales in emerging markets - for $11.9 billion.

Part 3 – Paying Down Debt – While Nestle has historically run a very conservative balance sheet, the company has levered up a bit during this time of uncertainty. The prime event was borrowing (again, at ultra low interest rates) to buy the Pfizer subsidiary.

Part 4 – Paying Dividends. – Nestle has paid dividends continuously since 1959. Since 1990, the dividend has increased *ten-fold*. It is a beautiful record and the current yield is about 3%.

Part 5 – Buying in Stock – Stodgy old Nestle refused to buy in shares for many years. More recently the company opened to the idea, another step in its becoming more attuned to adding shareholder value. From 2005 to 2010, the company executed nicely on a buyback of $30 billion CHF of shares. There is no current buy-back plan.

Nestle scores well in all areas of allocation in our book – a rare gem of a company.

And THAT'S our conclusion. Companies that have huge cash hordes and cash flows must have a clear path to allocating that cash in a slow growth world. Such companies that can do so at high returns will be sure winners in the years ahead.

Dan Pecaut Corey Wrenn