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

August 2012

EXECUTIVE SUMMARY

- **Market Update**
- **Bearish Sentiment**
- **Business Adapts**
- **Resource Conversions**
- **The $30 Trillion Opportunity**

MARKET UPDATE

Dan and his sons, John and Charlie, went on RAGBRAI this year – a weeklong 500 mile bike ride across Iowa with some 10,000 riders. Charlie completed the whole thing including the Century Ride (100 miles) on day 3 – what a beast! We partook of the three basic RAGBRAI food groups: pie, sweet corn, and pork chops. A boon for the Iowa towns on the route, *The Wall Street Journal* reported that this river of bikers spent $2.4 million per day. The heat was extreme, of course. What did we learn? Start EARLY! Listen to the body. Hydrate, hydrate, hydrate (and, my sons tell me, jump on the "slip and slides" every chance you get).

Last year at this time we were worried about record flooding. This year we are worried about drought. The heat wave that brought triple-digit temperatures across the country is devastating crops across the Midwest. The USDA recently rated only 40% of the corn crop as good or excellent, down from 69% last year. Corn on the Chicago Board of Trade touched an all-time high of $8.205 a bushel, and soybeans reached a record $16.915 a bushel on July 23. Meanwhile, ethanol continues to consume about 40% of our corn crop. Policy has been slow to react to real world conditions. While promoting lower carbon fuels may have some merit, doing so at the expense of food for the masses and global unrest makes little sense.

Also making little sense are negative savings rates developing in Europe:

"Denmark's central bank…brought the rate it offers on certificates of deposit below zero…the deposit rate was reduced to minus 0.2 percent." Bloomberg 7/5/12

Who among us ever dreamed we would read an article about a central bank ***setting deposit rates below zero***? At confusing times, we find it very useful to ask "who's selling?" and "who's buying?" to orient our thinking.

Who's selling? A fearful and cautious public. In the U.S. in the fall of 2008, short term Treasury yields briefly turned negative. The subprime mortgage meltdown sparked a stampede to safety where frightened investors chose to lock in a guaranteed small loss in U.S. Treasuries rather than endure more market volatility. Something similar is happening in the Euro zone now. Denmark is offering "guaranteed loss deposits" and investors are stampeding into them. This flight to safety has generated negative short term rates in Germany and Switzerland as well. For those with short term horizons, these are rational actions in a volatile world.

Who's buying? Some shrewd investors and corporations have been very active. In a complete reversal of the last decade when Berkshire Hathaway sat on tens of billions of cash awaiting better buying days, Warren Buffett has been on a spending spree over the last 4 years, including the purchase of the Burlington Northern Santa Fe railroad. Other corporations are borrowing at these ultra low interest rates to fund value-creating activities such as business expansions (particularly in emerging markets), acquisitions, dividend increases, and stock buybacks. For those with long term horizons, these are rational actions.

The big picture is that global issues call for long term global problem-solving, going beyond local and regional reactions. It feels as if the policies and structures of the last 50 years need to be reviewed and revised altogether to adapt to a globalized economy and technologically connected world of 7 billion people. A long term process providing adequate food for all, for example, should be a headliner, but it is not as yet. In the U.S., coming to terms with our $66 trillion in obligations for Social Security, Medicare and Medicaid should be another headliner, but the issue is lost on short term election thinking and crisis management of our budget. Mostly we have had the Fed going it alone, trying to keep the boat afloat with its zero-based interest policy and little fiscal policy support. In any case, for the moment we can agree that there is no shortage of problems in the world. Enormous sovereign debt and budget issues must be dealt with and it will be a messy process. As investors, we can also say that a fair bit of that fear is in the price. Asset values in certain industries have gotten cheap. In other industries, the strong are getting stronger. Global brands have very long runways of growth ahead. All of which makes select equities compellingly cheap, especially in a zero-based interest rate world.

Our long-held advice to be debt free continues. To the extent you owe no one, 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 continue to see opportunity in stocks.

BEARISH SENTIMENT

"A poll by the American Association of Individual Investors showed 44.4 percent of respondents say U.S. stocks will fall over the next six months. That's the eighth week that pessimism stayed above the 25-year average of 30 percent." - Bloomberg 7-3-12

In the summer of 2007, optimism was rampant. That uncritical good feeling was a key contributor to the 2008-09 market down draft. Market crashes are characterized by a shift of mood from greed to fear. Today, much fear is already in the headlines. Pessimism abounds – note the stampedes into negative yielding deposits and into bond funds over the last 5 years. So while we still will have market volatility, for the conservatively positioned future market downturns may look more like jumping off a curb than a cliff.

BUSINESS ADAPTS

Investors seem to forget that businesses are not static. They persistently adapt to the ever evolving conditions of the world economy. In that light, the 2008-09 market down-turn gave us a look at just how agile U.S. companies can be. While many companies suffered severe balance sheet pressures at that time, the collective balance sheets of corporate America now have over $2 trillion in cash, the most in post WWII history. In addition, profits and profit margins are at or near record levels.

One additive to those margins is the ongoing refinancing of corporate debt at ultra-low interest rates. Unilever, the large European food conglomerate, just sold $550 million worth of 5-year notes with a record low corporate coupon of 0.85%. Texas Instruments recently broke the record for the lowest coupon on 3-year debt at just 0.45%. To put this in perspective, the U.S. government is borrowing money for 5 years at 0.5%. Spain is borrowing at 7%.

Another tailwind for some businesses is low natural gas prices driven by new reserves of natural gas from new drilling technology. An example of rapid adaptation, Southern Company, an Atlanta-based utility, expects to get just 35% of its fuel from coal this year versus 70% five years ago.

A number of industries are clearly in better shape than they were a few years ago. Bank capital ratios are the highest in 70 years even as bank stock multiples of book value and earnings are severely contracted. Housing and auto manufacturing are on the mend.

RESOURCE CONVERSIONS

"The book value for the DJIA at April 30, 2012 was 42.2% greater than the book value at December 31, 2007…….the financial strength of the thirty companies making up the DJIA was far superior in April 2012 compared to what it was in December 2007." – Marty Whitman, April 2012

In addition to old fashioned growth in sales and earnings, publicly traded corporations can create value through "resource conversion" activities, a term coined by Marty Whitman, Yale professor and founder of Third Avenue Value Funds. These activities can include spin-offs, assets sales, restructurings, stock repurchases, special dividends, bankruptcies, and the like. The beauty of such actions for investors is that they can create value irrespective of the direction of the general market. Given the build-up of book value and financial strength of corporations since 2007, we suspect there will be a fair bit of opportunity for resource conversion situations.

THE $30 TRILLION OPPORTUNITY

For all the worry and hand-wringing about sovereign debt issues, the bigger long term challenge and opportunity for global businesses is the "Rise of the Rest". A recent McKinsey Quarterly report entitled "Winning the $30 trillion decathlon: Going for gold in emerging markets" claims the rise of emerging market consumers to be the biggest growth opportunity in the history of capitalism. The folks at McKinsey predict that spending in emerging markets will to triple to $30 trillion by 2025. The article reports that leading companies in the developed world earn just 17% of total revenues from emerging markets even though these markets already represent 36% of global GDP. The process of growing in these countries is complex. China, for example, has 56 different ethnic groups who speak 292 distinct languages. Residents of Africa's 53 countries speak an estimated 2000 different languages and dialects. This is part of why we like global brands. With decades of experience and the ability to invest long term, such companies are set to be prime beneficiaries of these trends.

Dan Pecaut Corey Wrenn