Pecaut & Company

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EXECUTIVE SUMMARY

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Market Update

The Harvard University band is famous for its chaotic football half-time shows. A spoof on the military precision of Big Ten bands, the Harvard band makes a mad dash to each new formation, spelling out one bad pun after another. Yet, when the conductor's baton goes up, everyone is in place, ready to play (though maybe a bit out of breath).

That's a pretty good metaphor for the S&P 500 in 2011 which had chaotic bursts up and down, sometimes on a daily basis, leaving participants breathless. Yet, when the smoke cleared, the S&P 500 finished the year right where it started: 1257.6. To the tenth of a point! Amazing!

While that may not feel like much of a year, U.S. investors benefited from a flight to quality. Foreign markets faired much worse as stocks in the euro zone fell 18%, Japanese stocks dropped 17%, and the BRICs (Brazil, Russia, India, and China) lost 18%, 20%, 25%, and 22% respectively. Under the heading of "you can't make this stuff up", it was the S&P's *downgrade* of the credit rating of the United States of America that marked the beginning of this flight to quality. While the U.S. has become less great as a credit, it is still the best credit around.

This pattern of chaos followed by no real progress also characterizes the last 13 years of market performance. The S&P index finished 1998 at 1242. Isn't that something? We have had globalization, Y2K, the Internet bubble, the housing bubble, the rise of China, India, and Brazil and the S&P 500 is essentially unchanged from where we were 13 years ago. Remarkable and no doubt dispiriting. If we include dividends, the S&P returned about 2% per year. This is the "lost decade" the media writes so much about and that has investors abandoning equities and stampeding into fixed income investments.

What To Do?

We continue to recommend our age-old (yet remarkably rare!) wisdom. As much as possible, pay off your debts. 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 assets. You'll earn microscopic rates of interest but the money will be there when you need it.

With the balance, you can think and invest longer term. 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 AAA and AA stocks yielding 3% (with earnings yields of 6-10%) and offering some protection from inflation and currency debasement currently offer significantly better value.

Value in Stocks

"Buy when most people, including experts, are pessimistic, and sell when they are actively optimistic."

\- *Sir John Templeton*

Most people are pessimistic. Disillusioned fund investors continue to liquidate equity funds and flock to bond funds. According to data compiled by Bloomberg and the Investment Company Institute, debt mutual funds have attracted $789 billion since 2008, compared with a $341 billion drop in equity funds. The trend continued in 2011 with investors redeeming $185 billion of U.S. equity funds and adding $130 billion to taxable bond funds.

Experts are pessimistic. After two years of relentlessly negative headlines about the sovereign debt crisis, many experts are convinced the euro zone mess could fly apart at anytime with disastrous consequences. Congress is in gridlock at a time we desperately need intelligent fiscal policy. Currency debasement is widespread. Deleveraging the enormous debt accumulated over the last three decades will clearly take more time to unwind. Hedge fund managers are all about hedging "fat tails" – small probability risks with potentially enormous ("fat") consequences. Some have gone to gold or cash. Others have adopted hyper-trading strategies to limit market exposure, moment by moment. Still others are keeping their short positions up to the keep their "net long" position low. Only a fool would buy and hold well run companies at cheap prices in a world like this!

"So if most people, including the experts, are pessimistic, what are you doing?"

We can hear Sir John challenging us. In our experience, an investment approach focused on buying stocks as part ownership in businesses at reasonably cheap prices works in the long run. If anything, we are more optimistic than ever about prospects for value investing. Valuations are far more reasonable than they were in the year 2000. And we see a dearth of original and thorough analysis – the bread and butter of value investing. Instead, it appears that macro analysis has come to dominate the minds of the investment industry.

Full disclosure: we, of course, are inveterate value investors. Incurable, perhaps. We get rather excited about being able to buy good companies at fair to bargain prices. We get a bit giddy when there is a universal consensus of negativity. Think seriously about this for a moment. The last two years have been like Groundhog Day, that movie where Bill Murray has to keep reliving the same day over and over until he gets it right. In our current version, we have been reading headlines about the euro zone mess every week for two years. Greece was ready to default then and we're still waiting! Week after week, we have been bombarded with headlines filled with fear and confusion. Is there an investor alive who hasn't heard about some sort of dire problem in euro land? And, having heard about that for the umpteenth time, hasn't already taken some sort of defensive action?

In the U.S. sequel, we read week after week about a Congress that cannot agree on anything. So disagreeable are they that even with the hallowed AAA credit rating of the United States of America hanging in the balance, they grandstand over raising the debt ceiling. Is there an investor alive who hasn't heard that the U.S. has enormous government debt and deficits and we need someone to do something about it and soon? And, having heard about this for the umpteenth time, hasn't already taken some sort of defensive action?

And, knowing all of this, is there a CEO alive who hasn't also taken appropriate measures to grow the business and yet batten down the hatches as needed? We have seen company after company trim costs, tighten inventory controls, refinance debt at generational low rates, accumulate cash reserves (U.S. corporations hold nearly $2 trillion in cash equivalents), invest in improved efficiencies (which, unfortunately, has contributed to our unemployment numbers), expand brands, strengthen balance sheets, extend global reach, and grow value through stock buybacks and increasing dividends. As Mason Hawkins of Longleaf Partners put it in his most recent report, "Adapting to a possible 2012 recession would be like stepping off of a curb rather than falling from a skyscraper for these businesses."

Psychologically, how much fear is in the price? Well, a fair bit, anyway. The S&P 500 currently sells at about 13 times earnings versus an average valuation of 17.5 times since 1945 (and versus the effervescent 30 PE of 1998 with the NASDAQ zooming to 200 times earnings in 2000!) Despite proving their resilience in the 2008-09 debt crisis, shares of U.S. global corporations offer great balance sheets, a call on global expansion, and modest valuations. Shares of cyclical companies that have managed to be profitable despite lousy end demand look interesting. Some conglomerates look safe and cheap and are building value by aggressively buying back shares at depressed prices. A number of financial companies sell at just two thirds of book value. Shares of deal stocks, spin-offs and restructurings can earn returns in any market. Dividend yields are in excess of bond yields. It is a most remarkable time.

<u>Time for the Melt-Up of 2012?</u>

While much could go wrong, much of that is in the price. What isn't in the price is things going right.

So much money abandoning the market brings to mind the time when John Templeton told us about a *shrinkage of shares* back in the late 1980's. He noted that a sustained lack of investor interest had contributed to a period of low valuations and a low volume of new and secondary stock offerings. At the same time, a splurge of buy-outs and buybacks was shrinking the total number of shares outstanding on the NYSE. As investors returned to the market, Templeton predicted, a long, sustained bull market would ensue. He was so right. The 1990's were a great period for stock investors.

Today we are in a somewhat similar situation. Investor disenchantment is high after the lost decade of 2000-2010.

Issuance of shares in primary and secondary offerings has been light. Reduction of shares through buy-outs and buybacks is on the rise. Trillions of dollars are chasing zero-based interest rates and the perceived safety of government bonds, money market funds, annuities, bond funds and the like. Meanwhile, one can buy the four remaining AAA companies in America, ADP, Exxon, Johnson and Johnson, and Microsoft, for a blended PE of about 14 and a blended yield of 2.8%. Other than a sustained period of deflation, what could make zero-based investing the way to go? And even then, over a decade, these companies are sure to outperform the 10-year Treasury yield of 1.9% *on dividends alone.*

Coca Cola makes a reasonable poster child for this quandry. Trading at about 17 times earnings, KO's high return business generates earnings that are essentially all free cash flow. So let's treat KO as a "bond" with an equity "coupon" of 1/17 or 5.9%. That's a pretty attractive earnings yield in today's environment. Consider also that KO, during the "lost decade" *tripled both earnings and dividends*. However, like much of the market in 1999 the stock was very expensive, KO hit a high of 67 with a PE of 47. Believe it or not, KO trades today at 67! It has taken the "lost decade" for KO's worldwide franchise to grow into that price. The business did very well. The stock, purchased at an extremely rich valuation, did not. However, today's valuation, at the low end of its 20 year PE range, is much closer to cheap than expensive.

If the euro zone mess breaks badly, we can guess that the U.S. stock market might drop 10-20% on fearful selling. However, we doubt it would be anything like 2008-09. Unlike 2008, when few considered systemic risk, nearly everyone has been discussing such risks for the past three years.

On the other hand, let's suppose the euro zone finally gets something right. Perhaps Greece is unseated from its chair in the euro zone without a domino effect. (Incidentally, we read where some Greeks are already developing local barter networks and pseudo-currencies, moving on while politicians remain frozen in the past.) We could easily imagine a buying panic from performance-oriented managers followed by a surge of return-hungry investors re-entering the market. Stampede out. Stampede back in. It's happened before. With a shortage of shares, it could be quite dramatic.

The Challenge of Buying Low

"It's the cheapest that I've seen it in a while," said Tom Lewandowski, an analyst with Edward Jones & Co., who has a "hold" rating on Berkshire shares. "It's hard for me to get really positive on that."

- Bloomberg 8/4/11

One might think an analyst who even bothers to look at Berkshire must be a value investor. Apparently not! This is one of the reasons value investing works. Mr. Lewandowski's analysis is right on. However, acting on his insight was a step beyond his framework.

Our view is that when you buy a stock you're buying part ownership of a company. And if you're not going to buy part ownership of a great company when it's the cheapest you've seen it in a while, when are you going to buy it? Corey and I agree that Berkshire is really cheap but we come to the opposite conclusion. (Of course, it's already our largest position, so we haven't bought too much.)

By the way, Berkshire Hathaway may be as cheap and as rich in depth and in quality as it's ever been. Consider for example that the share price of Union Pacific has nearly doubled since November of 2009. That's when Berkshire Hathaway announced its $44 billion buy-out (including the assumption of $10 billion of debt) of Burlington Northern Santa Fe. If we assume the value of BNSF appreciated at a rate similar to that of UNP, that would add more than $20 billion to Berkshire's value. This increase alone equals about two-thirds of the increase in Berkshire's market value since November 2009. A number of Berkshire's other companies have clearly increased in value as well.

Buffett agrees with our view having announced Berkshire's first buyback program since 2000. He apparently was not only able to get positive on Berkshire's cheap price, he acted on it. According to Berkshire's 10-Q, the company bought 15 A shares at $17,461.67 each and 227,669 B shares at $71.45 each from Sept. 26 to Sept. 30, 2011. So there you have it. Warren Buffett, in a world full of investment opportunity, was willing to pay $71.45 to buy in his own stock.

A Case for Conglomerates

We've noted in past newsletters the extreme trading mentality in today's markets. This creates particular difficulties for open-end mutual fund managers. Rapid fund flows create a dynamic where the least patient or most fearful investor is making your portfolio decisions for you. So either you hold inordinate amounts of cash or you live with the occasional bout of forced selling to redeem shares. We read where the country's second-largest fund family, American Funds, with $854 billion under management, had $81 billion in outflows last year. That's nearly 10% of assets. Ten more years of that and American Funds will cease to exist! And that's a solid company whose average mutual fund outperformed 65% of its peers. At the margin, the most fearful investor is making the portfolio decisions, not the manager.

In addition to the aforementioned stampede into fixed income investments, there has also been an increase in indexing. Index mutual funds took in $76 billion last year and exchange-traded funds took in $121 billion. In a sense, investors are saying it doesn't pay to think anymore.

Meanwhile, for those who still think thinking about business matters, a number of corporations operate much like closed-end funds. With the capital captive, they are free to think very long term in allocating assets. This has been one of the keys to success for Berkshire Hathaway. Buffett was able to buy aggressively in the teeth of the 2008-09 sell-off because he called the shots and he had plenty of dry powder to put to work. We've mentioned White Mountains Insurance which is using excess capital to aggressively buy in shares well below book value.

Another such company is Loews Corp. (38, symbol L) which sells at about 70% of our estimate of intrinsic value and is run by the Tisch family. Since it is nearly always selling at some sort of discount, Loews is nearly always buying in shares. Since 1995, Loews shares outstanding have shrunk from 707 million to under 400 million today. When the stock got drilled in the 2008 market plunge, they really went to work buying in 95 million shares, some 18% of shares outstanding that year. Loews owns 90% of CNA Insurance (which itself trades at two thirds of book value), 50% of Diamond Offshore (drilling rigs), 61% of Boardwalk Pipeline, and Loews Hotels among other assets and has about $8 a share of net cash. Even the best of owner/mangers make mistakes, yet the Tisch family has done enough right that Loews shares over the 50 years from 1960 to 2010 delivered an average total return of 17.6% versus 9.6 % for the S&P 500. During the flat S&P 500 period of 1998-2011, Loews shares rose from 16.40 to 37.92, a gain of 131%.

Such companies will bounce around in a market decline, but their structure assures that scared investors cannot force the hand of smart owners. For those who think, that is something to think about.

Macro Notes

"Just as you can't solve the problem of being drunk with more whiskey, you can't solve a debt problem with more debt."

\- *John Mauldin*

As noted in past letters, Central Bankers have been on a borrowing binge, seeking to solve a problem of too much borrowed money by borrowing more money. In just 9 years, Western sovereign governments have increased government borrowings from $80 trillion to roughly $220 trillion. The U.S. has done its part with our national debt rising from $6 trillion to $15.2 trillion. At best, this debt reconciliation process will be painful, continue to reap headlines, and take years to muddle through.

It really is hard to believe that Greece was essentially declared insolvent back in 2009 and, yet, here we are with the powers that be still fiddling with what to do with Greece (whose short term debt features interest rates of 362%!). Now Portugal is considered the new Greece and Italy and Spain are on the edge. Some 462 billion euros of bank debt comes due in 2012. More problems await. Perhaps the only question is how disorderly will the reconciliation of the euro zone's economic mess become.

Not to be outdone, the U.S. Congress has staged its own adventure in ineffectiveness. Our $1.3 trillion deficit amounts to 9% of GDP. Our $15 trillion in government debt equals 100% of GDP, the danger zone where the growth of the debt and debt servicing costs begins to exceed the growth of the economy potentially resulting in a debt-driven death-spiral (the very thing that swallowed Greece and now threatens Portugal.). Scarier still, these numbers do not reflect the $59 trillion estimated present value of our obligations for Social Security and Medicare. The key element we see distressingly little discussed is the potential jump in costs in financing the debt in the event that interest rates go up:

"Every one-percentage-point increase in interest rates would add $140 billion to our deficit. If you get up to $200 to $300 billion, that would take interest on the debt pretty close to the defense budget, and that's when you really get into trouble."

\- *Van Hoisington*, Hoisington Investment Management, Barron's 12/19/11

It's an incredible abrogation of responsibility by our elected officials not to make credible policy change in the face of such financial risks.

A Leadership Opportunity

Here's a thought that has been rolling around in our heads for sometime: we see it as one of the great ironies of our time that that the cradle of capitalism, America, sought for two centuries to enroll the big wide world in her ideals of democracy, capitalism, free trade, and open society. America was the scrappy underdog in a world dominated by models of centralized and often repressive power - dictators, monarchs, and oligarchs. Then, quite suddenly, with the fall of the Berlin Wall, nearly the entire world shifted toward freer trade and more open markets. Within a decade the Internet accelerated a worldwide shift toward freer sharing of information and more open society. From Russia to China to India to Brazil, capitalism was in ascendance. *America's time had come!* The world was at last adopting her ideals! And so all of America rejoiced, yes? No. Oddly we seem to be stuck in a Romulan force field of fear and despair. It's really bizarre. At a time America could be taking the lead in creating partnerships around the world, many seem to be stuck in an era of navel-gazing and finger-pointing. We see a wide open opportunity for some visionary leadership.

Notes On Taxation

"Some people regard private enterprise as a predatory tiger to be shot. Others look on it as a cow they can milk. Not enough people see it as a healthy horse, pulling a sturdy wagon."

\- *Winston Churchill*

Much has been made about Warren Buffett's ideas about increasing taxes for the wealthiest Americans. We agree with a recent letter from Howard Marks of Oaktree Capital Management that it is important (and seldom done) to put issues into context. How does one determine the correct amount? How much is not enough? How much is too much? We'll leave those questions for the policymakers. However, for the curious, with thanks to Mr. Marks, here at least are the numbers:

The top 1% of U.S. taxpayers pay 38% of all individual federal taxes. The top 10% pay 70% of all taxes. The top 25% pay 86% and the top 50% pay 97%. The bottom 50% of all taxpayers pay 3%.

The average federal income tax rate for the top 1% of Americans is 23%. For the top half it is 14%. Average for the bottom half is 3%.

Making The Simple Complex

We heartily agree with Paul Volker's ideas on restricting the freedom of big banks to trade securities and invest in hedge funds, the Volker Rule, which ran some **11 pages** in its original form. The October 21, 2011 version of *Grant's Interest Rate Observer* reported on how the system expanded on the original idea:

The FDIC circulated a document seeking comment on the proposed rule. It ran for 298 pages and posed 383 questions to interested members of the public….the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, a quintessential legislative expression of the doctrine of statism in money and banking, announced "Here it is in 2,323 pages". The law firm of David, Polk & Wardwell reckoned that 67 new studies would be necessary before the 11 relevant federal agencies could draft the requisite 243 new rules."

Dan Pecaut Corey Wrenn