Pecaut & Company

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

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EXECUTIVE SUMMARY

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MARKET UPDATE

Most markets have inched higher in recent weeks.

There has been a noticeable uptick in buyout activity. Corporations are using some of their cash horde to make strategic acquisitions. Also, U.S. stock funds continue to be shunned by investors, a good contrary indicator. The ICI (Investment Company Institute) reports that an estimated $506.6 billion flowed into long-term funds in the 52 weeks ended March 10. $409 billion went into bond funds. $66 billion went into the foreign-stock sector. U.S. equity funds had net *outflows* of $8 billion.

Another plus - both the consumer and U.S. corporations are getting their balance sheets in order. Household net worth plummeted from $68.5 trillion to $48.5 trillion between the end of 2007 and the first quarter of 2009. Thanks to massive government stimulation and last year's market rally, household net worth rebounded to $54 trillion by year-end 2009. Despite the rebound, the mood continues to be one of hunkering down and realigning balance sheets. According to the March 15 *Barron's*, U.S. household debt shrank 1.7% in 2009 – the first yearly drop since 1945. Total cash for consumers and corporations now exceeds $10 trillion.

Of course, for one sector to de-lever, someone or something must lever up. And that something has been governments around the world. The amount of debt taken on by governments worldwide is gigantic (see "Keynes Has His Day" below). It is not at all clear how these leveraged sovereigns will be able to handle any additional financial shocks to the system. Nor is it clear when the de-levering process will occur and whether it can be done in a non-calamitous way.

With this unprecedented borrowing by sovereigns, there comes a wide range of possible outcomes. Investors must be wary and flexible. Currently, we see the value sweet spot of this market in large companies with global brands, rock-solid balance sheets, pricing power, selling at low double digit PE's with yields comparable to the 10-year Treasury.

We Need a New Adjective - The Emerging Markets Have Emerged

"Almost miraculously, communism seems to have rotted at the center…We will look back at these times as the Second Renaissance."

- John Templeton, *Forbes*, January 8, 1990

Sir John was always so insightful and, in this case, totally prophetic. The collapse of the Berlin Wall in 1989 did indeed usher in a Second Renaissance of global growth. Following up on Sir John's insight, we wrote in our Jan. 1990 newsletter, "*We are in the early stages of a worldwide free enterprise revolution, a 'Second Renaissance', which will result in freer trade, more innovation, and increased emphasis on savings versus consumption…..It will be a lurching, halting trip, but the Soviet Union, Eastern Europe, Asia, parts of Africa, and parts of Latin America are clearly moving toward freer enterprise*." (While that analysis was more or less on target, we must take back the "increased emphasis on savings versus consumption" line. We never dreamed at the time that America was about to embark on a 20-year monster credit expansion and a concurrent path of steadily decreasing savings! American policies have favored debt/credit over equity/savings for far too long.)

Ever since that time, we have closely observed the unfolding of this new era of global growth, particularly among "emerging" nations. We have watched with great interest as these countries grew rapidly even as they struggled through the Mexican crisis of 1994 – jokingly referred to as the "submerging markets" at the time - the collapse of the Thai baht and Russian rubble in 1998, and the global tumult of the last few years.

To a large degree, these countries are emerging no longer. They have emerged. In our fourth quarter client letter we noted that China dethroned Germany as the world's top exporter of goods in 2009. The nation has also surpassed the U.S. as the world's largest auto market. China is also on track to pass Japan to become the second largest economy after the U.S. Car sales in

2009 for emerging economies exceeded those of developed nations. Exports from Brazil to China exceeded those of Brazil to the U.S. in 2009

From the *Wall St Journal* 2/25/10 – Spending by consumers in emerging markets now tops spending by their U.S. counterparts. Economists at J.P. Morgan project that emerging markets will account for 33.6% of global consumer spending this year, compared with 27.1% for the U.S. As recently as 2007 the U.S. accounted for the larger share. The rise of the emerging-market consumer is helping to revive global economic growth after the severe recession.

And these nations have a long, long ways to grow. According to T. Rowe Price, these developing nations have a float-adjusted market capitalization representing just 12% of global stock capitalization, but they hold 87% of the world's population, 68% of its foreign reserves and a potential work force and consumer base that is much larger than that of the developed world. To give you an idea of how much growth potential there is, consider that GDP per capita (a measure of the total goods and services produced by the average worker) is only about $2,000 annually in China and $655 in India compared with about $39,000 in the U.S.

Perhaps most sensationally, Carlos Slim Helu of Mexico took over the No. 1 spot on Forbes World's Billionaires list as the world's richest man, bypassing Bill Gates and Warren Buffett. Slim's fortune swelled to an estimated $53.5 billion with last year's rally, with Gates at $53 billion and Buffett at $47 billion. This year the World's Billionaires have an average net worth of $3.5 billion, up $500 million in 12 months. The world has 1,011 billionaires, up from 793 a year ago. The U.S. commands 38% of the collective $3.6 trillion net worth of the world's richest, down from 44% a year ago. Of the 97 new members of the list, only 16% are from the U.S. For the first time, China (including Hong Kong) had the most billionaires outside the U.S. with 89. Eleven countries at least doubled the number of billionaires they had a year ago, including China, India, Turkey and South Korea.

Sir John Templeton called it – it's been 20 years of worldwide economic growth since the fall of the Berlin Wall. And now the countries, companies, and entrepreneurs of the so-called "emerging markets" are taking an ever larger share of the global economic pie. This is why, of course, we have been focusing on positioning our clients to benefit from global growth over the past couple decades. Corporate America has seen the light as well. According to Bloomberg, roughly 40% of the revenues of the S&P 500 now come from overseas. With large, multinational U.S. companies like Coca Cola and Proctor & Gamble selling at reasonable PE's, we continue to believe this is the biggest sweet spot in the U.S. stock market for value investors.

Certainties: Death, Taxes, and Increased Calorie Consumption

While Corey and I have long debates about what could go wrong (and that list is a long one these days), what the big trends may be, and how we should position our clients' value-oriented portfolios, there is one thing we agree on that seems simply inevitable: calorie consumption will continue to rise. When people have more money, they eat better. It's happened in every culture. In our Nov, 1989 newsletter we added a new stock to our model portfolio: Nestle – it had just become available as an over-the-counter ADR and sold for just 12 times earnings. As the world's largest branded food company, we saw AAA-rated Nestle as an ideal play on the global growth of calorie consumption. It was also undermanaged, sporting some of the lower margins in the business, so there was a bit of a double play too as margins improved.

Today we believe Kraft offers a similar opportunity. Kraft is the world's second largest branded food company. Brands include Kraft cheese, Nabisco cookies and crackers, Post cereals, Maxwell House coffee. Its margins are at the back of the pack (running in the low teens when the best run food companies are running in the upper teens). CEO Irene Rosenfeld has already taken extensive measures to up Kraft's game. In addition, Kraft recently closed on a somewhat controversial purchase of Cadbury's (Cadbury confections, Dentyne and Trident gum, Halls cough drops). We love the candy business and Kraft now has 40 leading candy brands each with annual sales over $100 million. In total, the new Kraft/Cadbury will have sales of around $50 billion of which 25% will be from those "emerging markets" we keep talking about. Half of revenue will come from snacks and confectionary products, with Kraft number one in both confectionary and biscuits. Yielding nearly 4% and selling at a mid-teens multiple of earnings, Kraft offers good value with handsome upside. Just the sort of global brand opportunity we've been talking about.

By the way, Berkshire Hathaway is Kraft's largest shareholder and Buffett was quite vocal in his displeasure for the deal, believing that Kraft was significantly overpaying. He was especially concerned about Kraft issuing its undervalued stock for Cadbury – a classic wealth destruction technique. He was also steamed with Kraft raising cash for the deal by selling its DiGiorno pizza division to Nestle for $3.7 billion or about nine times earnings. Selling cheap and buying dear is not the Buffett pathway to wealth. We have read that the sale of the pizza business also came with an agreement by Nestle not to offer a competing bid on Cadbury.

Keynes Has His Day

Six decades after his death, Keynes's ideas are being put to the test. While he was unsuccessful in efforts to persuade U.S. and British leaders to boost government spending during the Depression, the world is listening to him now. In aggregate, according to Bloomberg, governments have spent more than $2 trillion to spur growth since the credit crunch began. Budget deficits will equal 5.6% of global GDP this year, about 10 times the level prior to the start of the crisis, according to IMF forecasts. A global experiment in Keynes's policies is full on.

From *Grant's Interest Rate Observer*, we read that in its October 2009 report on worldwide financial stability (or its absence) the International Monetary Fund counted up *153* publicized acts of government or central bank intervention by authorities in the euro-zone, Japan, Sweden, Switzerland, Britain, and the United State in the two years ended June 2009. The list of actions encompassed interest-rate manipulations, liquidity support, bank recapitalization, debt and deposit guarantees and asset-purchase programs.

A study by the Bank for International Settlements reckons the cost of financial-rescue programs, "including capital injection, treasury purchase of assets and lending as well as upfront government financing (but not debt) guarantees," at 13.2% of GDP to date.

Michael Levitt in his "Advisors Perspectives" newsletter notes that 2010 borrowing by the U.S. government will approximate $4 trillion, of which roughly $2.5 trillion will involve the refinancing of existing debt and the remaining $1.5 trillion will require raising new capital. European governments must raise an additional 1.6 trillion euros this year. European banks need to roll over more than 1 trillion euros of debt over the next two years. Finally, over $600 billion of high yield bonds and bank loans are scheduled to mature between 2012 and 2014. That is an imposing mountain of debt obligations coming due and makes the outlook for corporate credit extremely troublesome.

In Berkshire We Trust

The bond market is casting its vote on the above machinations by governments around the world. Bloomberg recently had an article on how Berkshire's short term debt yielded *less than a comparable Treasury bond*. And it wasn't just Berkshire. Other business titans like Johnson & Johnson and Proctor & Gamble had bonds yielding less in the marketplace than comparable Treasuries. Clearly the U.S. government is pushing its AAA credit rating to the edge. Just as clearly, the debt of cash rich, cash generating entities like Berkshire and J&J is seen as a safer haven than that of heavily-indebted sovereigns. Sounds like the market is simply paying attention to what is going on.

On Healthcare: It's Costs, Costs, Costs

There has been much fanfare about the new healthcare bill. While we would guess most everyone feels better about the idea of making sure that each of their fellow citizens has medical coverage, the bigger issue – cost – went totally unaddressed.

Corey was correct early on in noting the healthcare reform debate in Congress has been focused on reforming who gets and who pays for healthcare rather than reforming the efficiency and effectiveness of the system. As Board Chairman of the Siouxland Community Health Center (SCHC), Corey has a closer look than most of us at what's really going on. While it's a fine idea to insure everyone, if we don't improve the cost/benefit equation, it may not much matter who is and isn't covered in the long run.

(Corey's perspective: As many of you know, I have personally seen the lows of the health insurance industry from my experience with my daughter's eating disorder. As our case drags out against Principal Financial Group (PFG) in the United States Eighth Circuit Court of Appeals, I can't think of a system more broken. Health insurance policies contain exclusions and obtuse language that would be unheard of in the property casualty world. I often compare health insurance policies to a mythical car insurance policy that excluded coverage on Wednesday afternoons – sometimes! But what do I know, the people at PFG obviously know how policies should be written, especially the Chairman and CEO who was paid almost $17 million the year I carried Sarah into the hospital.

On the flipside of that I've also seen incredibly selfless behavior in the health care industry through my association with the SCHC. Health care providers, nurses, and administrative staff working at below market wages to provide care often to the neediest in our community, in our clinic, in a local high school and places like the Gospel Mission. In this system, patients are charged based on their ability to pay and the health center is partially compensated through a federal grant to help provide this care. This is an example of a public/private solution. In my mind, this works really well.

So while everyone talks about this bill providing health care to more Americans, the reality is that even before this bill was passed, society had chosen to provide healthcare to people - whether it be Medicare, Medicaid, community health centers, or emergency room write-offs. The insurance policy solution drafted may have addressed some of the problems of the current system, but without standardizing policies and addressing the hard choices about how much society wishes to spend on health care and on whom, it seems doomed to fail.)

In a recent interview on CNBC, Warren Buffett weighed in on the same idea, noting that we in the U.S. spend 17 percent of GDP on healthcare – a cost that is like a "tapeworm eating at our economic body". In contrast, other developed countries spend 9-10% of GDP. So everything we produce carries an extra 7% cost into the highly competitive global marketplace. In addition we are getting less for our money. We have a little over two and a half doctors per thousand, much of the world has well over three doctors. We have 11 nurses per thousand, much of the world has far more nurses per thousand. We have three hospital beds per thousand, much of the world has six or seven beds per thousand. We have higher infant mortality than many places and we have shorter overall mortality than many. So we have a health system that, in terms of cost, is really out of control and we get significantly less for what we spend than other developed countries. If current trends continue, we will continually become less and less competitive.

Welcome John Pecaut

The fourth generation of investing Pecauts is in the house. Dan's son, John, joined the firm late last year. He is a graduate of Iowa State University in psychology – perhaps one of the most useful majors for being an investor. John is currently learning the basics of compliance, administration and office systems. In addition, John is supporting our research efforts. If you haven't met John already, be sure to introduce yourself next time you stop by.

Dan Pecaut Corey Wrenn