Pecaut & Company

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

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EXECUTIVE SUMMARY

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MARKET UPDATE

As mentioned in prior letters, our long term concern is that massive borrowing by the U.S. government has not solved our problems but simply bought time. With the sugar high of stimulus abating, it appears that the global economy is still weak and that the de-leveraging of the developed world still has years to go.

The most bearish of commentators seem to "have the mike". Daily, we hear dire news of imminent deflation or inflation or stagflation. Clearly the problems of massive indebtedness will take years to unwind. The good news is that folks are now aware of the issues. Concern and caution mitigate risk in markets. Contrast the current mood from that of the go-go mortgage boom days of 2007. Now *tha*t was a risky market.

In the midst of fear and uncertainty, there lies opportunity. We continue to see the sweet spot of this market hidden in plain sight. Some of the finest corporations in America are selling at low double digit PEs with better-than-bond yields. Worried about lending? – these companies are self-financing. Worried about currencies? – these companies are a natural hedge, doing business all over the globe. Worried about regulation? – these companies are used to handling it while smaller competitors may be overwhelmed. Worried about inflation? - these companies have pricing power and/or low capital requirements to offset the corrosive effects of inflation. And these companies sell at the lowest valuations relative to the market in a half-century.

NEVER SEEN ANYTHING LIKE IT

I've been in a reflective mood lately, in part, because it's been a year since dad died. This week I find myself reminiscing about my grandfather, Russell Pecaut, co-founder of Pecaut and Company in 1960 with my father, Dick, and my uncle, Jack. (50 years ago! And now John, the fourth generation, is on board, joining Corey and me last fall. As my grandfather often said, "I never dreamed things would work out so well.")

I regret that Papa, as I called my grandfather, had retired by the time I graduated from college and joined the firm. However, I am very grateful that he stopped in to have lunch with me when he was in town. We'd go to Bishop's Cafeteria, where they had a chocolate ambrosia pie that was fantastic. I especially remember one such lunch in 1980. Fears were circling that America would become a banana republic with runaway inflation. Interest rates had skyrocketed. The prime rate touched 21.5% in those days and Treasury yields nipped 15%. I distinctly remember my grandfather's sense of astonishment, "I never dreamed we'd see interest rates like this. My whole life interest rates have been between 1% and 5%. I've never seen anything like it."

Coming from someone born in 1902, "never seen anything like it" made quite an impression on me. Among his bond holdings, Russell had AT&T bonds, the safest of the safe for 50 years. His bonds carried a 2% coupon at par. With soaring interest rates, those bonds traded at less than a third of his purchase price. Losing two thirds of your money on an AT&T bond? Unimaginable! Yet, there we were.

The other thing about Russell was that he had arranged his affairs so that this unforeseen setback in his bond portfolio didn't undo him. He kept roughly a third of his assets in bonds, a third in stocks, and a third in real estate. The stocks and real estate held things together. In addition, being a man of the Great Depression, he was debt free. Cash on the barrelhead was his style. Then, no matter what comes along, you own what you own. (It also helped, no doubt, that he kept a clear mind, a grateful heart, and an optimistic outlook right up until his passing in the year 2000.)

Often I've wondered what Papa would say about our modern, debt-laden society. How often have I found myself saying such things the past 10 years. Buying homes with nothing down? Unimaginable! The government paying people to buy cars? Unthinkable! And now – this is perhaps the strangest market, with more divergent movements going on, that I've ever seen in my 31 years in the business. I've never seen anything like it.

IT'S A DOUBLE DIP – BUY TREASURIES

Here's a strategy. Clearly there has been a flight to safety since the debacle of 2008-2009. In the fall of 2008, you may recall there were days when the yield on short term Treasuries was *negative*. In effect, people were taking a known loss on their principle just to know that the rest of the money would be safe. Incredible! Remarkably, we are nearly at those levels again. Recent treasury yields: the 3-month 0.13%, 2-year 0.49%, 5-year 1.37%, and 10-year 2.52%. We are as far from the rates of 1980 as we could be.

We find these extremely low yields surprising. Yes, deflation is the fear of the month. Yet, given the debasement of currencies around the world and that increased inflation is a possible (likely?) outcome of massive governmental debt and deficits, the longer term bond market looks risky to us. Just a whiff of inflation fear and the bond market would likely tumble. As Jim Grant of *Grant's Interest Rate Observer* cleverly puts it, the government bond market has become a world of "return-free risk".

By the way, it's not just the average Joe going to cash. Corporate America has more than $2 trillion in liquid assets, the highest cash as a percentage of assets in post WWII history.

REACHING FOR YIELD

Clearly there has been a flight to bonds of all sorts. Investors have poured some $400 billion into bond funds over the past two years. This includes risky credits like emerging market bonds and junk bonds. If the world economy is so suspect, why is this a good idea? And isn't "reaching for yield" what created the mortgage bubble in the first place?

Warren Buffett was the first to teach us that if you are going to regularly need money in an enterprise, the time to borrow is when money is cheap, not when you need it. Corporate America is borrowing when money is cheap. IBM raised $1.5 billion on Aug. 2 *at **1%** for a three-year note*. Recently Norfolk Southern issued *100-year bonds* at 5.95% and had to increase the issue from $100 million to $250 million to satisfy demand. On Aug. 12, Johnson and Johnson issued $550 million of 10-year notes at 2.95% - a rate just 0.43% over the current rate on 10-year U.S. Treasuries.

GO LONG INFLATIONARY RECOVERY – BUY CYCLICALS

Here's an even more aggressive strategy. In last year's rally, the worst did the best. Small caps, highly levered companies, commodity producers, cyclical stocks got the biggest bang for the buck. With economic uncertainty, this trade has become more mixed. Yet a number of these sorts of stocks continue to sell at relatively high prices.

One reason is deal activity. Corporate America is using some of its cash and cheap debt to do some buying. M&A activity has clearly ticked up, headlined by BHP Billiton's $40 billion offer for Potash Corp. of Saskatchewan. Hewlett Packard and Dell are battling for 3Par, a maker of storage products. Intel is on a spree, bidding $7.7 billion for McAfee and $1.4 billion for the wireless communications unit of Infineon. AmeriCredit Financial received and accepted a $24.50 a share buy-out from GM (your tax dollars at work!). Yes, the same GM that had to be bailed out by the government in part for the massive losses at its auto lending arm.

Also, Berkshire Hathaway has announced it will offer to buy in the shares of Wesco Financial it doesn't already own for cash and stock. **Just as we predicted** (ahem) a couple decades ago. We are saddened as this may mean the end of one of our all-time favorite learning venues: the Wesco annual meeting with Charlie Munger holding court.

WHATEVER YOU DO, AVOID HIGH QUALITY, GLOBAL COMPANIES

Over the past two years, investors have pulled some $200 billion out of domestic equity funds. This massive net redemption is at least one factor in creating what we think is the sweet spot in this market: dominant, global brands. These companies sell at lower than average PEs, have great balance sheets, generate loads of cash flow, offer generous dividends, benefit from global growth, and have proven their staying power through the crisis. They have shown incredible flexibility in adapting to change, often have pricing power and/or low capital requirements to offset inflation, and are far better able to handle increased regulation than smaller businesses. Relative to the overall market, these stocks have never been this cheap. Why?

We're not sure. To think investors would be net sellers of domestic equity funds is understandable after the scary ride of 2008-2009. Not owning stocks is clearly one way to avoid the pain of a declining stock market. In fact, I haven't seen this much antipathy (I don't know that we're at "revulsion") for stocks since I started out in 1979. I remember recommending mutual funds on my cold calls back then and nearly getting thrown out of the office! I asked my dad what that was all about and he explained how mutual funds became really popular in the 1960's but did nothing but go down in the 1970's, so "mutual funds" had become a dirty word. In today's market, after the lost decade of 2000-2010, where the S&P 500 lost money despite a wonderfully expanding global economy, people are no doubt becoming similarly frustrated.

All this leaves us feeling even more so that large cap, global companies are more the answer than the problem. Clearly Coca Cola was too high in 1998, selling at 80 with a PE of 50 on overstated earnings inflated by sales of bottlers. It was a product of its time. The lost decade has entirely re-priced Coca Cola – today it sells at 55, yields 3%, PE 16 – very reasonable for one of the world's most powerful brands.

THE CURIOUS CASE OF JOHNSON AND JOHNSON

Here's our poster child for the current strange market: Johnson and Johnson. As we noted above, J&J issued 10-year notes yielding 2.95%. Meanwhile the stock yields 3.7%. And the dividend has been raised for *48 consecutive years*. How can those bonds be such a hot deal and the stock not be at least as interesting? Yes, J&J has had some embarrassment with some product recalls, but those clearly are fixable problems. And yes, the new healthcare plan creates uncertainty for providers, though J&J is currently measuring its estimate of this impact in pennies per share.

Just one of four AAA rated industrial companies left in America, J&J was founded in 1887 - just 15 years before my grandfather was born. We also note that J&J has sales of over $62 billion of which 50% is international. J&J is a nicely diverse leader in healthcare products with sales coming from pharmaceuticals (36%), medical devices and diagnostics (38%) and consumer products (26%). The balance sheet is a source of strength, lightly levered with debt equal to 14% of equity. The company generates annual free cash flow of $8 billion (about equal to long term debt). Valuation-wise the stock sells at less than 12 times estimated 2010 earnings, well below its 30-year average PE of 20. And there's that lovely dividend. *Grant's* notes that the dividend in 1980 was $.0464 a share. It has since grown at 13.7% annually to $1.93 currently, a level *greater than the stock price* back in 1980. Let's see a bond do that!

Indeed, this gets back to the strangeness of the market. How is it that a 2.95% bond is in such great demand when the stock of the world class corporation floating the bond yields 3.7%? Even, assuming no growth and merely continued solvency, the stock is probably the better deal except under the most dire of circumstances. Yet assuming some growth seems reasonable for a company that has been growing by providing first class healthcare products for 123 years. If we assume the growth rates in earnings and dividends drop to half the 30-year average and that the PE remains at historic low levels, shares of J&J would compound at better than double the bondholder's 2.95% rate.

But what about the last 10 years, the years of the Lost Decade? Good question. As of 12/31/99, J&J closed at $46.27 with a PE of 31, at the very top of its historic valuation range. As of 12/31/09, J&J closed at $64.91, where J&J featured a PE of 14, at the low end of its range. With a PE contraction of 55%, you might think J&J had a negative return for the decade. However, the total return for the decade was still better than 60% because of the handsome growth in the earnings (a triple) and dividends (up nearly fourfold). Buying J&J at all-time high valuations probably wasn't the best idea and, yet, given 10 years it worked out reasonably well. Our guess is that buying J&J at all-time low valuations is likely to work out reasonably well also.

KEEP IT SIMPLE

So let's keep it simple like Papa did. Pay off your debts. Diversify. Have some money in cash and bonds (though we'd tread lightly on anything longer term), own some stocks, own some real estate. With all the shouting about deflation, inflation, stagflation – the only thing we're really certain about is the inflation of the egos doing the shouting. The truth is that nobody knows for sure what will happen. Both J&J and Papa lived through two world wars, the Great Depression, and a century of innovation and change. Despite all these machinations, in Papa's lifetime the Dow went from 67 to 11,551. We'll get through these times as well. And no doubt, along the way, we'll find ourselves saying, "I've never seen anything like it…."

Dan Pecaut Corey Wrenn