

September 2009

EXECUTIVE SUMMARY

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MARKET UPDATE

Thank goodness the bungee cord grabbed. After plunging to a 12-year closing low of 676 for the S&P 500 on March 9, Katy bar the door, the S&P has gone huckledyduck and rallied over 50%, one of the largest bounces in history. Now standing at 1043, the S&P has returned to levels seen last October, though still well below its all-time high of 1576 reached in 2007.

For all their potential ills, the massive stimulus packages by governments around the world have worked. The wheels of credit and commerce have revived and the Great Depression II has been averted. What's next? There are simply too many variables to know. However, to guess that there will be unintended consequences seems like a sure bet. If one of those consequences was significant inflation, that would not be a big surprise. As a result, we put a larger premium than average on flexibility and adaptability in this environment. Staying nimble may prove to be important.

In terms of strategy, this may be a time to raise a little cash for those that will be needing it within the next year or two. This may also be a time to cram down expenses to keep living expenses affordable – as consumers retract, they gain power with providers of products and services - so use that to your advantage. And for investing, it leaves us feeling more comfortable in stocks than bonds. Inflation is the enemy of the fixed-dollar investor (of which China is the largest!). We especially like well-run world leaders with strong balance sheets – they will best be able to adapt to whatever unintended consequences come down the pike.

In Memorium: Richard Pecaut, 1930-2009

We are sad to relate that the co-founder of our firm, Richard Pecaut, died August 19 after a three week stay in the hospital.

It was sort of magical really, those last few weeks. Dad handled the diagnosis with such grace. He had cancer, two very large abdominal tumors. The doctors gave him a few weeks, maybe a couple months to live. Dad was tired with the MS. It had become a struggle just to survive. So in a way, he was relieved. He felt he'd had a wonderful life and he was ready to wrap things up.

He was so clear about what he wanted. No chemo, no radiation, not even a biopsy. "Just keep me comfortable," he requested. A nurse offered him a Nexium (for stomach acid) and he roared, "I've got Noah's flood going on here and you're trying to sell me a raincoat! No, I don't want any Nexium." I roared with laughter. The old lion was going to go out his way.

He also wanted to stay at the hospital, which surprised me and the hospital staff. Apparently, no one had ever requested to stay in the hospital. He was quite right about it – Marilyn could sleep in the room and stay by his side which is just what she wanted. Stacey, his daughter, worked as Chaplain at the hospital so she could advocate for his care daily. The nurses love Stacey so they in turn took extra good care of Dad. I could stop in and see him several times a day on my way to and from work. And the homerun that I didn't notice until after the fact was that his friends and associates could see him so easily. My guess is that three or four times as many people dropped in to pay their respects to Dick as might have done so had he been at home. It eventually struck me how much it felt like Jimmy Stewart in *It's A Wonderful Life* where the whole town comes out at the end of the movie to show their love and support for the man.

He let go step by step. First there was no more TV – no more Fox News, his daily staple for years. No more Starbucks. Then a sign went up for no more visitors. His sentences became shorter. The day before he died he was down to one word answers. On August 19, his eyes became glassy - as if staring off in the corner - there would be no more answers. In the end, he died in peace and with those he loved around him. It was three weeks from diagnosis to death. And he played it perfectly.

Dick was my father, teacher, mentor, and, of course, my business partner. It only occurs to me now how he must have had his doubts about me joining the firm. I recall the grade school paper in which I wrote that my father's

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occupation was working with “stocks and bombs”. I must have thought he worked at the stockyards and a munitions plant. He never pushed, wanting me to choose what I wanted for my life. Shy and bookish, not exactly classic salesman material, I joined the firm in 1979 and he welcomed me into his exciting world of finance.

One of the many gifts he passed on to me was his love of reading. He was a voracious reader. As a youngster, I recall his nightly ritual where he would become ensconced in his La-Z-Boy recliner with a stack of financial periodicals and annual reports on his right side. As he read, the neat stack worked its way from his right side to the middle and the left, deteriorating into a three foot radius of magazines, newspapers, and newsletters strewn about the floor. He continued this habit up until he entered the hospital. As a result, he was incredibly well informed about world events as well as the economic scene. He was my Google before there was Google. It amazes me how many times Corey and I could get resolution to an issue with a quick chat with Dick. I now realize what an integral part of my data processing system Dad was; just last week, stuck on a question of historic financial matters, I caught myself picking up the phone to give him a call...

More gifts than I can count came to me through the day to day experiences of the operations of Pecaut & Company. Dick founded Pecaut & Company in 1960 with his father, Russell, and his brother, Jack. Russ always marveled that they were a success from day one. By the time I arrived on the scene, Russ had retired, so I regret not being able to work with my grandfather – wouldn't that have been something? But I did learn his principles which had been fully absorbed by his sons. Honesty – your word is your bond. Service - the customer always comes first. Do Your Job - get the money right and get the trade right. Those simple truths covered most of the terrain. There was no training manual. It wasn't written down anywhere. It was in the air. Dad, as CEO, brought awareness to these key values everyday with how he showed up, how he handled problems.

He also managed with an eye to keeping costs down so the firm could thrive under any economic scenario. It reminds me of one of the first things Corey taught me coming from Berkshire Hathaway – a company that has a “cost-cutting program” knows nothing about cost-cutting. Yes. Keeping costs down needs to be a reflex, part of how one thinks about every decision. That's how Dick's principles were with him. He didn't need a course in honesty or ethics. He simply lived them. (My two cents: if someone needs a course in ethics, they know nothing about ethics. It's an attitude, not a course of study.)

As for keeping costs down, Dick did run the firm so that even if the market plunged dramatically, we'd still be able to make sure we made payroll and covered the rent. Such

wisdom seemed so practical and yet so rare, and even rarer than I would have guessed as I traveled the larger world of finance. Dick coined a phrase to capture his philosophy: *“err on the side of cheap.”* He was quite pleased when Adrian Banky, then president of the Securities Industry Association, quoted Dick in a SIA essay – in the late 1980's I believe - on how the industry needed to be smarter about costs. While he was thrilled to have his wisdom quoted on a national basis, he suffered no delusions that Wall Street behaviors would change in the slightest. (He was not the least surprised to hear of John Thane's \$37,000 toilet.)

Investing is where his passion and enthusiasm came to the fore. As Corey puts it, “Dick was two parts patient value investor and one part riverboat gambler.” He had an enlightened approach where the bulk of client assets were in low risk, well-researched investments. And for those clients looking for a little more excitement, he had his “ad-venture capital” ideas.

With the safe money, Dick stuck to conservative stocks and bonds and funds. For instance, the firm did loads of business in the bonds of the regional utilities, Iowa Public Service (now MidAmerican Energy) and Northwestern Public Service. He steadfastly eschewed Wall Street manufactured products like real estate limited partnerships, new issues, country funds, fancy annuity products, and the like. Invariably he would note that the hot new product of the day was made to be sold, not bought. They weren't good for the client, had high fees for the broker and were likely to end in tears. Over the years, I saw how he was right again and again about this. His mantra here: *“When it comes to investing, vanilla is a pretty good flavor.”* If only Wall Street had adopted a similar mindset with mortgage securities.

Then there were the more speculative story stocks - the ones that got his blood pumping. When one was close to some sort of breakthrough or deal that could set it soaring, he'd get excited, using terms like “it could go gangbusters” or “Katy bar the door” or “it'll go huckledybuck” (Huckledybuck? I've never heard anyone else use that term.), and my personal favorite, “the shorts will be filling their shorts.”

Through it all, Dick maintained a profound intellectual integrity. He would never ask a client to invest in something into which he wouldn't put his own money. He'd never ask a client to sell when he thought he should hold, foregoing again and again an easy commission. As he liked to say, *“We eat our own cooking.”* When he was honored in 1988 as one of *Money Magazine's* Top Ten Brokers in the nation, that was the quote with which they led off the story.

I'd like to close with noting that Dick also had the heart of a poet. He'd astonish us kids, usually at the dinner table,

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by bursting into a recitation of Shakespeare or Longfellow. I often remember thinking, "Where the heck did *that* come from?" One of his all-time favorites was William Cullen Bryant's *Thanatopsis*, the final stanza of which goes as follows:

*So live, that when thy summons comes to join
The innumerable caravan which moves
To that mysterious realm where each shall take
His chamber in the silent halls of death,
Thou go not, like the quarry-slave at night,
Scourged by his dungeon; but, sustain'd and
soothed
By an unfaltering trust, approach thy grave,
Like one who wraps the drapery of his couch*

About him, and lies down to pleasant dreams.

And that's just how he did it. He wrapped the drapery of his couch about him, and lied down to pleasant dreams. I'm grateful to have had such a wonderful father, teacher, mentor, and business partner. And I'm grateful that he died well and at peace. Sweet dreams, Dad. We miss you already.

Dan Pecaut Corey Wrenn