Pecaut & Company

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EXECUTIVE SUMMARY

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The Quake

On Friday, March 11 the north eastern coast of Honshu, Japan was struck by an 8.9 magnitude earthquake with an epicenter approximately 230 miles north of Tokyo. It's hard not to be deeply affected by the home movies of the tsunami. Some 13,000 lives were lost (and still counting). As if that weren't enough, there is this slow motion nightmare unfolding with the damaged nuclear power plants. Our thoughts and prayers go out to the families and relief workers. The scale of the tsunami, the human suffering, and the potential release of radiation are all humbling reminders of the power of nature and the fragility of the human condition.

Market Update

The stock market has been a bit choppy of late with the headlines of unrest in the Middle East and concerns for Japan. After doubling over the past two years, investors are uncertain as to what comes next. One irony in this is that while the headlines may be volatile, the improvement in the economy has been remarkably steady. Month by month, inch by inch, the economy has been slowly improving. We hear it on conference calls. We see it in the data. As an example, U.S. railroad volume for the first nine weeks of the year was up 6% from a year earlier according the Association of American Railroads. Perhaps it's too dull for headlines, but it is encouraging and provides some support for stock prices.

While there has been real improvement, it's also true that the unprecedented and massive stimuli from both U.S. fiscal and monetary policy have succeeded in stimulating market prices for commodities and stocks worldwide. They have bought us time.

Rather than reconcile the massive overhang of debt accumulated over the last several decades, policymakers of the Western world have chosen to shift the debt from the private sector to the public sector. (The one exception we see would be the U.S. housing industry, where the over-indebtedness is being reconciled through the process of foreclosure.) The question of how and when these governments de-lever remains open and that leaves investors with a wider than average range of potential outcomes to consider and for which to prepare.

One element seems clear – nearly all of the major developed governments are pursuing policies of currency debasement.

Currency Debasement

Corey and I have long been interested in money, so it's probably no surprise that we both collected coins when we were kids. Corey still likes to look for the old "wheat" pennies with the stalks of wheat on the back, which were issued from 1909-1958. In recent years, you may have noticed the U.S. mint has gone away from the old Lincoln memorial penny and has been issuing pennies with different sorts of art on the back. For example, last year, the U.S. mint issued a penny with a union shield. Corey and I compared it with one of his "wheat" pennies and the difference in weight was shocking. The new penny was less than half as heavy as the old.

A numismatic friend, born in 1951, has an 1851 penny in his collection. He likes the idea of having something that was created 100 years before he was born in his pocket. That copper penny is nearly as big as a silver dollar. Over the past 160 years, the shrinkage of metal in the U.S. penny has been quite dramatic.

We are simply noticing firsthand the process of ***debasement***. This is nothing new. Profligate governments for two millennia have systematically reduced the amount of metal in their coinage. In particular, by replacing a fraction of a coin's precious metal content with a ***base*** metal (often copper or nickel), governments routinely reduced the intrinsic value of their currency (hence the term ***"debasement"***).

The Roman denarius initially was made of nearly pure silver. By the second half of the third century, it was only about 2% silver. Each succeeding emperor reduced the amount of silver in the denarius, seeking to create financial gain for the empire (and emperor) at the expense of her citizens. By reducing the amount of silver required in each coin, the government could make more coins. The process of debasement impoverishes the citizenry by

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reducing the purchasing power of the currency over time.

On occasion, debasement also took the form of "coin shaving", where the unscrupulous would shave small amounts off the edges. This, of course, reduced the amount of gold and silver in the coin. As the shaver accumulated enough shavings, he could counterfeit more coins. (By the way, this problem was solved by none other than the Master of the Royal Mint, Sir Isaac Newton. He ordered that silver and gold coins be produced with milled edges, a tradition the U.S. mint continues today with dimes and quarters.)

Modern Coin Shaving

In our modern, technology driven era, debasement is done with the keystroke of a computer. We are currently witnessing the largest stimulus ever seen in America in terms of both fiscal policy (deficit spending of some $1.5 trillion) and monetary policy (currently featuring zero based interest rates and QE2). How it ends is unclear and to think it could end badly does not take much imagination.

As our informal research on pennies suggests, coin shaving is nothing new in this country. In fact, in 1930, the year my father was born, you could buy a Coca Cola for about 6 cents. By the time of his passing in 2009, it took a dollar to buy that same bottle of Coke. Think about that. Sustained and systematic debasement of the currency made for a *94% decrease in purchasing power in the span of a single lifetime*. Put another way, one's net worth would have needed to increase *16 fold* from 1930 to 2009, just to maintain one's purchasing power. As Warren Buffett once said, "You may feel richer but you don't eat richer. That's inflation."

But inflation has been pretty quiet the last decade or so, hasn't it? Well, that depends on how you measure it. According to the CPI, where our depressed housing prices comprise 37% of the index, the answer would be "yes." As measured by any practical notion of a full collection of prices that matter, the answer would be "no." As mentioned in our last newsletter, the following items *at least doubled in price* over the past decade: homeowner's insurance, gasoline prices, heating oil, Medicare premiums, eggs, property taxes, college tuition. Maybe you could do without the eggs, but the rest would be hard to skip for the average American family or retiree. (See Healthcare Inflation below)

Furthermore, with the massive stimulus from both the fiscal and monetary spigots (as we speak, Helicopter Ben Bernanke is printing dollars at the rate of $3.3 billion per day or $2.3 million per minute), we are in the midst of a gigantic financial experiment. It's not just America, but the entire Western world that has engaged in extreme Keynesian policies. How all this turns out is unknown and the *range of possible outcomes* is much wider than anyone living has ever experienced. There could be deflation. There could be inflation. There could be really significant inflation. What's a rational investor to do? How does one preserve principle and purchasing power in such a world?

How to Maintain Purchasing Power in a World of Currency Debasement

"I would much rather own the grocery store than the mortgage on the grocery store."

- Sir John Templeton.

So what is "safe"? Throughout our careers, for many folks, "safe" has meant investing in bonds, annuities, certificates of deposit, installment sales, and the like. In sum, "safe" means fixed-rate, fixed-dollar contracts where the principle and interest rate are "guaranteed" (a term we could investigate as well, perhaps, in another newsletter). What is not guaranteed here is *purchasing power*. In our September 2010 newsletter, we shared the story of my grandfather, who, if he had put all his money into "safe" bonds, the living standard of his retirement would have been disastrously impaired by 1980. Sharply rising inflation and interest rates (to 21.5% on the prime rate) cut the market price of his gold-plated AT&T 2% bonds by two thirds. At the very time he needed more income to deal with rising inflation (i.e. decreasing purchasing power), his bond values were being destroyed. Perhaps we are simply prisoners of our experience, but it seems to us that long term, fixed-dollar, fixed-interest rate contracts, especially at today's ultra-low rates, carry much higher risk than the average investor may realize.

Rule 1: Diversify

Even Papa, for all his worldly wisdom, never dreamed he'd see such high interest rates. However, he was wise enough to plan for the unknown by being diversified. He had roughly a third of his assets in bonds, a third in stocks, and a third in real estate. When the bonds suffered, it was appreciation in his other assets that pulled him through. So rule one is to *diversify*. Set up your portfolio so it can handle a wide range of unexpected outcomes.

Rule 2: Own Businesses

Sir John was one of our all-time heroes. He was well aware of economic history and spoke often of the proclivity of governments to inflate (i.e. debase) away their problems. We live in a capitalist world, so his recommendation was to be an owner of capital. Be leery of being a fixed-dollar investor (e.g. the holder of the mortgage on the grocery store). That's essentially what Templeton was saying. So rule two is *own businesses,* especially those that can roll with inflation.

Remember how we noted that one would have needed a 16-fold increase in net worth to maintain one's purchasing

power from 1930 to 2009? In 1930, four shares of Coca Cola had a market value of $546 and kicked out dividends of $24. By 2009, those four shares would have grown into shares with a market value of $7.2 million, an increase of more than 13,000-fold. The shares would now be generating dividends of $7557. Thus, the *dividends alone* would be nearly 16 times the original investment.

Buffett Buys Another Business

Warren Buffett agrees with John Templeton that the best inflation hedge is a business that generates cash and has the pricing power to pass along inflation. Acting on that belief, Berkshire has announced it is buying Lubrizol, a chemical additives company, for $9.7 billion. In his recent letter to shareholders, Warren Buffett allowed that Berkshire's cash horde was growing and that he had an "itchy trigger-finger". This continues Berkshire's decades long shift from an insurance company with an investment portfolio to a conglomerate with a powerful portfolio of wholly-owned businesses.

The *Wall Street Journal* had a nice graphic on Berkshire's top six buy outs since 1998: General Re ($16.2bb), MidAmerican Energy ($8.4bb), PacifiCorp ($9.4bb), Marmon ($4.5bb), Burlington Northern Santa Fe ($35.9bb), and now Lubrizol.

Buy Gold?

"Businesses with pricing power, bought cheaply, will outperform gold in the next 20 years by a wide margin."

- Mason Hawkins, Longleaf Partners

We often get asked about precious metals or commodities as inflation hedges. While hard assets have real value, Corey and I much prefer real assets that also generate cash. We've never seen anyone put it better than Warren Buffett recently on CNCB. Buffett noted that if you took all the gold that has ever been mined you could make a 67 foot cube of gold. At recent market prices, you could sell that cube and buy all the farmland in American, plus 10 Exxons, and have a trillion dollars in cash. Buffett and Hawkins both prefer to own assets that produce cash versus commodities that may or may not rise in price over time.

Global Consumer Brands

As foretold in prior issues of this newsletter, China passed Japan to become the second-largest economy. India is on track to pass Japan in 2011.

Our favorite theme for the past decade has been to invest in the growth of the emerging world. Standards of living are rising for consumers from China to India to Brazil. In addition, these emerging countries and consumers are far less levered than their counterparts in the Western world. Those companies that can sell simple, valued products to these consumers have a large tailwind for decades to come. Not everyone can play. For most products, you must already have sophisticated infrastructure, logistics, sourcing, and operations in place to participate. For the far-sighted global brands that have this in place, we see wonderful years ahead.

In addition, most consumer non-durable products are small dollar items, like gum or a Coke or a tube of toothpaste. Thus, these companies can far more easily pass along inflation (debasement) by raising prices than can businesses that sell large dollar, consumer durable products like cars or refrigerators.

Low capital requirements plus pricing power equals a powerful business combination that can see investors through a very wide range of potential economic climates over time. Many people think of the stock market as place to go try and "make money". We see the stock market as a place to become part owners of exceptional businesses that can grow and preserve purchasing power. When we can do that at reasonable to bargain prices, we are buyers.

Healthcare Inflation

We all know healthcare costs are up, but maybe not by how much. A clever and insightful presentation was made by Uwe Reinhardt, Professor of Political Economy at Princeton at the National Congress on Health Insurance Reform in Washington, D.C.

Reinhardt offered several interesting data points on health-care prices. For example, between 2000 and 2009, net revenue per inpatient hospital day in California increased 18% for Medicaid, 76% for Medicare, and a whopping 159% for commercial payors. A knee replacement in Oregon cost 44% more in 2009 than it did in 2005. Average reimbursement for a normal childbirth in Oregon increased 69% between 2005 and 2009. Reinhardt joked that while the babies may have improved in four years, he doubted they were 69% better.

Comparing the U.S. to other developed countries, the average price for a normal childbirth in the U.S. was around $8,400 in 2010. In Germany, it was $2,100. In France, it was $3,800. And just across the border in Canada, it was $2,300. An appendectomy cost $13,100 on average in the U.S., compared to $2,600 in Switzerland, $6,500 in Australia, and $3,800 in Canada.

In Memoriam

My father Bernard Wrenn died February 6, 2011. I would like to thank those of you who have expressed your sympathies. Barney is yet another fallen WWII veteran. He was stationed in Italy, where he served in the Army Air Force with the 384th Bombardment Squadron. There, he drew the short straw and was a B-17 ball turret gunner. After the war, he and my mother settled down in the Freeman SD area where they tried their hand at farming.

In 1961, they got out of the farming business and purchased a bar and restaurant called the Covered Wagon and another bar in Dolton, SD creatively named the Dolton Covered Wagon. He worked there until 4 months before he died.

Regrettably, he struggled with alcoholism and anger issues most of his life and for the most part was an absentee father. When he was around, most of my memories are painful ones. As I have gotten older I realize that I did not know him when he was young and the world was his to be conquered. I did not know him before he went through the horrors of war or the struggles of having a large family and very little income. Fortunately, as he reached his twilight years, I saw glimpses of a man who was, I believe, at his core a good man. And now Barney, off you've gone into the wild blue yonder - I pray you have found your peace.

Dan Pecaut Corey Wrenn