BARRACK YARD ADVISORS

Current Anchors

April 2012

Debtors Are the New Prodigal Sons

Savers are continuing to subsidize debtors via a policy of negative "real" interest rates. While some in the media focus on supposed class warfare, a true transfer of wealth is occurring right under our noses, from the responsible to the profligate.

While unfair, it's an expedient solution to the debt problem we have as a society. It eases the debt-bubble hangover for those who partied too much, and for the rest of us, it's meant to encourage risk-taking to get the economy growing, thereby reducing relative debt burdens.

Short of a run on the dollar, or Policymakers deciding the economy is no longer fragile, expect negative interest rates to continue.

History has shown us that flooding the world with unprecedented amounts of liquidity is not a sustainable policy, and all unsustainable trends eventually come to an end.

When the current trend ends, when the price of money is no longer at zero, most assuredly a permanent loss of capital awaits those who've given little thought to the implications of cheap money.

Investors will remember there's a thing called interest rate risk.

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Volatility is not going away

Investor sentiment has improved markedly, particularly over the past six months, though the problems that spooked investors last year endure.

The European crisis is far from over, US house prices remain in the doldrums and the economy is fragile. Politicians who presided over the US Sovereign debt downgrade remain in office, and Geo-political issues such as Iran and uncertainties surrounding the Arab Spring threaten an oil-price shock.

Back in October we wrote,

"We advise caution when things look good and optimism when they look bleak. And things look bleak. Accordingly, we are moving portfolios to a more fully invested position."

Since then investors have enjoyed a beautiful rally in stock prices.

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Redefining what constitutes safety continues to be a high priority.

Is a US Treasury bond yielding 2% for 10-years really risk-free, given consumer prices are increasing by at least 3%? How about T-Bills yielding zilch for all practical purposes?

Knowing you'll fall behind in real terms after inflation and taxes looks a lot like purchasing-power-risk to us.

We believe all vehicles propped up by cheap money are highly risky. This certainly includes bonds of most types, including US Government bonds.

Bonds are expensive by historical measures. They yield less than 0% in "real" terms versus a positive return of 2-3% historically.

"We believe all vehicles propped up by cheap money are highly risky. This includes bonds…many real estate investments, utility stocks, highly indebted companies… and, of course, gold."

Other assets artificially inflated due to cheap money include, but are not limited to many real estate investments, utility stocks, highly indebted companies, firms that need constant funding in the capital markets and, of course, gold.

Could there be a scenario where we'd be wrong about interest rates?

Possibly, but only if consumer prices were to fall for an extended period, like in the 19th Century. But we dismiss this as a low probability outcome.

Why?

First, policymakers are fighting the 1930s, so to speak, and will continue to use the power of the printing presses in their struggle against deflationary forces.

Second, politicians fear deflation more than inflation because they know people suffer from money illusion, the tendency to view money in "nominal" terms; not "real" terms.

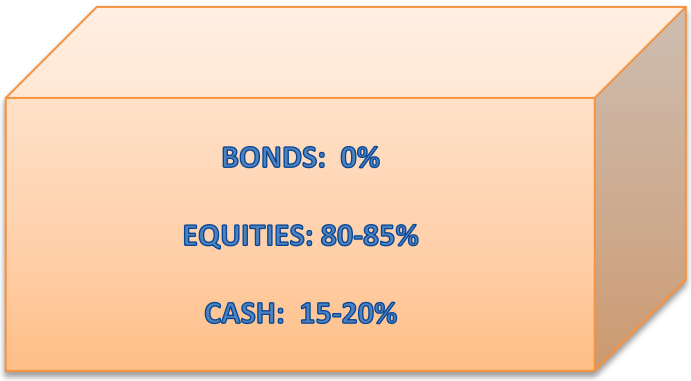
Studies show most workers, given a stark choice, would pick a pay rise that's below the inflation rate than take any pay cut, even one that's less than the deflation rate.

Money illusion and other factors make politicians supportive of pro-inflation policies because it's the easy option. Unfortunately, savers are the ones who pick up the tab in the early years.

As a result, savers will continue to be given a raw deal and there's not much to do about it except:

1. Protect yourself by trying to avoid interest-rate sensitive vehicles.
2. Redefine in your mind what constitutes "real" risk.

In our mind, a financially strong company that's been in business for generations, providing things people will always want and need—and which pays a growing dividend of 3% plus—is less risky than an investment vehicle tied solely to the general level of interest rates.



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Core Portfolio Comments:

One of our Core Holdings, Viterra, is the subject of a takeover by a consortium led by Glencore, the Swiss-based natural resources conglomerate.

The deal's expected to close by July for a cash price of about US $16.00 per share.

We added two names to the Core Portfolio in the first quarter.

PepsiCo Inc. is the largest company in the Global Macro-snacks business, with roughly 8% worldwide market share. Brands include Lay's, Doritos, Ruffles, Olive Coast, Tostitos, Fritos, Smartfood, Sun, and Walker's. The industry is expected to continue to grow by 6% per year. Pepsi also owns Quaker Oats, Gatorade, Tropicana, 7-Up and Aquafina.

During the past 10-years, earnings per share have grown by about 11% compounded and dividends have increased on average by 12.5% a year.

The current dividend yield is about 3.4% and the P/E ratio is 15.

For the decade ending in 2006, Pepsi's P/E ratio averaged in the mid-twenties—and higher—every year.

So the current valuation is attractive relative to how investors use to value its shares.

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...The Stock Market continued from page 1:

Major indexes are up 25 to 30%. Sentiment is clearly more optimistic, though not wildly so.

According to EPFR Global, $1 billion was pulled out of equity mutual funds during this stretch. By contrast, $74 billion was pumped into bond funds.

Our best guess is that equities currently are at "fair value" for long-term investors. Although many companies in the *Barrack Yard Core Portfolio* are continuing to trade at suitable levels, the huge recent rally is making it harder to find new ideas that excite us.

We're enjoying the ride for now but are skeptical of its lasting power. Policymakers and politicians have little experience in dealing with debt-fueled deflation.

Therefore, investors are on the lookout for unintended consequences and are jittery. Volatility is not going away.

Natural Gas Prices:

Natural gas prices in the United States are below $2 per million BTU for the first time in over a decade, down 87% from peak prices set in 2005.

Reason: simple supply & demand. Supplies are abundant thanks to new technologies allowing production to reach all-time high levels here in the US. But the necessary infrastructure to move the product hasn't been built yet. So there's a glut of natural gas.

What particularly intrigues us: an old rule-of-thumb indicates there's a price relationship between oil and natural gas, and it should be ten-to-one. If oil is $100 then gas should be $10. And indeed, in Europe

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Core Portfolio Comments:

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SLC Agricola is one of Brazil's largest landowners and producers of cotton, soybeans and corn. They've been in business for 67 years and revenues last year exceeded $550 million. They own about 740,000 acres of prime farm land spread out over 14 farms located in 6 different states.

SLC expects to grow acreage significantly in the next ten years. By 2021, SLC's Strategic Plan calls for the ownership of 1.7 million acres of farm land, 80% located in Brazil and 20% in Africa. At current prices, SLC is selling close to its book value, 8X cash flow and roughly $1,700 an acre. The stock pays a variable dividend of over 2%. According to Iowa State University, the average selling price of farm land in Iowa last year was $6,700 an acre.

We believe there are valid reasons why farm land should cost more in Iowa than in Brazil. But given that farmers in both countries generally receive roughly the same price for their production and SLC Agricola's cotton and soybean yields are higher than the average yield produced by American farmers (USDA data), a 75% discount for SLC's acreage seems pretty extreme.

Natural Gas Prices (Continued):

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the relationship holds. Europeans get their natural gas mostly from Algeria and Russia and they're paying about $10.

Our best guess is that natural gas prices will remain low for a few years until LNG ports are built, utilities convert their plants from coal to gas, and trucks are retrofitted to gas usage. But we believe at some point there'll be a reversion-to-the-mean adjustment in prices and the ten-to-one relationship will re-establish itself in the US.

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