BARRACK YARD ADVISORS
Current Anchors

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Overpaying is Dangerous; Paradigm-shifts too

The biggest factor affecting the *future rate-of-return* on any investment is the price you pay for it.

Buy something at a reasonable price, or below, and you're bound to do well if you hold it long enough; so long as the investment is not negatively affected by a paradigm-shift—a profound change in the way the world works.

Examples of a destructive paradigm-shift include expropriation of private property by a previously business-friendly government, or failure to adapt to changing market dynamics by individual companies or industries.

In each case, the ability of the asset to generate cash for the owner is forever impaired and losses become permanent. In the US stock market, think buggy-whip manufacturers in the 1890s, newspaper publishers a century later or more recently, highly leveraged investment banks.

So as long as you avoid getting wiped out by a paradigm-shift—and *don't overpay*—you should be alright as an investor, if you are patient.

But *overpaying* for an asset, even a quality one, is a different story. Overpaying can result in a very long wait before you achieve investment success – if success comes at all.

In the case of stocks, you might have to wait a market cycle or longer. Most quality tech stocks still remain below their highs from the last Great Bull Market. Wonderful companies like Cisco, EMC, Intel and Microsoft are priced lower today than they were in February 2000; by some 40-70%. It's a lesson in why we fret about overpaying: though many of these companies have grown their businesses at an impressive double-digit clip during the last 13 years, the growth hasn't been fast enough to compensate for a P/E ratio contraction from 60X to 10X.

In the case of other asset classes, it could take even longer to get your money back if markets move against you. Bond trends are often generational because the debt cycle is so long: the current bull market in bonds is 30 years old—the previous bear market ran for over 30 years and bonds were derisively referred to as certificates of confiscation by the end.

In the case of investment grade real estate, illiquidity adds a further painful possibility. A bear market in real estate can become like the Hotel California. That is, "you can check out any time you like, but you can never leave."

Concern with overpaying for investments is the first of our five enduring principles. And given that many markets are at all-time highs, it remains top-of-mind. But equally, thinking through paradigm-shifts that could result in losing money also keeps us up at night.

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The Significance of the Stock Market's All-Time Highs

When I speak to the financial press, I'm often asked about the significance of the new stock market highs. But no one asks about the bond market's all-time highs.

Whereas the stock market is simply back to where it was 13 years ago, the bond market is currently in uncharted waters. The stock market is roughly half as expensive as it was in Y2K, but valuations in the fixed income market have never been higher. Earnings for the S&P 500 are roughly a third higher today than when the US stock market was last at these levels in 2007. Yields on fixed income haven't been slimmer since at least 1703, when the Bank of England began to keep decent records.

We have warned before that "safe" investments are paradoxically not safe. We are also aware that being too early in warning about something can look a lot like being wrong. But history has repeatedly shown that most participants in overvalued markets eventually wind up losing money.

Our question for owners of bonds, preferred stocks, highly indebted companies, REITs and so forth: "Why is it different this time?"

Getting back to the significance of the stock market's all-time highs, we stress two points:

- They show the Fed's zero interest rate policy has been successful in boosting asset prices. That's step one: Get investor portfolios to rise, arousing "animal spirits." Steps two—hope that increased risk-taking and financial prosperity spill over into the real economy—and three—shutter the liquidity pumps once 'Normalcy' returns—are yet to be completed.

- The highs also indicate we may be on the cusp of knowing if the Great Bear Market that started 13 years ago is indeed dead, or if the bear has simply been hibernating. As I have noted before, for the second time in the current secular Bear Market, we are up against a glass-ceiling known as the previous Bull Market highs. If we burst through the previous high by some 30%, this would signal the death of the Great Bear and the birth of a new long-term Bull.

It may be safe to surf for now, but it's still dangerous out there!

It's dangerous out there partly because valuations are elevated but even more so, it's at this point in a cycle that investor regret kicks-in.

Market participants feel pangs of remorse for not having bought this or that stock when it traded at lower prices; for having sold out of a position too soon; or for not having enough money in the market, etc.

Investor mindset changes from fear of losing money to fear of missing out. It's when this change in mindset occurs, investment mistakes are often made—and that's the greatest danger.

Our current strategy involves a bit of speculation, but is mostly true investment. J.M. Keynes was a great investor as well as an influential philosopher. He made this distinction. You're speculating when you're forecasting the psychology of the market; you're investing when you're forecasting the prospective yield of an asset.

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Our best speculation is that the current bull run, fueled by cheap money and a growing infatuation with the risk-on trade, will not end in a whimper.

This powerful rally is up 35% in 18 months; so, the question becomes, how long can it keep rising without a meaningful break? We obviously don't know the answer, but we're probably close to the point where we may do some portfolio pruning and lock in gains.

Our investor mindset, the one that looks at the prospective yield of the stock market, tells us that a large segment of the stock market is overvalued. This is somewhat worrying, but given that we own individual stocks and not ETFs, we can avoid the overvalued areas and focus instead on areas with reasonable valuations.

The current strategy is three-fold:

- Continue to buy/***own stocks for their income***. Pick companies that will benefit from the inexorable rise of the global middle-class and from the Shale Revolution. Globally, we're still finding good businesses that are paying attractive dividends of 3 ½ to 6%, or so. We believe MLPs, many of which offer distribution yields in excess of 7 ½%, are attractive but one needs to be very selective as prices have risen recently.

- In the absence of being able to buy income, ***manufacture income*** through an options buy/write strategy. Selectively, we're able to sell deep-in-the-money call options on companies whereby we have 13-20% of downside protection; and get paid anywhere from 7-12% (annualized) for writing the contract.

- ***Keep healthy cash balances*** and begin to sell our positions that have become expensive as the market rises.

Buy low; sell high?

In the October 2011 issue of *Current Anchors* we noted that stock market sentiment had become so negative, that pessimism was so rife—we had no choice but to be bullish. Prices are now up over 35% since then. We also made an observation about gold: the average prediction by "experts" at a Global Conference back then called for gold prices to be 25% higher within a year; and some experts even expected a doubling in prices. Gold prices today are lower than they were at that time.

This anecdotally shows the danger that lies in optimism (gold prices had risen by over 50% in the previous year); and the opportunity inherent in miserable performance (stocks had been battered by US debt downgrade, etc.).

As investors, our goal is to fish in the miserable ponds and avoid the optimistic ones. Interestingly, one area of current misery includes the miners, particularly gold mining stocks. Many of these companies now sell for less than their tangible book. Sentiment is overwhelmingly negative primarily because they've been terrible performers. The typical gold mining share is down some 25% in the past year and sells at one of the lowest levels relative to the price of bullion in living memory. We added one miner for the first time in the Barrack Yard Core Portfolio in the first quarter. We'll probably add more if prices remain low or go lower.

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MARKET INDEXES

END OF Q1 2013	PRICE:	12 Mo. Change:
Dow Jones Industrial Average:	14578.54	+ 10.3%
Dow Jones Transportation Average:	6255.33	+ 19.1%
Standard & Poor's 500 Index	1569.19	+ 11.4%
NASDAQ Composite	3267.52	+ 5.70%
Swiss Large Cap	7660.00	+ 25.00%
Euro Top 50 DOW	2595.00	+ 9.10%
Gold	1576.00	- 4.00%

U.S. Treasury Securities:

3-month: .006% 6-month: 0.09% 1-year: 0.13%
5-year: 0.70% 10-year: 1.78%
10-year (inflation-protected): -0.68% 30-year: 3.03%

Tax Exempt:

1-year AAA-rated: 0.20% 1-year A-rated: 0.80% 5-year AAA: 0.87%
5-year A: 1.81% 10-year AAA: 2.11% 25-year AAA: 3.19%

Corporate Bonds:
Financial (10-year) A-rated: 2.92% Utility (25/30-year) Baa/BBB-rated: 4.35%

S&P 500 dividend yield: 2.01% (*compared to 1.6% in July '07 and 4.05% in March 2009*)

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