BARRACK YARD ADVISORS
Current Anchors

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THE MOST IMPORTANT INVESTMENT VIRTUE

"People invariably feel better after the market gains 600 points and stocks are overvalued and worse after it drops 600 points and the bargains abound." --Peter Lynch

Let us explore the following scenario together: you have bought a collection of investment properties for $1 million. These properties are of high quality and you have every reason to believe you will be able to increase rents over the long term.

Let us further assume you want to be a passive owner and let a professional deal with leaky plumbing, collecting rents and all of the other hassles that comes with ownership.

In our scenario these properties, after expenses including management fees, generate $80,000 or more a year in cash for you. That's quite attractive in a world where a "riskless" 7-year bond will pay you less than $20,000 a year. Right?

Now assume you own this portfolio and someone comes along and tells you the properties are only worth $900,000. You know the properties well, you are happy with the cash being generated from them, and you invested for the long term. What will your response be? I suspect a polite, "so what."

Let us further suppose time passes and strangers start calling you, telling you the property market is falling and offering to buy your portfolio at successively lower prices. First $875,000, then $800,000, then $775,000. How will you react?

I believe most people would ignore these calls and add them to their smart phone's "block caller" list.

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This is the analogy I am applying to the current downdraft in the global stock markets. Most of the companies we own, in aggregate, fit the theoretical portfolio to a tee. They were bought for their attractive free-cash-flow-yields and they are meant to be long term investments. The only real difference: instead of making money from rental payments, our companies make money from providing goods and services to people and entities.

Some of our companies pay out all of their free-cash. Carlyle Group, the leading Private Equity Money Manager is an example. Their distributions are based on the three ways they make money, including incentive profits, so the amount will fluctuate widely over the years. So far this year Carlyle has paid out

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$2.83 and the stock closed yesterday at $20.35. I do not know what the payout will be next year, but I believe allocations by Institutions to alternative investments will continue to grow over time. Carlyle is well positioned to continue to get more than their fair share of that business.

A company that has a high-free-cash-yield but keeps most of it to reinvest in the business is IBM. During the past year, the company generated over $13.2 Billion in free-cash-flow, or $13.33 per share. After paying its cash dividend yielding over 3%, that still leaves nearly $9 Billion for IBM to purchase other firms, reduce debt, or buy back stock. Based on yesterday's closing price, the free-cash-flow-yield of IBM is 9.5%. My understanding of IBM leads me to believe that the company is continuing through a period of smart transition, and they will end up doing something significant with our money.

A new addition to the portfolio is Viacom, a company that has declined precipitously not only due to the general market sell-off but to concerns about disruptive technology. The narrative is that Netflix will put everyone out of business (think Amazon in retailing), and "old" Media like Viacom will end up like the Newspapers: struggling to remain relevant.

I have racked my brain, but I cannot understand how Netflix's success will *completely* undermine an entertainment content provider like Viacom. Even if consumers abandon FIOS or Xfinity, kids will still watch Sponge Bob, stay-at-home adults will continue to consume reality TV, and for the rest of us, the appeal of experiencing story-telling via a cinematic format will not change (Viacom owns Paramount Pictures with its robust film library that includes *Brave Heart*, *Forest Gump*, *Titanic*; as well as *The Godfather, Indiana Jones, Mission: Impossible* and *Star Trek* franchises).

Viacom generated $5.52 per share of free cash over the past 12 months. That works out to be a free-cash-yield of over 13%. After paying out dividends giving shareholders a current yield of over 4%, Viacom earned some $1.6 billion which can be used to buy back stock, pare debt or acquire other companies. Founder and Chairman, Sumner Redstone, owns some 35 million shares.

There is an old adage that "it is in the sitting" that investors make their money. During the type of market turmoil we are currently experiencing, when markets become scary, owning such high free-cash-flow-yielding equities gives me confidence to stay the course, seek bargains, and place the Stock Market's ever lowering bids on my "block caller" list.

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"We have stressed theory not for itself alone but for its value in practice." --Benjamin Graham

So what is going on? It is anyone's guess, so it is probably best to remember that protracted stock market declines are associated with major economic recessions. Thankfully the economy is still growing here in the US, although the collapse in oil and other commodity prices have implications that must still run their course.

Globally, lower input costs for Europeans should be a positive for its economy. China, based on the views of economists I respect, is not headed for recession. China is clearly transitioning from a fixed investment economy to a more consumption-based one, but it will probably muddle through. Positioning for the long-term rise of the Chinese middle-class is still a reasonable activity.

Blame the robots! An interesting explanation for the market turmoil is provided by Gillian Tett of the *Financial Times*. She partly blames automated computer programs, algorithms created by similarly trained programmers that have produced a herding effect, particularly to the detriment of Index Funds, among others. We have seen this before. Think program trading in the 1980s.

My personal opinion is borrowed from Tolstoy and his reasoning regarding the root cause of the Napoleonic Wars: simply that the men of the West decided it was time to slay the men of the East. Similarly, Mr. Market, after being uncharacteristically benign for nearly 4 years, decided it was time to throw a tantrum. He's decided to add some thrills and bumps to the investment ride!

Once we filter out the noise of these bumps, what remains are a few important things.

- There is a name for those who can consistently buy at bottoms and sell at market tops. The great financier, Bernard Baruch, called them liars. So, rather than worry about timing, let's concern ourselves with the knowns.

- What we know is that businesses selling at high free cash flow yields historically do well over time. This is the amount of money left after everyone's been paid and can be used to hike dividends, pare debt, and make acquisitions, or buyback stock. But to benefit from that compounding cash, we need to hold those businesses through the bumps.

- More importantly, we know that stock market declines do not keep us from achieving our financial objectives. It is our own reactive behavior—buying expensive or low quality assets because prices have risen and selling assets simply because they have fallen—that will hold us back from long term success.

In times like these it is important to remember that we suffer from confirmation bias. We want the market to affirm our choices by going ever higher and when it doesn't, it is not uncommon to take it personally. We can end up feeling foolish.

The way to negate these feelings is to remember the true reason we bought these businesses in the first place. They were bought to make an attractive return over a business cycle. They were bought to enable us to compound the cash they produce. Constantly receiving short-term love vibes in the form of rising quotes from the market was not part of the bargain!

On the Barrack Yard website, http://barrackyard.com/principles.html, we articulate the 5-Enduring principles which guide us. I have copied the one about volatility below.

Principle 3: Investment prices will fluctuate.

Volatility and risk are not the same.

Volatility is the price you pay for liquidity. It creates both buying and selling opportunities, but does not alter a fundamental anchor:

Over time, companies we own become more valuable if they continue to manage cash flow effectively.

Driven by current perceptions, volatility indicates that finance is fundamentally a social science, not a hard science. Since successful investing requires a balance between feeling and logic, Barrack Yard Advisors believes that smart patience wins, so long as one's portfolio is anchored by the enduring principles.

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There is nothing about the recent market turmoil that would compel me to change our investment philosophy of *buying quality, not paying too much and being patient.* Nor has the market decline changed my opinion about volatility. The philosophy has always held us in good stead in the past.

Recent events have simply provided an opportunity to live our philosophy, and to be reminded that patience can be at once, the most important virtue and equally, the most difficult one to uphold.

So let's all take a deep breath, let go of our fearful emotions, and practice the virtue of patience.

Marty Leclerc

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