BARRACK YARD ADVISORS

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A Cheerful Outlook: But Be Prepared

Running with the herd, ignoring valuations, buying the dips, and staying exclusively in domestic stocks produced the winning market strategy last year. Time-honored approaches like diversifying, thinking "margin-of-safety," focusing on where the values are, and being contrarian generated lower returns.

The American stock market moves relentlessly higher mostly because investors are happy to pay more for a dollar of earnings. The S&P 500 is up over 50% in the past 2 years but earnings are only up about 12%. This represents the biggest non-recessionary price-to-earnings multiple expansion for half a century.

Clearly P/E multiples cannot expand indefinitely because, among other things, stock prices mirror growth in earnings over the long term. There is, however, no law that says P/E multiples cannot continue to expand in the short run.

Most people instinctively assume the recent past is prologue to more of the same. Given the upward move in the US Stock Market, the prevailing view for 2014 is unsurprising: staying with the bullish crowd will continue to produce good results. Nearly everyone is expecting a 10% rise this year.

Fear of losing out on making money is replacing the simple fear of losing money. Money is flowing out of underperforming assets such as bonds that are supposed to anchor a portfolio and into US stocks.

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The developed world continues the process of deleveraging made necessary from the bursting of the credit bubble some 5-years ago. Deleveraging produces deflation and there is scant evidence to suggest our world is anything but deflationary.

This is also the view of Central Bankers—and notwithstanding the Fed's decision to taper its asset purchases—the policy of zero short-term interest rates and liquidity pumping will remain with us for quite a while yet.

In addition to this view we see the 15% decline in bond prices, the fact the global savings glut is not going away any time soon, and our understanding of the history of interest rates after similar periods of deleveraging, as reasons to reassess our previous, just-say-no to bonds, strategy.

We continue to be *significantly* underweight in bonds, but are less negative on them for clients needing income. We believe they can provide a diversification anchor for some portfolios.

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A massive rally from Bear Market lows of 5-years ago has roused "animal spirits," and our guess is that the fear-to-greed cycle has not yet run full-cycle. A return to fearfulness is a story for another day.

Optimists say the US market's rich valuation is defensible. We are the developed world's best place to be in terms of projected economic growth, we are on the verge of energy independence because of the revolution in drilling technology, and our corporations are highly profitable. There is a glut of world savings and the US will be the destination for much of it.

US stocks are expensive but current levels of valuation are not unprecedented: from the late 1950s until the early 1970s; and again, from 1991 until 2004 the US Market was at similar levels of valuation.

"If the market chugs higher, the implied long term return from American stocks will soon reach negative territory."

So, given low interest rates, these heightened valuations can remain for an extended period.

The favorable narrative for US stocks is compelling and *feels* plausible for the period just ahead. We are rooting for it to happen. We believe, however, there are reasons for caution when looking at US stocks as an asset class.

In the short-run investor sentiment numbers, short sales data and insider selling activity are all flashing yellow light. Given these readings and other short-term gauges, a 5-7% decline in stock prices would not be unusual, even if later in the year the market continues to move much higher.

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In the stock market our strategy is a continued focus on valuations. We want to own businesses that help us meet our investment objectives and not pay too dearly for them. This typically involves looking to the underlying cash flows of the businesses. It also requires us to consider whether we are positioned properly versus looming macro-risks and opportunities.

In the US, the best values are also among the financially strongest companies: the Big Information Technology firms with long product cycles. Their low valuation means our two favorites, IBM and Cisco Systems, are selling on a free cash flow yield of roughly 10%.

Globally we find Singapore particularly attractive. We believe it offers exposure to Asian growth but with Developed World safeguards. Many of their companies will benefit from the rise of Asia's middle-class. Their stock market declined by nearly 3% last year and we expect to add new names to portfolios this year to complement our current holdings of Hutchison Port Holdings Trust, Keppel Corp and the Singapore Exchange.

We believe smaller European consumer companies like Van de Velde and Orkla ASA are well-priced. We will be adding to our stable of consumer companies this year but the ones we have our eye on are not quite cheap enough. In Agriculture, companies like farmer SLC Agricola and fertilizer group Mosaic remain in our buying range. There are other Ag names we will add if prices go lower.

Finally, stocks in many Emerging Markets were

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Share Buybacks:

Three quarters of a trillion dollars of share buybacks have been authorized by corporate boards in the US over the past year. That represents a large potential demand for shares.

This is good short-term news but it should give us pause longer term. Why? History shows aggressive share buybacks happen after stocks have rallied and are no longer cheap.

We applaud the use of company funds to shrink share count when shares are selling at low prices—IBM is a good example—but unfortunately this is the exception and not the rule.

Take the example of 3M, authorized to shrink share count by $22bn over the next 5 years.

3M's shares are currently 40% more expensive in real terms than they were every year from 2006 through 2012. As a result, this exercise will be 40% more costly for shareholders than if 3M had embarked on the program back then.

It is noteworthy that 3M actually increased their share count in both 2009 and 2010.

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Long-run gauges such as Tobin's Q, which compares share prices to the replacement value of assets, Shiller's P/E which considers long term valuations, and the current market capitalization of US stocks relative to GDP, all portend low average annualized returns from today's levels. If these indicators are correct, a long-term passive investor in the S&P 500 will do just as well, if not better, by simply owning a 10-year Treasury bond at 3%.

Another useful long-term indicator is provided by *Value Line*, an investment publication that has been around since the 1930s. Their analysis indicates the current "*median price appreciation potential of all 1,700 stocks in the hypothesized economic environment 3 to 5 years hence*" is 30%. By 30%, they don't mean 30% a year compounded; they mean a simple 30% over the entire period!

To put 30% in context, it is lower than the levels reached before the financial crisis at the market's peak in 2007. Back then *Value Line* was projecting appreciation potential of 35%. The actual 5-year performance from those highs was negative.

The *Value Line* indicator is not always gloomy. At the bottom of the market in March 2009 it cheerfully predicted appreciation potential of 185% and with three months to go, we are nearly there: the market is up a very merry 170%.

In summary, resurrected "animal spirits" are propelling this market higher and the odds favor a continuation, with set-backs, throughout 2014. But be prepared. If the market chugs higher, the implied long term return from American stocks will soon enter negative territory.

END

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crushed last year. For example, Brazil dropped over 20%, Chile fell by 15% and Indonesia was off some 3%.

For many years Emerging Markets represented growth and high valuations. They now represent among the cheapest markets in the world. We plan on adding a few names from select emerging markets this quarter.

Why We Bought Closed End Funds Last Month

Two reasons we added some closed end bond funds (CEFs). First, we became less negative on bonds. Second, they represented fixed income bargains.

Closed-end bond funds are mutual funds with a fixed number of shares that trade on stock exchanges. Unlike the open-end funds most investors are familiar with, CEFs represent a permanent pool of capital and the amount of money being managed is not expanded or contracted by the managers to meet liquidity flows from investors.

That means the price one pays for the fund can be higher or lower than the value of the underlying investments.

Last Spring CEF investors were paying something like $1.04-$1.05 for a dollar's worth of bond assets. Why pay a premium? The bond market had been rising for ages and people were hungry for yield.

Last month we bought those same bond assets for 85-87 cents. Why the discount? These are retail products and they were abandoned in droves by disgruntled bond investors who decided a 15% drop in bond prices was too painful.

History suggests a 5-7% discount is more "normal" and it would not surprise us to see the discount shrink to those levels in the months ahead as the fixed income markets stabilize.

Apart from the discount, we assessed the types of bonds held, the portfolio's duration, its earnings rate, the amount of borrowings used and the quality of the bond managers.

These funds are run as institutional portfolios and use leverage and derivatives. Individual Investors cannot replicate their strategies and pricing power.

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