BARRACK YARD ADVISORS

Current Anchors

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The Cape Crusader

The way investors think about stocks has changed over time. Prior to the 1920s, stocks were considered especially risky. There was a clear distinction between investment grade and speculative stocks. Investment grade companies paid dividends through thick and thin and were backed by real assets. Investors typically demanded yields of 4-5% and more. That meant P/E ratios remained low except for the occasional speculative rally. Book value was the anchor investors relied upon. If a stock did not produce income, and if the share price was considerably higher than the value of underlying assets, it was speculative.

Then in 1924 Edgar Smith published a study, *Common Stocks as Long Term Investments*. That seminal work showed how stocks had consistently outperformed bonds—since at least the Civil War—due to rising earnings and dividend growth. Its publication changed investing in two ways: stocks were now considered much less risky and investors became obsessed with growth. The metrics investors relied upon to make decisions transitioned from what we now call a value approach to growth stock investing.

Clearly there is nothing wrong with expecting a business to grow. The problem was that in the new mind-set of the 1920s growth trumped everything else and investors ignored the price they paid for perceived growth. Benjamin Graham said it lead to a belief that, "a stock with good long-term prospects is always a good investment. This meant that the factor of future expectations had become the sole criterion of investment choice." (Not unlike the late 1990s.) By the late 1920s perceived growth stocks were routinely selling for 45-50 times earnings, while companies that were not regarded as growth stocks were selling with P/E ratios of roughly 10 times.

We know things did not turn out well for most investors who participated in the 1920s mania. By 1932, when stocks were down by some 85% and the dividend yield on the stock market was in the double-digits, the entrenched view was that stock ownership should be avoided.

One may be surprised to know that by the mid-thirties there was a rebirth of confidence in the merits of owning "good stocks." From the depths of depression the stock market had more than tripled by 1937 and, according to Graham, investors now looked to combine both the old-time approach with the growth mind-set in valuing stocks. This rebirth in optimism was short-lived, unfortunately, and a new bear market would take stock prices lower by some 45% within 14-months of the '37 highs.

Reviewing the history of prevailing investment theory and stock valuations since 1871 (when good record keeping began) can be instructive. Ways investors think about stocks tend to evolve along with changes in their price levels. A recent example is investors who in 2009 thought stocks were too expensive at 10 times earnings, but now are quite comfortable paying 17 times for them. It's as if, when stocks are cheap, they become too expensive for most people.

The starting point for investments, the price you pay for an asset, determines future rates-of-return. In other words, where you end up as an investor depends mightily on where you start. To understand where we are starting from today, let's look no further than the "CAPE crusader," aka Robert Shiller.

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Though we do not know if he is indeed batman, Robert Shiller's day job is professor of economics at Yale. Famous for the Case-Shiller Home Price Index, he is also custodian of stock market data going back to 1871 and author of CAPE, the Cyclically Adjusted Price Earnings ratio, which measures average corporate earnings over ten years.

There's an old adage that it's better to be approximately right than precisely wrong and CAPE has a marvelous track record of predicting the approximate long term future returns from stocks. It is useless as a short-term tool, but below we have created an "earnings yield" from some starting points and then compared them to the subsequent actual 10-year record. All data is taken from the Yale University website and the book, "Triumph of the Optimists: 101 Years of Global Investment Returns."

DATE:	CAPE YIELD:	ACTUAL REALIZED 10-YEAR REAL-RETURN FOR STOCKS:
1900	5.4%	7.8%
1920	16.2%	14.4%
1940	6.1%	4.0%
1950	9.8%	15.7%
1960	5.3%	5.6%
1970	5.7%	-0.7%
1980	11.4%	11.0%
1990	5.6%	11.4%
2000	2.5%	0.73%

On first blush it looks like CAPE got it more than approximately wrong in 3 out of the 9 periods. In the 1950s, corporate profits and margins grew fast and wide from artificially depressed 1940s levels. It is hard to make the case corporations today will be able to grow in a similar fashion, given the current high base. In the 1970s, the nominal return on stocks was not far off the prediction but inflation destroyed "real-returns." Finally, in the 1990s, CAPE failed to predict the mother of all stock market bubbles but as a 20-year indicator, it got it pretty right. We have looked at innumerable periods and are convinced CAPE is a useful long-term tool in helping to know where we stand. Right now the CAPE yield is 4.3%. As an asset class, therefore, U.S. stocks look pretty expensive.

The Core Portfolio Strategy:

We make a distinction between speculating and investing. Predicting the market's sentiment is speculating and forecasting future cash flows from an asset is investing. Our speculation is that the stock market's ebullient mood is bound to change in the coming months, if not weeks. Investors assume Central Bankers will continue to keep things on a high but we believe markets have already anticipated a lot of good possible outcomes. Also it would not be unusual for the markets to take a step back at some point given the massive rise in US equities in the past 20 months. Therefore we believe risks have heightened for investors and we certainly do not want to participate in the game of buying things solely because they have gone up in price. If there is a melt-up in the stock market from here, it will likely be relatively short-lived and we will have future opportunities to participate in what comes next, but on our own terms.

In the second quarter we repositioned a part of the portfolio with companies using the pre-1920s mind-set. Our focus in the investment process is to own companies for their attractive dividend yields and underlying assets. Many of the stocks are at 10X earnings or less and pay dividends of 4 or 5% or more. By comparison, all stocks that have earnings and pay a dividend have a median P/E of 18X and yield 2.0%, according to Value Line.

Our view is if this 4-year bull-run turns out to be a mirage, then we have the comfort of owning assets that pay us a higher level of income than most other investment vehicles. If the bull market is for real, however, then at some point these out-of-favor stocks could have their turn to come back into favor, and we get paid handsomely while we wait.

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Apart from a couple of special situations, we continue to avoid American stocks that are high dividend payers because they are too expensive. This includes electric utilities, REITs, preferred stocks and other growth-free zones. Europe remains a focus because, apart from glamour stocks like L'Oreal and Diageo, many of their global companies are at deep-recession valuations. Examples include AstraZeneca, GDF Suez, Royal Dutch Shell, Tesco Plc., Veolia and Vivendi, though AstraZeneca's bargain level is more a function of its well-publicized patent-cliff. The Singapore market has lagged most others and we are finding attractive opportunities like Keppel Corp and Hutchison Port Holdings Trust.

We remain defensive because where you end up as an investor depends mightily on where you start and a 4 ¼% CAPE yield for US stocks is not particularly compelling. Fortunately, there are attractive CAPE yields in other parts of the developed world, particularly in Europe. As an example, in France the CAPE yield is 9%. Noteworthy too is Singapore's CAPE yield of 8.2%.

A specific example of a recent portfolio addition that represents our mind-set is GDF Suez (GDFZY). This Paris-based company generates over $120 billion in revenues and its free-cash flow yield to market cap is 13.7%. Its EBITDA to Enterprise Value margin is 21.7%. Based on the recent stock price and euro/dollar exchange rate, the dividend yield is 7%. Its credit rating by S&P is 'A' and its Moodys' rating is 'A1'. GDFZY is in three businesses. First, they are the number one independent power producer in the world with 41% of their revenues generated in emerging markets. Second, GDF has one of the largest natural gas portfolios in the world. They explore for oil & gas in 16 countries, serve as a gas storage operator, own a large transmission and distribution network and are No. 3 globally in LNG. Their other business is called "services" and it includes one of the largest suppliers of environmental, water and waste services in the world. Most of their capacity in their various businesses is under long-term contract. The shares sell at a discount to their book value.

In summary the portfolio strategy is threefold: (1) continue to hold a large amount of cash, roughly 25%, in the model portfolio. (2) Own inexpensive stocks bought for the cash they generate as a tribute to the pre-1920s mindset. (3) Apart from a few special situations like Detrex and Frisch's Restaurants, continue to own companies that will benefit from the rise of the developing world's middle-class. Many of these companies are attractively price because they are seen to be tied to the "Commodities Super-cycle's Demise Thesis" as outlined below.

Reports of the Commodities Super-cycle's Demise May Be Greatly Exaggerated

There have been reports in the financial press saying the decade plus bull market in commodities, the so-called super-cycle, is over. The gist of the argument: China's economy is permanently set into a lower growth mode and Beijing's focus has moved from building infrastructure to encouraging its consumer economy. This will slacken demand for commodities and put downward pressure on prices.

Perhaps it is coincidental, but this death of the commodities super-cycle thesis has gathered steam as commodity prices have fallen. Since Labor Day 2011, gold has dropped by 34% and many other commodities have not fared much better than gold. Gold shares have been even more of a disaster: a proxy for gold mining shares is the Market Vectors Gold Miners ETF (GDX) and that is down 50% year-to-date. Oil and gas shares have generally underperformed the stock market this year but are up slightly in price. The same is true generally for shares of most Agribusinesses except for fertilizer companies and farms, down slightly on average. Shares of some companies involved in global infrastructure are at bargain level with deep-recession valuations.

We outlined both the bullish and bearish case in a recent Forbes.com article:
http://www.forbes.com/sites/greatspeculations/2013/07/09/reports-commodities-bull-market-demise-may-be-greatly-exaggerated/

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Our view is the Demise Thesis is exaggerated because middle-classes in the developing world will continue to expand by the hundreds of millions. Aspiring towards a better life is a universal desire and, apart from some obvious places, a better life is defined in the modern world by having more and better quality stuff. Great demand will remain for energy, better food, water and the infrastructure to support it. Middle class people buy personal care products, consume health care, expect security and spend money on things like education and travel. We assume governments in these countries will continue to seek to meet the demands of their vocal and increasingly better informed populace. Recent civil unrest in the Middle East and the developing world in general underscores that people everywhere want more, not less, today. If their rulers want to hold on to power, they will have to deliver on increased expectations.

We see no evidence in the developing world that a paradigm-shift away from materialism is happening. We conclude globalization remains alive and well and the Age of Pax Americana is not over by a long-shot. There may be a less intense rush for certain commodities like iron ore and copper, but the need will remain. In short, reports of the commodities super-cycle's death may be greatly exaggerated.

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	PRICE:	Year-to-Date Performance
S&P 500 Index	**1,688.77**	**+17.74%**
Dow Jones Industrial Average	**15,548.54**	**+17.98%**
EURO Stoxx	**2,683.79**	**+ 0.69%**
Bovespa (Brazil)	**46,185.22**	**-31.16%**
10-Year Treasury Bond	**2.56%**	

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