BARRACK YARD ADVISORS

Current Anchors

February 2013

The Great Rotation Theory (GRT) and Other Bullish Explanations…

The stock market has more than doubled in the past four years and is up 25-30% in the past 18 months alone. Given what business school teachers call "Recency Bias", it's no surprise many investors and advisors—including major brokerage firms—are saying a new Bull Market is in the cards.

According to the Great Rotation Theory (GRT), the yield from "safe" investments is so pathetically low that investors are changing their behavior. They're fed-up with earning negative returns after taxes and inflation. This is making risk-taking more attractive, resulting in a rotation out of bonds and into stocks.

This theory has a basis in common sense since ***the dividend rate on many high quality stocks exceeds the yield on their bonds***. Take Johnson & Johnson stock. Its 3 ½ % dividend has increased for 51 consecutive years; doubling since 2005. By contrast, a J&J bond maturing in 12 years pays a paltry 3.0% that doesn't grow. What's the better bet, even if your objective is income alone?

Furthermore, for the first time, interest rates on Junk bonds are less than the dividend yield on blue-chips. In other words, ***you get paid more for owning the strongest companies than you do for lending money to risky, low quality companies***. How long can that last?

Proponents of the GRT point to last month's mutual fund flows as evidence the great rotation into stocks has begun in earnest. Money flows into equity mutual funds beat the previous record set in February 2000, according to Lipper. This is a major reversal of the recent 7-year trend during which US investors pumped some $600bn out of US stock funds; and over $800bn into bond funds instead.

GRT or no, stock markets are enjoying a healthy rally and major Indexes are either hitting new highs or are close to them. ***Volatility is muted, reflecting both an optimistic calm and a perception that risks are low. There's a feeling we've moved beyond the Great Recession and investors are betting Central Bankers will do whatever it takes to avert a financial collapse***. And another Bull Market thesis, based on the implications for American's competitive edge due to the "shale revolution" (mentioned in October's *Current Anchors)*, is becoming more widespread.

All in all, optimism reigns in investor-land.

Then there are the Killjoys…

Pessimists argue that the ***fundamental problems facing the world have not gone away.*** There's still too much debt in the developed world, demographics are not favorable, ***the entire global financial system remains fragile***; and ***we remain in a high risk environment made more so by*** both ***rising valuations*** in the stock market and the bubble in bonds and the credit markets. Only market prices have changed.

As one pundit has aptly put it, the system remains vulnerable to shocks without warning.

100 Chetwynd Drive, Suite 204, Bryn Mawr, PA 19010 | Office: 610.525.0949 | Cell: 215.460.0099 | barrackyard.com

Bears further point out that investors have given short-shrift to ***considerable geo-political risks*** and the implications of "de-globalization," including 1930s-style beggar-thy-neighbor currency policies in which as many as 38 countries are manipulating the cost of money and pumping in liquidity at unprecedented rates. ***Central Bank "puts" give a false sense of security*** and will have unknown and unintended consequences, some of which could be hurtful to portfolio values.

There will be a ***fiscal drag this year due to the Presidential Cycle***, the Bears argue, and ***corporate earnings have arguably peaked***. Bill Gross of PIMCO notes that corporations have benefited over the past decade from lower wage costs—a full 5 percentage points—and that roughly a third of corporate America's earnings growth in the past several years is the result of lower interest payments on debt. Neither trend is sustainable. Furthermore, ***it's not a given that the economy won't remain sluggish***, a further drag on profits.

Our View…

We're in sympathy with both theses. Long-term we're always optimists. The potential to compound wealth from owning great businesses bought at good prices; and from owning good businesses bought at great prices excites us. And due to our skeptical nature, we do try to guard against not being optimistic enough.

But ***it's far too soon to know if a secular Bull Market is upon us***. ***If this rally keeps going***, we doubt it'll be due to the Great Rotation. ***It's more likely a function of the enormous amounts of money being printed by the Fed and other Central Banks.***

The big mutual fund inflows last month may be nothing more than ***retail investors chasing short-term performance***—on the back of a great year for stocks in the second half. Equally, a rotation implies an inverse relationship between the demand for bonds and the demand for stocks. If that's true, how is it that US stocks have doubled in the face of hundreds of billions of dollars being rotated out of stock funds, and into bond funds during the past four years?

We are ***more sympathetic to the Bull Market Theory based on America's Energy Independence***, and the opportunities for companies that will benefit from relatively cheap energy. But that is probably years away.

We have a theory of our own. It's inspired by what the Head of the IMF recently said about 2013 being a "make-or-break" year. She mentioned it in relation to global financial stability. But we believe it applies to the Stock Market. And if history serves us, ***we're on the cusp of learning if the long-term Bear Market that began in 2000 is dead, or simply hibernating***.

There have been three secular Bear Markets since Wilson was President of the US: the 25 years ending in 1954; the 17 years ending in 1982; and the past 13 years. All periods experienced multi-year trading ranges. Over the years the stock market would flirt with all-time high prices set in the previous Bull Market, only to hit a glass ceiling near those levels and subsequently fall back to lower prices, frustrating investors.

Going back a century, Bear Markets didn't typically end until the stock market was some 30% higher than the previous Bull Market highs. Then in the years following, investors were rewarded with double-digit average annual returns.

The current Bear Market attempted, but failed, to burst through the old highs in 2007. ***In 2013, we are again up against a glass ceiling. If we burst through it by 30%, this would signal the death of the Great Bear and history suggests we could see the Dow Jones Industrial Average at 35,000 in a decade, or sooner.***

100 Chetwynd Drive, Suite 204, Bryn Mawr, PA 19010 | Office: 610.525.0949 | Cell: 215.460.0099 | barrackyard.com

If, on the other hand, we don't decidedly smash through the glass-ceiling, that means the Bear lives. History tells us we should then expect markets to fall by some 20-25%. If nothing else, this would send terror into the newly stock-market-enamored Great Rotators, if they exist.

The other lesson from history: ***in the Bull Market break-out years of 1955 and 1983, stock valuations were much lower than they are today by every metric—dividend yield, price-to-earnings, price-to-book, etc. This does not augur well for the continuation of the Bull…***

In summary, our thoughts on the Big Picture environment:

- ***Volatility is coming back and the outcome for investors will be binary***: ***History says stock markets will either melt-up by 30% or the Indexes will decline by 20-25%. It's a "make-or-break" year.*** The options markets are priced as if volatility is not coming back and this presents opportunities for buyers (though it's bad news for options sellers).

- The future is unknowable; so ***we must look to our investment philosophy to guide us***. And one precept is: *use caution when things look good, and embrace optimism when they look bleak*. ***Right now things look so good that we must be counted among the cautious.***

- ***No need to chase stocks. If we have a melt-up, expect many years of rising prices but with corrections to provide good future entry points. If the Bear lives, valuations will get cheap,*** and we can have fun bargain hunting!

- Therefore, ***being patient and waiting-for-our-pitch is the strategy***. Invest in companies that will benefit from long-term themes, so long as the dividend remains attractive and the shares haven't fully participated in the rally. But ***keep cash reserves in the 20-25% range***.

The Core Portfolio Commentary…

There's a popular narrative that big, bad Central Bankers are flooding the world with paper money and you're an idiot if you don't own gold. We've stated our case before that gold is for jewelry and not for serious investment because it's just too risky.

Apart from the gentleman's suit metric, we know of ***no credible method of determining the fair value for gold***. For a firm whose tag-line is, "compounding money by design," we have a further problem as ***there's nothing to compound with gold***. And finally, we believe ***there are better ways to hedge against potential inflation/currency debasement.***

We sympathize with the issues gold-bugs are trying to hedge (apart from Armageddon or to give a coin to the ferryman, to mix metaphors) but believe ***owning assets in the global agricultural value chain gives us better protection***. ***Equally, we take comfort in owning toll-taker infrastructure assets (that don't consume too much capital).***

Agriculture: First off, demand/supply. ***Agriculture represents sustainable global demand*** due to both population growth and the clamor for better food in places like China and India. On the supply side, ***inadequacy of supply*** due to stresses on the environment is a long-term reality. ***No one has a clue as to future demand/supply dynamics for gold.***

We think of agriculture as comprised of "unmovable" assets such as farms, ranches, vineyards, orchards; and "support" assets such as distribution networks, storage, trading, fertilizer, etc. on the other. In both cases, ***these are real assets cultivated/built over centuries (in some cases); and potentially rarer than gold.***

100 Chetwynd Drive, Suite 204, Bryn Mawr, PA 19010 | Office: 610.525.0949 | Cell: 215.460.0099 | barrackyard.com

“Unmovable” agricultural assets we continue to buy include **SLC Agricola**, a farm owner and operator in Brazil selling roughly at book value. And **Laurent-Perrier**, a champagne maker that’s been in business for 200 years, selling at 1.4X book. Both companies pay a dividend—unlike gold—and ***we consider them to be rare assets. There are few farm operators the size of SLC. Fewer still enjoy their world-class productivity. Needless to say, there is only one Champagne Region on the planet***.

We added two “agricultural support” names to the portfolio since the last *Current Anchors*: ADM and Mosaic.

Archer Daniels Midland trades, moves, stores, and processes agricultural products around the world. It has compounded earnings, dividends and book value by over 10% a year for more than a decade. We paid less than book value for the shares.

Mosaic Company was spun out of Cargill and is a fertilizer company with valuable mines in the US and Canada. Mosaic is set to start increasing its dividend in a meaningful way; and we paid 11X earnings for the stock.

Cash-generating ***infrastructure assets***:

We think ***a better hedge than gold is an asset that people need to use, that doesn’t cost an inordinate amount to maintain, and which enables the owners to benefit from rising prices in fairly short-order. To us, that describes both financial exchange operators and port operators.***

At the end of last year we owned two Financial Exchange operators, **NYSE Euronext** and **Oslo Bors VPS**. It was announced the Intercontinental Exchange is buying NYSE and the deal should be consummated later this year. For now we’re holding the stock and enjoying the attractive dividend. Should you want a detailed explanation of the deal, please either call me or see the December 22 issue of ***Barron’s***, where I was extensively quoted. The online article: http://online.barrons.com/article/SB50001424052748704379604578185681060862800.html#articleTabs_article%3D0.

Oslo Bors VPS remains a Core Holding despite its languishing stock price. We believe it’s misunderstood by the market and we continue to hold it. The dividend, paid out of free cash flow, is over 10%. Another infrastructure example is **Hutchison Ports Holding Trust** which owns two major deep-water ports at the mouth of the Pearl River in China, the nexus of world trade. To us it’s the ultimate toll-taker. Even though the stock has moved higher, its dividend yield exceeds 7%.

February 8, 2013

100 Chetwynd Drive, Suite 204, Bryn Mawr, PA 19010 | Office: 610.525.0949 | Cell: 215.460.0099 | barrackyard.com