BARRACK YARD ADVISORS

Current Anchors

September 2014

Why Anchors?

The future rate-of-return for any long held asset is tied to its starting valuation, to the price paid at entry. This is because an asset's real value is simply a function of the cash it will generate over time. Determining how to value those future cash flows is a function of many things, including the general level of interest rates.

Think of it this way. If there are two properties of a similar nature, the one that generates more net income over time should be worth more, once differences in sustainability of the income stream and in growth rates are taken into account. After all, which would you rather own, a property with net income of $10,000 per month or one generating only $1,000?

We are able to approximate long-term returns for individual assets and for entire markets because both the cash produced from an asset, and the growth of that cash flow, are finite. In addition, most markets eventually revert to some sort of long-term mean.

In the short-term, valuations can be irrelevant as collective thinking and momentum propel markets to soar higher, or plunge lower, as the case may be. Markets can seem to take on a life of their own and the old lessons are forgotten. Eventually market sentiment and trends reverse themselves, such as when prices fall after a big market surge, and many investors panic since they are not clear on the reason they own stocks.

Thus we are convinced that you must have an anchor to do the right thing in these situations. Typically this means buying businesses we are happy to own even if the stock markets were to close for an extended period. It means not selling securities after a big fall in general prices. The anchor of good assets generating cash flow can help us from caving in at the wrong time. It helps avoid the common mistake of panic selling at a low price after having bought high.

In short, as investors, we always focus on valuations and look to the underlying business strengths of our investments. This is for a very practical reason. To paraphrase investment sage Benjamin Graham, successful investing is much more about having the right temperament than it is about having a high IQ. Focusing on valuations is our way of trying to maintain the correct temperament during good times and bad.

American Stocks Are Expensive. Does a Bubble Await Us?

Despite our qualms about current valuations in the U.S., we do not believe we are at bubble levels yet. Long term, the implied rate-of-return remains on the plus side. This is unlike the very late 1990s when stocks were priced to deliver negative returns. We think this bull market could have room to run.

Looking at U.S. stocks over nearly a century, earnings per share (which can be viewed as a proxy for cash flow) grew by about 4% per year. Notwithstanding America's energy renaissance, given the headwinds of too much debt, unfavorable demographics and the reversion-to-the-mean likelihood of corporate profitability, we think 4-5% growth in US earnings is about the best we can hope for over the next few market cycles.

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Right now our valuation analysis, based on metrics we have written about before, indicates American stocks are priced to deliver no better than a 2-3% total return above inflation over the next decade. Put another way, this is a total return potential of 50% spread out over the next 7-10 years.

The current bull market ranks as the fourth best since 1928 in terms of both duration and magnitude. The stock market has tripled in value over the past five years and there are numerous reasons why the powerful bull could continue to run in the near term. Financial excesses, though present, are more contained than they were prior to the Great Recession. The economy continues to heal, the shale energy revolution is in full swing, interest rates will probably peak at cyclically low levels and geopolitical risks are not likely to derail the raging bull.

Meanwhile, many great businesses continue to be valued at reasonable prices with dividend yields higher than fixed rate bonds. There is no rule that says an expensive market has to go down. To us, low interest rates remain the driver and believe if they continue to surprise on the low side, this would eventually result in a change in the market's perception of interest rates and be good for stocks.

Currently interest rates are below the inflation rate and consensus opinion is expecting a rise in rates to what is seen as more normal levels. That is something like 2 or 3% above the inflation rate. This is known as the real interest rate and many large money management firms' investment models are based on the expectation of 2% real returns.

But what if that was to change? What if, as postulated by Pimco's Bill Gross, real interest rates only rise to 0%? That is a credible theory given that too much debt combined with bad demographics, equal deflation and a possible "permanent" low level of real interest rates.

If such an environment were to come to be, and money managers changed their interest rate assumptions accordingly, that could be a major catalyst for higher prices. It is simple math. Lower interest rates mean you can justify paying more for future cash flows.

To be clear, it is our high conviction belief that U.S. stocks will deliver no better than around 50% returns over the next decade (4 or 5% per year, including dividends). We are simply intrigued by the thought much of that return could be front-loaded in the period immediately ahead.

The Core Portfolio:

Despite U.S. stocks trading at a 25-30% premium to its long-term average valuation, many stock markets around the world are at discounts. For example, Belgium, Brazil, Chile, France, Hong Kong, Norway, Singapore, and the UK all qualify as selling below their long-term averages and there are companies headquartered in each of these countries in the Core Portfolio.

Apart from the U.S., the only country that is not at a discount to its long-term median, and in which we own stocks, is Switzerland which is currently valued at only a slight premium.

An Exercise in Reversion-to-the-mean:

Let us experiment a bit and combine simple math with what is called reversion-to-the-mean analysis. Take two markets, the U.S. and Singapore, and assume both markets will revert to their average valuation levels in a decade. Further assume U.S.

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earnings and dividends will grow by a very optimistic 6%. For Singapore assume they will grow by a modest 4%. Using a simple bond table, the U.S. is therefore poised to deliver annual returns of 4.7% while Singapore would deliver annual returns of 17%. (This is not a prediction but does demonstrate the potential power of buying at low levels.)

Commentary on the Portfolio:

We are underweight U.S. equities but have built new positions in several companies this year believing they are attractively priced, including Aqua America, Carlyle Group, Independence Realty Trust, National Presto Industries and Oaktree Capital.

The thesis for alternative asset managers, Carlyle and Oaktree, was mentioned in my comments quoted by *Barron's* on May 31, 2014 entitled, *Easy Entry into Private Equity*, and in my *Forbes.com* commentary. In a nut-shell, both firms are best-in-class growth businesses that we believe are significantly undervalued in the marketplace and will generate attractive dividend income in the years ahead.

On January 31 the case for our position in Aqua America was quoted in *Barron's* and on August 15th I stated it again on PBS' Nightly Business Report, along with my thoughts on Carlyle and IBM. (You can link from our website to these press reports.) We see Aqua as a quality and predictable growth utility at the nexus of some interesting long-term trends.

Recently we also initiated positions in Independence Realty Trust, a small REIT that owns garden apartments in growing but smaller cities in the American heartland. Due to the short trading history of the stock and its low capitalization, we believe the stock to be undervalued with an expected dividend yield over 7%.

Finally, we now own shares in National Presto Industries, a quirky conglomerate that makes small appliances, adult diapers and low tech armaments. The company is run by Maryjo Cohen, a 30% stakeholder, and has no debt and excess cash. Valuation is low and we particularly like the fact National Presto pays a variable annual cash dividend that could average 7% or more in the years ahead.

Globally, we are in the process of significantly adding to our allocation to Singapore, a gateway to Asian growth and known for its respect for property rights and low levels of corruption.

A new addition to the Asian portfolio is Hong Kong-listed Spring REIT which owns one of the highest quality office towers in Beijing's Central Business District built in 2006. Deutsche Bank has its name on the tower and other tenants include the corporate offices of SAP, Baxter International, Bain & Co. and Cartier. The stock pays an anticipated dividend from operations of over 8%.

We added two European growth companies that we view as "compounders" with low risk business models: SGS Surveillance and L'Oreal. By low risk we are not referring to stock prices but to the highly profitable nature and the enduring aspect of what they do, and to the economic moats they have built to protect their businesses.

We think of 135 year-old Swiss-based SGS, world leader in the testing, inspection and verification industry, as providing the grease for the global economic engine. They enable trust, reduce risk and increase efficiencies for businesses and governments. Their core competency is to ensure tragedies such as the Deepwater Horizon blowout, deadly toys emanating from China, and the Fukushima nuclear plant disaster do not happen, if humanly possible.

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SGS should continue to benefit from the rise of the global middle-classes with their demands for safety and quality and from the hydraulic drilling revolution resulting in the continued proliferation of oil and gas wells in the U.S. An aging infrastructure in the developed world will require stiffer regulation and that too should be beneficial for SGS. As product cycles shorten on many fronts, the need for SGS' services should increase.

Industry consolidation should be an SGS growth driver given that the top three industry players account for less than 10% of the market. SGS has a disciplined M&A track record and the financial wherewithal to pounce on acquisition opportunities as they arise. Globally only about a third of testing, inspection and verification is outsourced by businesses and governments. The trend is now leaning towards greater outsourcing of this key service.

L'Oreal is one of the world's great consumer businesses. They have an unrivalled portfolio of brands including Body Shop, Garnier, Kerastase, Kiehl's, Lancome, Maybelline, Urban Decay, and Vichy. They are poised to benefit from the rise of the global middle-classes given their continued success in the emerging markets. China is now their third largest market after France and the U.S.

The competitive advantages of L'Oreal include its size which enables them to outspend everyone on R&D, their organizational structure which gives them a ruthless efficiency and their strong balance sheet which includes a 9% stake in pharma-giant Sanofi. A catalyst in getting us to buy their shares is the fact L'Oreal is selling at its lowest relative valuation versus its peer group in 25 years.

On the sell side, one position we have exited was Tesco, the global retailer based in London. The UK price wars were more destructive to the overall business than we anticipated. Tesco cut their dividend and we concluded any potential turn-around of the business could be a multi-year process, and we no longer are getting paid to wait.

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