

Current Anchors

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STILL THE ONLY GAME IN TOWN

Easy money policies are creating major distortions in our world. In the social sphere, by elevating asset prices and reducing the affordability of many things, they contribute to the widening divide between rich and poor. They actually benefit the profligate at the expense of the thrifty.

In the marketplace, easy money has kept struggling businesses alive and has contributed to deflation, the very thing Central Bankers are fighting. These corporate Zombies continue to produce redundant stuff, creating a greater supply of things than in a 'normal' economy.

Stocks moving in tandem—to an unprecedented degree—is another consequence. This means most boats have risen with the tide, giving rise to the popularity of index investing although that strategy still doesn't guard against frustration and loss. For example, an indexing strategy based on the S&P 500 Index generated no returns whatsoever for the decade ending in 2010.

In parts of Europe, where negative interest rates hold sway, bankers treat everyone like the gangster in the movie Scarface: depositors must pay bankers for holding their funds. Betting that deflation will become entrenched, European Institutional investors are buying bonds guaranteed to lose money, at least in nominal terms. They then hope to make money in real terms.

If that last sentence is not intuitive to you, count yourself among those afflicted with "money-illusion." Money-illusion refers to the tendency people have to feel richer, or poorer, without considering the inflation or deflation rate. People fear deflation because of money-illusion, but also because it is associated with bad times like the 1930s, and not boom times like the late 19th Century. Politicians know this and that is why they promote feel-good inflationary policies.

Most of us have only experienced inflation. But it is now possible we are in deflationary times. Generally lower prices for everything is not necessarily good, or bad. It is just different.

In the US, stocks have only been more expensive twice before: in 1929 and 1999. Bonds have never been more expensive, at least since good record keeping started in 1694. Investment real estate, so sensitive to the level of interest rates, is equally over-valued. The recent collapse in oil prices, predicted by virtually no one, reminds us that commodities are not investments but speculations.

Market chatter today is consumed by talk of potential interest rate hikes. In the US, we may move from ZIRP (Zero Interest Rate Policy), to LIRP (a Low Interest Rate environment). As an investor, if you spend more than a passing moment worrying about interest rates rising, you are either over-levered or you own things that are too risky.

Easy money is probably here to stay and this continues to be a positive for the "only game in town," the stock market.

Easy money helps stocks in many ways including the following three:

- Investors are willing to pay more for earnings.
- The income they produce competes favorably with bond rates.
- Companies can issue debt and buy back stock because low interest rates make the math work. At least for now.

The corporate demand for stocks is massive. In aggregate, last year Corporate America issued roughly \$600 billion of debt to buy back roughly \$567 billion of its own shares. That represents nearly 3% of the value of all publicly traded companies.

How does all this play out over the next couple of years? It's anyone's guess, but a bigger bubble in the U.S. followed by a bad ending is not out of the question.

Right now my thoughts are focused on how to protect ourselves in this economy while still trying to make money!

THE BEAR IN THE ROOM:

As an investor, I try to remember mistakes and quickly move on from successes. Unless, of course, success was due to a process that can be repeated (as opposed to dumb luck). Predictive success attributes can include skin-in-the-game, low price-to-earnings multiples and discounts to net asset value.

One mistake I made way back in the 1980s, helping to guide me today, relates to oil. Like today, oil prices collapsed, seemingly out of nowhere, after having enjoyed a seven-fold rise in the previous decade or so. Like now, experts made compelling cases for why oil prices are bound to resume their upward trend. The mistake I made then was listening to these experts.

I have no special insight as to where oil prices are headed. I have no conviction as to whether prices will continue to rebound from recent lows, or go lower and remain there. I do know, however, that Wall Street expects oil prices to rebound to \$70 or so this year versus a current price in the mid-50s. The lesson from the 1980s is that Wall Street is as likely to be wrong about future oil prices as right.

Oil prices in real terms peaked at roughly \$115/barrel in May 1980. Interestingly, this is about the same level set in its recent peak and about its high before the brief upward spike in oil prices back in June 2008. (Data from *Macrotrends*.)

After peaking in the early '80s, oil prices did not bottom until 1998, some eighteen years later, at about \$16 adjusted for inflation. The first wave of price declines was accompanied by numerous oil industry bankruptcies and home price declines in places like Texas and Oklahoma. The real killer came in the late '80s when there was yet another 50% drop, contributing to the S&L Crisis, among other things. The silver lining was the collapse of the Soviet Empire and the extra cash oil consumers were able to pocket.

If the consensus view on Wall Street is correct about oil prices, then we do not have much to fear from this sector. Unfortunately, if history repeats the pain has only just begun. Quality businesses in this sector will be relatively "dead" money for many years to come. Everyone else will suffer permanent loss of

money. It will have a knock-on effect hurting oil industry creditors such as banks and owners of high yield bonds. Real estate prices in the oil patch will also fare badly.

And it could be contagious, triggering one of those big standard deviation events that believers in the Efficient Market Theory say only happens once in a thousand years, but seem to come around every now and again.

THE STRATEGY—WHAT TO DO NOW:

The strategy is to play defense by renewed emphasis on the first Enduring Principal: *valuations matter and price focus is the best protection*. There are three ways to approach this.

- First, own quality low-PE stocks that no one wants.

In every environment, the longer-term investor has done fine by owning excellent businesses bought cheaply. The reason this works has to do with the concept of earnings yield, although I use free cash-flow yield too. A stock trading on an 8% earnings yield (12 ½ P/E) should generate a similar return for its investors over time, plus or minus. Plus, if earnings grow and the stock becomes popular. Minus, if the business declines.

It is therefore important to own businesses that can grow. To grow, a company needs to be relevant in its marketplace and it needs capital. This is where quality is important. A quality business has dependent customers and the economic wherewithal to fend off competitors. Three examples of this are Deere, IBM, and Oslo Borse. Their earnings yield is roughly 10%. By comparison, the earnings yield on all *Value Line* stocks with earnings is 5.2%.

- Second, own quality growth businesses that are cheap relative to their historic valuations.

In the US, there was a mini-bubble in domestic mid-cap industrial stocks that peaked a couple of years ago. Valuations are now much more reasonable and examples include Donaldson Co., Fastenal and Valmont Industries. These firms are elite in terms of long-term earnings growth, profitability and return on investment. Current earnings yields are higher than their long-term median.

- Third, own “strategies” that are either deeply discounted or have a degree of not being correlated to the stock market.

An example of something deeply discounted is Jardine Strategic Holdings, trading at a 35% discount to its publicly traded subsidiaries’ market value. Jardine has been in business for 175 years and owns several blue-chip Asian companies experiencing good growth. A company whose intrinsic value should grow independently of how the stock market performs is Third Point Re. This stock trades at its book value and over time its results will reflect the performance of Dan Loeb’s Third Point Hedge Fund.

From the depths of the Great Recession, we have experienced six years of upward stock market movement. Risks are elevated but a general mood of caution is in the air and that is positive. There is an old adage that Bull Markets do not die of old age or over-valuation. They are killed by recessions.

To assume a bear market awaits us in the near future is to believe we are on the cusp of recession. I may be wrong, but I think the economy continues to chug along and therefore the Bull has life in it yet.

Bull markets are always followed by bear markets. The end of bull markets is never heralded and when it happens, few are prepared. As Jonathan Swift said after losing his shirt in the stock market some three centuries ago, “no man prepared for it; no man considered it would come like a thief in the night, exactly as it happens in the case of death.”

In other words, the time to prepare for a bear market is always.

Value Line earnings yield:

July 13, 2007 -	Market Top Prior to Great Recession:	5.1%
March 9, 2009 -	Market bottom in Recession:	9.7%
April 22, 2015 -	Currently:	5.2%
Oct. 26, 2014 -	Six months ago:	5.9%

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