BARRACK YARD ADVISORS

Current Anchors

August 2012

No Place to Hide

Too much debt and the need for entitlement reform is the mantra for our times. To steal a line from a former Secretary of Defense, these are the known 'knowns.'

Another 'known' is that we've been here before. In the late 1940s, national debt as a percentage of national income was higher than today.

Like now, fear about the economy was widespread. Fixed income investors were enjoying a decades-long bull market; and stock market investors were muddling through a long period of miserable performance.

Like now, stocks yielded more than bonds.

The policy response in those days was two-pronged: keep interest rates artificially low and provide stimulus to support economic growth. Sound familiar?

And we know the outcome: Policy response successfully reduced the debt pile.

In the following decades, national debt as a percentage of income would decline by two-thirds bottoming at roughly 40% of income in 1980.

This long march toward debt reduction brought with it a prolonged and massive bear market in bonds.

…continued on page 2

IN THIS ISSUE

(Euro)-Misery Makes Good Company

For the moment, the US has regained its "safe-haven" status among global investors. The S&P 500 is up over 8% in the past year. The dollar has strengthened more than 14% versus the euro and by 20% against the Swiss franc. The greenback is enjoying its strongest run in relation to emerging market currencies since the Asian Financial Crisis of 1998.

There are many things for a global investor to like about the US. Exports are strong, consumer debt levels are down, our banks are among the better capitalized ones in the world and home prices are undervalued. The shale gas boom is for real.

Investors assume Congress will do something to avert falling off the "fiscal cliff." (That's what will happen to the economy if automatic spending cuts and automatic tax hikes go into effect in January!)

…continued on page 2

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

…continued from page 1 | **No Place to Hide**

Government bond yields slowly increased from less than 2% in the late 1940s to over 6% some 20-years later. Inflation-adjusted, bond investors suffered negative returns during the 1950s, the 1960s and the 1970s.

Wealth destruction would continue in 'safe assets' until yields moved decidedly into the double-digits in the early 1980s.

By then bonds were a discredited assets class, contemptuously referred to as "Certificates-of-Confiscation."

While acknowledging that history doesn't necessarily repeat itself, we do note that stocks did very well during this period of debt reduction.

> *"Wealth destruction would continue in 'safe-assets' until yields moved decidedly into the double-digits..."*

This is not meant to be taken as our bullish case for stocks. We believe sentiment is still too optimistic, and valuations too high, for a sustainable secular bull market in the US to emerge.

We only want to point out that today—as in the past—bonds may not be a true safe haven for investors. There may be no place to hide.

…continued from page 1 | **Misery Makes Good Company**

Long-term indicators suggest US stocks are currently neither cheap nor expensive. The earnings yield is about 7%.

But short-term the US market looks pricey, if not downright expensive to us.

There's quite a different story in Europe, though. The consensus view is that euro-land is in a recession, including Germany, and there's continued fear about a bad ending to its well-publicized debt crisis.

Stocks are down there by some 13% generally in the past year as the outlook remains pretty miserable.

So naturally we're attracted to Europe right now, given that miserable outlooks often imply bargain opportunities.

Indeed, we are finding many great companies in Europe are selling at good prices and many good businesses are selling at great prices.

One of the long-term valuation indicators we use is called CAPE, the cyclically adjusted price-earnings ratio.

By this measure, European stocks are close to their early 1980s levels and only about 20% or so above their all-time record lows.

(Euro)-misery may indeed be good company!

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

Core Portfolio Comments:

We added two names to the Core Portfolio since our last letter.

Sysco Corporation is the leading United States marketer and distributer of food, equipment, supplies, and related products to the foodservice industry.

The company has an excellent record of increasing its dividend and shrinking its share count. It historically enjoys a high return on equity and a ROIC in the mid-teens.

Earnings per share have compounded by 8 ½% during the past decade. Current dividend yield is 3.7%. P/E on this blue chip is 15X.

The Clorox Co. operates in four segments: Cleaning Supplies; Food Products & Water Filtration Systems; Household Products such as charcoal, cat litter, plastic bags and wraps; and Containers.

The company generates excellent cash flow and has repurchased 45% of its share count in the past decade. Earnings have grown by 9% and the dividend by 11%.

Clorox has more debt on its balance sheet than we usually like to see, but its cash flow is strong enough (and its business stable enough) to support it. Current dividend yield is 3.6%.

General Portfolio Comment: We are keeping roughly 20% of our portfolios in cash.

The Problem with Indexing, or *Why We Don't Like ETFs*:

Indexing is passive investing; commonly referred to as ETF investing. The objective of an ETF is to replicate the performance of a specified Index.

Since 1995, ETF share of all US equity assets has increased from 5% to 26%, according to Goldman Sachs. Clearly they are very popular.

For us, ETFs are problematic because ETF investing runs counter to three of our 5-Enduring Principles.

1. We believe original price paid is the most significant factor guiding future rates-of-return for an asset.

ETF manufacturers don't focus on price. For them, liquidity is paramount. Accordingly, certain things we view as positive are a big negative in the ETF world.

For instance, heavy insider-ownership is a positive for us—we believe owners are more apt to do the right thing than renters—but for an ETF it can be a big negative because it reduces float, i.e., liquidity.

> ***"…certain things we view as positive are a big negative in the ETF world. "***

2. We believe reversion-to-the-mean is the most powerful force in finance.

In ETF investing there's no mean to revert to. Within an asset class, ETFs are the mean.

…continued on page 4

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

…continued from page 3 | **The Problem with Indexing**

3. Careful investment selection trumps random diversification.

Capitalism produces winners and losers. ETF investing means owning both the winners and the losers, the 'good, the bad and the ugly,' so to speak.

We focus instead only on the good.

Apart from violating our investment philosophy, there is another problem with ETF Investing: it's subject to the "Law" of Reflexivity.

Evidence is building that many ETFs no longer just mimic an Index, but instead influence the Index itself.

ETFs don't simply reflect reality, they drive it. That's Reflexivity.

Concern about Reflexivity for commodities has been part of an ongoing debate—including the current one about copper in the US Senate—as to ETF's role in promoting boom/bust cycles.

In the stock market not much has been made of this phenomenon. Recently, however, Murray Stahl demonstrated that companies popular with ETF-manufacturers are more expensive than those that are not popular.

In an example used, ETF-popular firms were both financially weaker than, and twice as expensive as, the ETF-unpopular ones.

This is an important insight that has us thinking through its implications.

No doubt it will lead to creative applications. An ETF comprised of ETF-unpopular stocks perhaps?

Current Prices (7/30/2012)

S&P 500:	**1,380**
MSCI World	**1,253**
10-yr. T-Note:	**1.53%**
Gold:	**1,618**

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