Craftsmanship & Fertilizer

The last letter I sent to clients was an important one. It discussed specific techniques we can use to have efficient control over our market risk.

Unfortunately, after sending it, I received a few comments that it was too technical. One observer suggested that at six pages it wouldn't function well for marketing purposes. After all, this is the age of hyperlinks, sound-bites, and 140 character tweets.

I pushed back. "I'm not interested in investors that find six pages onerous. Those people can always use some online tool where they enter their birthday, income, and risk appetite and magically have all their questions answered. If they want, they can even invest in target-date retirement funds and telegraph straight to Wall Street exactly where to take their money next."

As soon as I ran out of breath—and reflected—I realized my critic was right, and I was wrong. I needed a way to communicate the gist of my approach to prospective clients succinctly. Highly customized, collaborative advisory deserves to be better understood.

So I turned to an old friend to help me produce a video that hopefully accomplishes that in 60 seconds—a window I hope even the busiest internet users can spare. Each image comes from my personal collection, and I hope you find it thought provoking:

Craftsmanship. What exactly does that mean for investors?

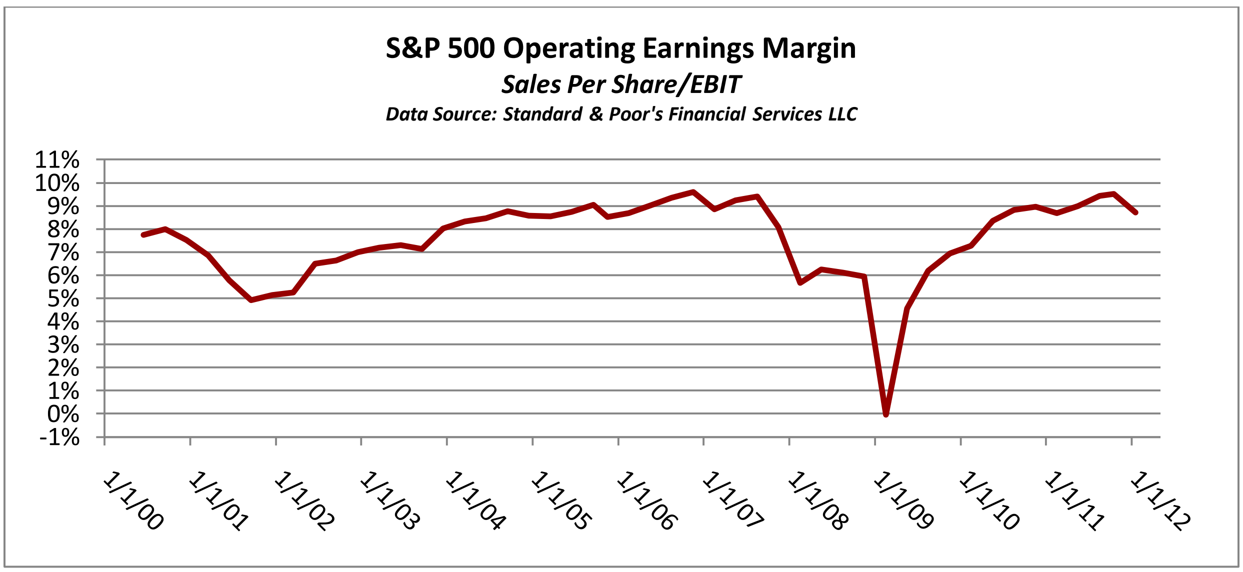
David Pye, a professor of furniture design at London's Royal College of Art, was interested in the "workmanship of risk," which he defined as "the use of any kind of technique or apparatus, in which the quality of the result is not predetermined, but depends on the judgment, dexterity and care which the maker exercises as he works." My last letter on risk management gave an overview of how investors can express *dexterity*. This letter will focus more on *judgement*.

Judgment requires something to judge against. In our case, this baseline is the S&P 500:

Year	S&P 500 Price	Operating Earnings (EBIT)	Dividends	Operating Earnings (EBIT) Yield	Dividend Yield	Current P/E Ratio	10 Year Cyclical P/E Ratio	10Y Treasury Yield	Earnings/Treasury Yield Spread
2002	$879.82	$46.04	$16.08	5.23%	1.83%	19	21	4.61%	1%
2003	$1,111.91	$54.69	$17.88	4.92%	1.61%	20	25	4.01%	1%
2004	$1,211.92	$67.68	$19.41	5.58%	1.60%	18	25	4.27%	1%
2005	$1,248.29	$76.45	$22.38	6.12%	1.79%	16	24	4.29%	2%
2006	$1,418.30	$87.72	$25.05	6.18%	1.77%	16	25	4.80%	1%
2007	$1,468.36	$82.54	$27.73	5.62%	1.89%	18	24	4.63%	1%
2008	$903.25	$49.51	$28.05	7.24%	3.11%	18	15	3.66%	4%
2009	$1,115.10	$56.86	$22.31	5.45%	2.00%	20	18	3.26%	2%
2010	$1,257.64	$83.77	$23.12	6.65%	1.84%	15	20	3.22%	3%
2011	$1,258.00	$96.44	$26.43	7.67%	2.10%	13	18	2.79%	5%
2012 est.	$1,450.00	$102.00	$29.00	7.03%	2.00%	14	19	1.90%	5%
Averages				**6.88%**	**3.11%**	**16**	**21**	**6.64%**	**0%**

What we see is that the opening Q4 price of the S&P 500 (~1450) is supported by ~$14 more dollars of earnings per share than the last time we saw that price in 2006. From a value perspective, that is a very good thing. We also have a much more attractive spread between corporate earnings yields and the yield on 10 year U.S. Treasury bonds – a 5% spread today versus a 1% spread then. Combined with the commitment of the Federal Reserve to keep interest rates low for the foreseeable future, there is also less uncertainly about this spread going forward. We can therefore judge that stocks remain quite attractive relative to bonds, given current corporate earnings.

How do we know if these earnings are sustainable? A baseline for that can be found by looking at operating margin history. At 9%, we are ~1% higher on margins than the 10 year average of 8%. The chart can be seen below. On a forward looking basis, since we are now almost 4 years into a cycle of improved earnings, it's getting increasingly likely that margins will soon revert towards the mean. Also, given the fitful underlying economy, there aren't many reasons to believe we have entered some new enduring era of higher margins. Much of the current rebound in margins was driven by cost-cutting, and so we must assume that companies are now running about as lean as possible given their sales. Simplified: sales are up, costs are down, and thus earnings are strong.



Fertilizer. Is the garden's bloom natural?

Looking at our portfolios right now is like looking at a garden where the flowers are all blooming at once. Most every color and description of investment is working: domestic stocks, international stocks, domestic bonds, international bonds and commercial real estate. Even the emerging markets are sprouting and showing life.

Isn't it unusual for everything to bloom at once? Yes, particularly for both stocks and bonds to be working simultaneously. This horticultural bonanza is sponsored by the economic equivalent of "Miracle-Gro® LiquaFeed® Advance™." This highly engineered product, *unconventional* *central bank policy and monetary stimulus,* is coming from all sides. The Federal Reserve, the ECB (Europe), the SNB (Switzerland), the PBOC (China), and the BOJ (Japan), are all working on a harmonized basis to stimulate the global economic garden. Our primary markets have responded to all this chemical fertilizer:

Performance Update	**Q3 2012**	**YTD 2012**
MSCI Germany Index	21.6%	20.3%
S&P 500 TR Index	9.1%	16.4%
J.P. Morgan Emerging Market Bond Index	7.6%	15.2%
MSCI World Index	6.8%	13.7%
Cohen & Steers Realty Trust Index	2.5%	13.7%
Market Vectors Vietnam Index	-12.0%	9.9%
Barclays U.S. Aggregate Bond Index	1.4%	4.0%
FTSE China 25 Index	8.1%	3.6%

This should be no major surprise to clients. Our base-case scenario since 2009 has always assumed that debt levels around the world were simply too high, and under those circumstances the answer for policymakers would be timeless – print new money to pay for it, and let society cope with the problems that inevitably follow after they depart office.

Certain assets are decidedly “in” for this type of season. We bought German stocks sporadically throughout the year because we believed German firms are some of the best managed and most competitive in the world. Moreover, they have been and still are priced quite attractively to U.S. stocks on an earnings yield basis. That is an unusual opportunity given the premium they typically command.

U.S. bonds, however, are flowers blooming out of season. While they continue to perform positively, I just don’t understand how investors can benefit sustainably by owning bonds whose only real enthusiastic buyer is the same entity borrowing the money – the U.S. Government. When I’m confused about an asset, I just don’t like to invest in it, and thus we have held minimal U.S. bonds. While forgoing these gains is tough, the numbers clearly show that our positioning has been correct on the whole: the 27% cumulative gain of the U.S. Aggregate Bond Index since 2009 can’t hold a candle to the 73% cumulative gain of the S&P 500 over the same period. Our error was to opt for cash over bonds, but making a Faustian bargain with the Treasury for 1.5% interest still seems as crazy as ever. In my analysis they would need to yield closer to 3.2% to be attractive here on their own merits.

Real Estate Investment Trusts (REITs) are also in good season. We've benefited from the view they would gain on more government intervention in bond markets. While individuals and families might be struggling to get mortgages or business loans, those who are borrowing on the massive wholesale level are getting literally "fantastic" rates. Many loans made to REITs on a shorter-term basis are structured around LIBOR, the London Interbank Offered Rate. Recent headlines have shown us this rate has been illegally held at artificially low levels by manipulative bankers and complicit government regulators in Europe. Combined with the generally low domestic interest rates being generated by the Federal Reserve, this has offered REITs uniquely good access to short-term capital. This has helped them secure excellent AAA real property on attractive terms, which they can now refinance for the longer-term in the equity markets. While the competitive advantage of cheap finance may be fading to some degree, the harvest to be had from owning real property in an inflationary environment remains quite possible. I hope to increase these positions on any weakness as well.

Finally, we remain interested in shares in China and Vietnam despite their relative weakness for a number of reasons. First, both countries are in very different parts of their economic cycles than the United States. They are depressed and experiencing intense bear markets. As a result, valuations have become attractive relative to domestic stocks:

	Price to Book	Price to Earnings
S&P 500 Index	**2.12**	**15.8**
MSCI Germany Index	1.45	13.3
FTSE China 25 Index	1.35	8.2
Market Vectors Vietnam Index	1.32	11.1

Source : S&P, Blackrock, Inc., Van Eck Securities Inc.

(Note: P/E based on trailing 12 month earnings)

Further, each of these country's markets has a range of factors (particularly their export economies/trade surpluses) which cause them to display lower correlation to the S&P 500 than other investments. This gives us both quantitative and qualitative optimism that they could react uniquely during a period of pressure for U.S. markets.

The hitch is that all of these ideas are ultimately relative-value based judgments. That means we expect them to do well if the whole garden keeps growing. But as value investors we think more like organic farmers, and are thus worried about the chemical fertilizer in the economic system. It threatens the long-term sustainability of our crops. The use of heavy chemicals leads to imbalances in nutrients, and if policymakers take the money printing too far, the whole garden will get burned regardless of relative value.

Fortunately, since I'm not a politician, I can tell the hard truth here. What the economy needs to heal for the long-term is more struggling and dying firms—something conspicuously absent in the aftermath of the biggest recession in two generations. When bail-outs and freshly printed money become the norm, capital is not released naturally back into the system to support the plants of the new season. This quick-solution mentality has gotten quite insidious in America, and is part of my interest in other global economies. The most egregious example I've seen yet happened last month when Knight Trading, a Wall Street trading firm, lost $440 million in a few hours because their software designers wrote some broken code. After requesting some of their trades get broken outside of clear regulatory rules, Thomas Joyce the CEO had the extreme gall to say "There's no reason to put a firm at risk because some knucklehead or series of knuckleheads at the firm made a big mistake." Mind you, this is a company that lives off the minutest trading errors of others. While glossed by the media, this type of statement is a stark reminder for us to monitor the financial sector's position on the hubris-humility index[i]. While they may feel bullet-proof again today, some plants will inevitably fall back to the earth and become compost yet again.

Succeeding at this stage of the cycle will require that we make some of the toughest decisions we've had to make yet. We will be buying in uncomfortable regions and selling down in those that seem the most comfortable. We must also start to actively reduce our net exposure, because the best of margin expansion is now behind us. While all the chemicals will probably cause lots of plants to stretch further towards the sky, we simply can't afford to be short of cash when the next contraction comes and good organic compost can be found once again.

Best,

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[i] A very interesting concept explored by University of Chicago's professor John Mearsheimer.