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Investment Newsletter – December 2012

Given the prominence of the "Fiscal Cliff" negotiations at year end, this newsletter will discuss the issues involved and the implications for the economy and for investors. For those of you wishing to avoid any further mention of the Fiscal Cliff, you may skip ahead to my analysis of the link between investment valuation research and controlling emotions in stock buy/sell decisions. Finally, this quarter's newsletter will review market outcomes for 2012.

The Fiscal Cliff

The numbers we see in the media about budget numbers are mostly the numbers made up by the politicians for their own purposes. But if we dig into the details of government financial reports we can get a rough picture of reality as it would be reported in the private sector. As we detailed in the June 2010 newsletter, the total of government liabilities (including official treasury debt and the present value of social programs) is roughly 26 times annual government revenue. In addition, liabilities are increasing at roughly 75% of revenue each year. To put this in terms of the family budget, it's equivalent to a family with after-tax income of $100,000 per year and debts of $2,600,000, who continue to spend $175,000 per year. Clearly the government cannot pay these obligations in the long run. The longer things continue as they are, the bigger will be the ultimate disruption to the economy. Despite the hand wringing about "falling off the cliff", the dramatic reduction in spending and increases in taxes set to take effect for 2013 are actually a good thing for our long run prosperity – even if it triggers some pain in the short run as the nation adjusts to a lower level of consumption. Even so, this fiscal tightening by itself will not be enough.

While a reduction in deficit spending is desirable for our own long run good, the exact composition of taxation and spending is obviously of great importance. The politicians in Washington who we elected to set tax and spending priorities, enacted the 2011 debt limit deal which specifies what happens if they cannot agree on entitlement reforms. Thus we face a 10% cut in all other government spending and taxes would rise for everyone. (Keep in mind these are not real spending cuts but rather cuts from what they otherwise might have spent). The split decision of the 2012 election implies that there is no national consensus in favor of the entitlement reforms needed to keep taxes from going up. By allowing the 2011 deal to take effect, the politicians will be heeding the election results. Making some "grand bargain" to "avoid going over the cliff" as touted in the media, really means that each side goes against the voters who elected them. It would also mean stepping back from deficit reduction and putting off the first step of the economic adjustments needed to get our finances in order.

Given the two sides' positions, it seems virtually certain that the tax increases will take effect (at least) for higher income taxpayers. It is also likely that spending reductions will be close to those scheduled. This combination will almost certainly push the economy into recession or deeper into recession if we are already in one. Such a scenario would tend to push down long run inflation as well as corporate profits. Thus it is more favorable for bonds and less so for equities.

Stock Investing – Emotions and Analysis

The essence of investing in stocks is deciding when to buy and when to sell. I've often heard from individual investors that they buy stocks based on tips from friends, or based on news stories. Hunches and positive views of the company often are the deciding factor without any consideration of the price paid - relative to company value. We also see professional investors investing without regard to price – as we saw with the Facebook's initial public offering. This phenomenon happens most frequently with "story stocks", those companies that are well known, with positive publicity and seemingly unlimited potential. People tend to understand and believe a story much more readily than they can comprehend the complexity of the underlying business and economic variables. This type of investing is essentially a short cut to avoid the hard work of analysis.

There are various alternative methods of investing but let's focus on fundamental value investing as practiced by Berkeley Investment Advisors (and Warren Buffet, and many others). Under this methodology the investor analyzes a company's financial statements to calculate an "intrinsic value" for the company (and its shares) – what the business is worth irrespective of the price quoted in the stock market. Of course the intrinsic value can never be known with certainty but there will be varying degrees of confidence in such a value. Even if the estimate is very uncertain, the stock may be confidently purchased if the market price is sufficiently lower than the estimated intrinsic value. Such a discount is known as the margin of safety (as described by Benjamin Graham the mentor of Warren Buffet). On the other hand, if we own such a stock and its market price rises above the intrinsic value we've estimated, our confidence that it will provide acceptable returns going forward will be diminished. At some point price will reach a point where we will want to sell so as to invest in something with a lower ratio of price to value. Since cash (by definition) has a price equal to its intrinsic value, it will be an alternative use of funds when stocks rise above intrinsic value.

Note that the above description of value investing contains a well defined rule for selling a stock – when its price exceeds its intrinsic value. Conversely since our buying confidence rises as price goes down (and margin for error rises), we will naturally be inclined to buy more shares as the price of our shares go down. So we are buying low and selling high – sounds good.

The importance of this becomes clearer when you look closely at how stock prices fluctuate in the market day to day. Prices of stocks are determined by supply and demand in the market. As noted above, fundamental investors will provide supply to the market as prices rise and will provide demand as prices fall – depending on their own estimates of value and their liquidity needs. Far larger sources of supply and demand will come from other sources – lets' call these sources technical traders or liquidity traders. Academics sometimes call them uninformed traders because they are buying and selling for reasons unrelated to the difference between price and intrinsic value. One example would be an Exchange Traded Fund that is tracking an index such as the S&P 500. If money is flowing into this fund, it will be buying every stock in the index, regardless of price. If money is flowing out, it will sell them all. There are also many day traders looking at charts (technical indicators) and trying to trade ahead of moves by the fundamental investors. All of this creates random fluctuations (also known as noise) in stock prices. Because fundamental investor volume may be much lower than volume from technical traders, stock prices may diverge very significantly from any particular estimate of intrinsic value. This is what creates the opportunity for earning higher returns.

Now suppose you are a story stock buyer who has no intrinsic value to compare market prices. When should you sell? The population tends to fall into two camps – the first is those who will sell from fear of losing more money once their threshold of pain is reached; the other camp will hold onto a loser no matter what to wait till they can break even on their investment. The good news is that each could be right some of the time.

Let's consider some possibilities. Suppose you bought a stock 30% above its true value and it subsequently drops 20%. Big downward price moves tend to negate the positive story and lead to bad publicity. If you are in the sell group, you're out with only a 20% loss. If you're in the hold group, you'll hold it and probably lose another 10% rather than putting the money in something more likely to rise than fall. The investor using intrinsic value as a guide would not have bought in the first place.

Now, suppose you bought a stock 20% below its true value. If it falls 20%, again the sell group will get out. In this case the hold for breakeven group will probably recoup their investment – but then sell at breakeven and miss the subsequent rise to full value. If it is technical factors driving the stock lower and not news, fundamental investors looking at price versus intrinsic value will increase their return estimates and their confidence as the price falls and buy more. This is how a stock "finds a floor".

The moral of the story here is that investors informed by thorough analysis of a stock's value are much more likely to avoid emotion driven buying and selling mistakes because they will have an objective rule for when to buy and when to sell. This is especially true when the market drops sharply. If we have no objective reason for believing our stocks will recover, fear will rule the day and we may sell when we should not. Of course, another alternative is to hire a professional advisor who you can rely on to help keep your emotions out of your investment decisions.

A Look at Stock and Bond Markets at Year End 2012

The stock market went almost nowhere in the first half of 2012 but the second half made up for it and the S&P 500 returned 16% for the year – despite falling revenue and profits at the end of the year. Our equity strategy, Long Term Value, was in line with the index until the end of October but lagged the index in November. The November performance can be traced to 4 stocks – two of which are gold miners. I fully expect that this underperformance will be reversed over the long run. Over the life of the strategy it has outperformed the index by a very wide margin (63.7% versus 41.2% according to Folio Investing – before fees).

Bond markets did extraordinary well in 2012 – primarily due to the Federal Reserve Bank's interventions to drive up bond prices. The Lipper high-yield corporate bond benchmark returned 13.6% for the year. By comparison our Long Term Income strategy returned 17.5% (before fees) and the Short Term Income strategy returned 24.5%. The Short Term Income strategy benefited from the growing popularity of bank loan funds in 2012 and active trading to take advantage of technically driven price swings. While I expect decent returns on these funds going forward, no one should expect a repeat of the 2012 results.

Outlook

The downturn in 2008 led U.S. companies to wring out excess costs and boost productivity by cutting less productive workers. Since then, the anemic level of growth has vastly restrained the urge to rehire these workers. Consequently, there is little room for cost cuts to drive future profit increases. I expect that most companies will not be able to cut costs enough to offset the drop in revenues that will come if we are entering a new recession. I expect market indices to drift downward as unfavorable economic conditions show up in earnings reports.

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