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Careful What You Wish For

There have been no shortage of things to worry about throughout this five year bull market. Though the crescendo of fear and uncertainties of 2008 and 2009 has receded dramatically, the rally in stocks and the daily drumbeat of global, national, local, political and financial news can still stir anxieties. It is difficult to keep the noise in perspective every day, but it is far easier to make reasoned decisions on individual stocks. **Today we are encouraged by both the individual stocks that we own and by the prospect of having a healthy slug of cash to put to work if we run into a period of heightened market anxiety.**

Few things are more encouraging to us than finding a company that we believe is on the way to ramping its earnings, trading at “our kind of valuation.” Remarkably, five years into this market up-cycle, we are still finding a few companies with improving fundamentals selling at around 10 times this year’s earnings in a market valued at about 16 times estimated earnings. Outside of periods of high inflation or recession, buying growing companies near 10 times earnings has been a solid formula for generating healthy returns. Looked at another way, if the P/E is flipped over it becomes the earnings yield. Thus, the 10 P/E equates to a 10% earnings yield. If a company’s capital expenditures roughly equal its annual write-off for depreciation and working capital is stable, then the earnings yield is a simple estimate of after-tax cash flow that could be distributed to shareholders as a percent of the share price. In fact, many companies return a large portion of earnings to shareholders in the form of dividends and share repurchases, with the remainder reinvested in the business for growth. Think of that 10% earnings yield compared with a 10 year Treasury at 2.7%, cash near 0%, or other alternative investments with less liquidity. On the other hand, a stock selling at the market multiple of 16, or an earnings yield of 6.3%, can still reward investors, but has less margin for error and will need to have high reinvestment rates and consistent growth, particularly in a higher interest rate environment.

To be clear, most of the market is fully valued, which is why we currently carry close to 20% cash. We have never felt compelled to be fully invested if attractive risk/reward situations are not available. While many view risk as underperforming an index or benchmark, we view risk as the permanent impairment of capital. High cash reserves will certainly result in “benchmark risk”, but can also shield capital in market declines and be put to work at opportune times. By providing cushion in downturns, cash can help stave off panicked reactions and allow the switch to offense when others are on defense. The value of liquidity should not be underestimated.

We are also building liquidity on the fixed income side of portfolios. Though intermediate-term Treasury yields have bounced slightly off their lows, they are still at extremely unappealing levels and the added yield, or spread, offered on corporate bonds has dwindled. Municipal bonds are relatively attractive but still offer skimpy absolute yields. Even most of the shorter duration preferred issues that we own have drifted below yields that we target for purchase. Our clients have fared exceptionally well through this fixed income cycle, but today one is reminded of the phrase “return-free risk” (as opposed to risk-free return) In other words, it is generally a time to wait for a “fatter pitch” rather than buy new bonds with minimal expected returns and material interest rate risk.

There are a number of developments that could provide an environment where we could put cash to work; but first, the backdrop. We subscribe to the “slower but longer” view of this economic cycle and believe that there are likely a couple more years of economic growth ahead

In fact, we expect that after a very sluggish, weather-impacted first quarter, economic growth will accelerate to a higher level of sustained growth than we have seen in the past three years. Further improvements in employment should enhance consumer confidence and spendable income. That, combined with pent-up demand and more widely available financing, should boost housing, auto and retail sales. Business spending will also be an important contributing factor after years of underspending. A lower level of policy uncertainty, rising utilization trends, the boom in shale oil/gas related spending, commercial development (which follows residential construction) and slowing growth and investment opportunities in emerging markets, should all contribute to a ramp in US business investment. The interesting question is ***how will financial markets react to the stronger growth that we have all been hoping for*****?**

Typically, stronger growth leads to **higher interest rates**. Currently, the Fed is holding short-term rates near 0% and gradually reducing its purchases of longer-term bonds. With the completion of the Fed's third round of bond purchases (QE3) in perhaps October, the Fed will cede its direct influence on longer term interest rates and allow the market to once again set rates. In this context, long rates should move higher and the Fed's timeline for increasing short-term interest rates should also move closer. With inflation still very moderate, bond yields may not have to rise dramatically and the Fed will drag their heels on raising short rates. Still, directionally this will be a headwind for fixed income returns. It is also possible that markets will decide that the Fed has fallen behind in acting to tamp down incipient inflationary trends or that negative fixed income returns could (again) lead to large outflows from the asset class, resulting in a sharper interest rate adjustment and greater bond losses.

For stocks there are several considerations. Better economic growth translates to better earnings growth for a wider range of companies, which is generally good news. At the same time, it makes earnings growth less of a scarce commodity and exposes high valuation growth stocks to multiple compression. In fact, we have seen dramatic declines in the past month in high valuation stocks while, thus far, the remainder of the market has been relatively unscathed.

Despite our optimism on the economy, **stocks may not respond positively** as the market begins to anticipate the end of ZIRP, the Fed's **z**ero **i**nterest **r**ate **p**olicy. While moving towards normalcy is a sign of progress, especially to savers, there will be repercussions. Stocks have directly benefitted from this Fed policy which, by design, pushes savings into risk assets. Only in retrospect, will we know where and to what extent investors have poured cash into risk assets around the world in a desperate attempt to flee the negative real rates of returns in money market funds, savings accounts and short-term Treasuries. How much may flow out of long-term bond funds, emerging markets, utility stocks, REITs, or the stock market as a whole, with the prospect of rising yields on cash and bonds? We do know that when investors reach for yield/returns, a lesson in risk usually follows.

The bull market is now five years old. Only two bulls in the last 80 years have lasted longer without a 20% decline and only a few have gone over 30 months without a 10% correction! **The good news is that valuations are generally not overextended, the financial system is highly capitalized and, outside of government, there are no major excesses in the economy to correct.** Still, a non-economic bear market (one not caused by a recession) could start tomorrow **or two years from now from a higher level**. This type of sell-off occurred in 1987 and in 1998 and both were very sharp, bottoming within two months. Whether this market rallies on for two more years or peaks this month, our goal is to protect equity capital by understanding our companies well, buying entities positioned to enhance value and not over-paying for their shares. We may lag in a strong market from here, but our cash reserves will cushion the bumps and position us to take advantage of opportunity, rather than react to adversity. **It has been a very profitable cycle and we intend to preserve capital and then continue to build it.**