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4th Quarter 2013 Investment Review

Investment Thoughts

Warning sign, warning sign,
I hear it but I pay no mind.
Hear my voice, hear my voice,
It's saying something and it's not very nice.
Pay attention! Pay attention, I'm talking to you and I hope you're concentrating.
I've got money now, I've got money now,
C'mon baby, c'mon baby

"*Warning Sign*" Talking Heads 1978

" The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs"

Warren Buffett

After you've been in the investment business for almost 30 years there really isn't much new under the sun. Old patterns re-emerge after lying dormant like so much winter grass. Experience has taught us to recognize these patterns of behavior that allow us to prepare for—if not predict—the future.

Unlike many investors, we don't attempt to forecast the economy, stock market trends, interest rates, currency exchange rates, inflation and other "important" investment variables. Sure, we pay attention to the current environment, but we're humble about our and most "experts" ability to accurately predict the future. Furthermore, the businesses we own and the people that run them don't generally change dramatically from year to year. What can change is ***the mood of market participants***, ranging from sheer despair and gloom on one end, to wild optimism and a lack of appreciation for risk, on the other. It's to this "pendulum" of market mood swings that we now turn our attention.

As you might guess from the "*Warning Sign*" lyrics, we believe the pendulum is currently occupying the risk-taking side of the spectrum. I'm not suggesting it's time to sell everything, take the cash, throw it in a suitcase, add some gold and go hide out in a bunker. Rather, today's environment is characterized by lower caution, increasingly positive sentiment and recent favorable investment results. Let's take a look at a few investor "Warning Signs".

Let's begin with some obvious Warning Signs. Stock markets in the U.S. are at all-time highs, after rising 25-30% in 2013. ***Stock valuations are somewhat higher than average, although not***

in bubble territory. Yet. The NASDAQ index recently topped 4,000 for the first time in thirteen years—although still below the 5,000 level of the late 90's "dotcom" super-bubble era. Initial Public Offerings, which often attract "hot money", raised $60 billion in 2013, the best year since 2007. Remember, 2007 was near the peak of the previous market cycle.

Further Warning Signs include individual investor behavior, captured through the American Association of Individual Investors Weekly Sentiment Survey, which lately shows a high level of optimism, and a lower level of negative sentiment. Unfortunately, many individual investors get more optimistic near market peaks, and turn negative around bottoms. Not a great approach for investment success. Right on schedule, stock mutual funds in 2013 saw the best inflows of money since 2004, and the first year since 2007 that investors bought more than they sold. More Warning Signs.

As the late night TV infomercial says, "***but wait, there's more***". Individual investors don't always play the game of "Buy High, Sell Low" alone. No, the average retail investor often has company. Many companies find themselves flush with cash during good times. It's often squandered on ill-conceived acquisitions or share repurchases. Last year, corporate America repurchased approximately $750 billion of common stock, the largest amount since $600 billion repurchased in, you guessed it, 2007. In contrast, only $140 billion was repurchased when stock markets were depressed during 2009. You'd think the people running the business would recognize when their own stock was cheap or expensive. They do, but soaring or plunging markets have a way of influencing the Captains of Industry to behave irrationally. Another Warning Sign.

We're not quite done with our anecdotal evidence—I'm hoping if we gather enough we might have a case. Collectibles, such as art, cars, wine, coins and rare books have been in a bull market of their own. Even farmland has been on a tear, with Midwestern U.S. acreage selling for record amounts. Loans to lower-quality borrowers reached $700 billion in 2013, exceeding the 2008 peak of $600 billion (sorry 2007, you can't have all the glory). And, right on time, complex securities are back, such as collateralized debt and loan obligations (an alphabet soup including CDO's and CLO's). High-yield (aka "junk") bond prices have been bid up in the search for income and are near record low yields of 5-6%. Several fund managers that we respect have closed their funds to new investors, as it's tougher to find outstanding opportunities amid the outbreak of optimism. More Warning Signs.

These "happy days" indicators are reflected in many stock prices. For instance, last week Beam Inc., purveyor of Jim Beam and Maker's Mark bourbon, Courvoisier cognac, Canadian Club whiskey and Sauza tequila, agreed to be purchased by Suntory, a privately-owned Japanese beverage company. We analyzed the buyout price, as we do for most public company acquisitions. The price of $83.50 per share was, in our view, a fair price—if we were magically teleported to the year 2017 or 2018. In our view, Suntory paid today for what Beam would likely be worth in 3 or 4 years. Suntory paid roughly 20 times 2014 pre-tax operating earnings, when most buyouts are done at 10 to 12 times operating earnings. It may be a good purchase, as liquor is very profitable. But they likely overpaid. But corporations, like individuals, are often susceptible to the Buy High, Sell Low fever. Still more signs.

I'm not forecasting any particular scenario, as that's not our game. We just pile up the evidence and see where it leads us. We assess the current environment, and try to understand where the pendulum is along the continuum from fear on one end to greed on the other. And we conclude that the pendulum today is closer to greed than fear.

What are we doing in response? Keeping a close eye on the value of our investments and each day comparing what we pay with what we expect to get. If we have to pay too much to get too little, we won't invest. Simple to say, harder to do. But that's what you pay us to do.

Economic Conditions

2013 ends with the economy chugging along. The recovery continues from the global meltdown of 2008-09, with help from the twin levers of massive monetary and fiscal stimulus. In plain language, cheap money and massive government budget deficits.

We've discussed before the after-effects of the previous cycle of shoddy lending and excessive consumer and government spending. Financial crises create hangovers that take up to 10 years for full recovery. We're 5 years into this recovery, so maybe halfway there.

Housing and real estate—prime culprits in the last boom and bust—continue to get healthier, but are still a drag on recovery. Over the past five years we've been building homes at an annual rate of around 600,000, but normal demand is 1-1.5 million per year. Few people realize this, but ***excluding construction the U.S. is back to the level of jobs held before the financial crisis***. Yes, you read that right. But when you throw ***construction job losses*** into the mix, we're still behind. Construction jobs peaked at 7.5 million in 2006, and are still down 20% from that level to a current 5.9 million. In previous recoveries construction had fully recovered by now. We imbibed on too much real estate, and the hangover is lingering longer than usual.

Here's a solution. Put many of these unemployed construction workers back to work, fixing roads, bridges, dams, schools and other parts of our crumbling infrastructure. Of course that would require action in Washington D.C. and state capitols. Don't hold your breath.

Still, the ***U.S. economic outlook is brighter in some ways than it's been in years***. Positives include higher worker productivity, increasing automation, lower energy costs and higher wages in many parts of the world, including China and other low-wage countries. So, our competitive position is getting better. As a result, jobs that disappeared years ago for cheaper locations are moving back to the U.S. These are long-term trends that should create new jobs.

Of course, there are plenty of risks. Corporate profits could decline, Europe is still fragile, China is grappling with prior lax lending and spending, interest rates will likely rise, especially if economic growth picks up, Washington D.C. is still around and as noted, investment values are elevated.

Investment Conditions

We had a decent year. For the year we had good ***absolute*** gains on stocks of around 25%+, but compared to other indexes that returned 30%+ we look like ***relative*** losers. Of course, the long-term is our focus, and our results are quite respectable. In general, ***equities still look fairly valued at best.***

We know that ***we'll frequently be out of sync with markets.*** Some years better, some years worse. If you want different—meaning better—results than other investors and markets, you need to do things differently. We do. Occasionally we look smart. Occasionally we look not so smart—ok, dumb. Last year, we thought stock valuations were getting a bit high, and we reduced some positions that looked more fully valued. We rolled the proceeds into neglected stocks. They remained neglected throughout 2013. They may continue to be unloved during 2014. It's a central part of our process to look longer-term when others can't or won't. ***Our willingness to endure short-term pain creates the opportunity for long-term gain.***

Unlike most of our competitors, we have clearly stated investment goals, as discussed in previous quarterly letters (Q1 2012 and Q1 2013). Our lofty ***goal is to generate equity investment returns 3% to 5% above market indices, after our fees, over the long-term.*** Sound simple or easy? The reality is probably 90% of active managers don't do that over time. So, we're aiming high. And, we plan to update our results annually. Such as now.

As of December 2013, our ***Concentrated All-Cap Equity Composite*** met our goal with a net return of 27.2% over the past 5 years compared with 18% for the S&P 500. Since inception (April 30, 2008) the 12.6% annual return also compares favorably to 7.6% for the S&P 500.

We remain confident in our investment philosophy and process. We remain focused on generating above-average long-term results while recognizing that short-term market volatility is inevitable and usually creates long-term opportunities.

We encourage comments, questions and suggestions. As always, your loyalty and patience remains our secret weapon.

Sincerely,

John Heldman, CFA
January 21, 2014

"Many shall be restored that are now fallen and many shall fall that are now in honor." Horace

"Always do right. This will gratify some people, and astonish the rest." Mark Twain