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In Pursuit of Value

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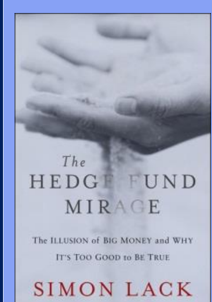
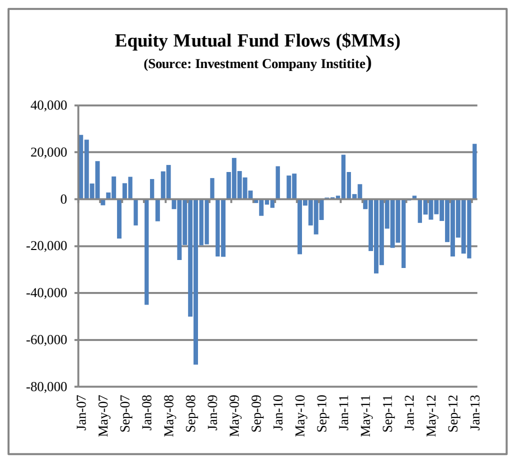


Buying Stocks, Gingerly

Money has been flowing into bond funds for a long time. During the financial crisis of 2007-08 many of us contemplated hitherto unthinkable risks to our investments. I spent a few miserable evenings in September 2008 calculating the fall in the value of my own portfolio and wondering where it might stabilize. Avoiding leverage, and leveraged companies, never felt so sensible as back then.

The financial near-death experience so many faced unsurprisingly led to a search for safety through fixed income – a search which has become increasingly price-insensitive over the past year or so as the Federal Reserve has squeezed virtually all the return potential out of bonds. Return-free risk is an appropriate description.

However, some signs are appearing to suggest that the singular focus on bonds is abating. Mutual fund flows have recently confirmed the strong start to the year made by stocks, and since bond inflows remain positive the main source of outflows is money market funds and cash. Figures from the Investment Company Institute (ICI) are likely to reveal the strongest monthly inflows to equity mutual funds in six years when January's full month numbers are published (the chart includes data only through January 16th). Money has been flowing relentlessly out of Equity funds virtually every month since May 2011.



Such figures are often confused with money moving out of public corporations. In fact, the pedantic truth is that for every buyer there's a seller and cash mostly moves through markets, not in or out. Dollars leave public companies through corporate actions (such as share buybacks or dividends) or through companies going private; it enters through IPOs, secondary offerings, and earnings. So although flows into equity mutual funds won't show up on corporate America's balance sheet, they do reflect a more constructive stock market view among retail investors.

Interestingly, a recent report by Towers Watson found that pension plans in most developed countries continued to reduce their equity allocations in favor of Alternatives (clearly not everybody's read my book) and in some cases bonds. In the U.S. the equity allocation of pensions at the end of 2012 reached 52%, down from 60% in 2007.

But the signs of thawing risk aversion are clearly visible and warm feelings for stocks are more evident than Spring-like weather outside. The Equity Risk Premium, the difference between the earnings yield on the S&P500 and the ten year treasury, has narrowed modestly as rising bond yields have coincided with higher priced stocks. We're still a very long way from where bonds could be remotely considered a better long term investment than stocks, but near term risks exist as they invariably do. Sequestration on March 1st is perhaps the most immediate "Made in DC" threat. $120 billion of automatic spending cuts, originally conceived to be so disagreeable as to force an alternative compromise, are looking increasingly likely to take effect unaltered. It is fiscal discipline of a kind, albeit delivered with a blunt instrument. Some observers have noted that greater certainty around fiscal policy is more important than fiscal policy itself, and perhaps by March this will turn out to be true.

Many investors I meet struggle to find the right balance between the mediocre certainty of fixed income returns and the less certain but more probable inflation beating potential of equities. Low interest rates, time and the receding possibility of another financial crisis are all factors. For some it helps to think of Cash as representing risk capacity. Although it earns close to 0%, holding some cash can make the possible volatility of equities more palatable. As mentioned in prior newsletters, a barbell portfolio of stocks and cash weighted according to one's risk appetite can offer better prospects than a high grade or government bond portfolio.

Within our equity strategies we have maintained low levels of cash over the past few months but recently made a couple of portfolio adjustments. The insurance sector has long been struggling with excess capacity with the consequence that in many cases premiums were not high enough to earn an acceptable return. This has been exacerbated by the very low investment returns available due to low interest rates, greatly reducing the value of the float and highlighting the need for Combined Ratios (which measure the percentage of premiums spent on costs and claims) solidly below 100%. The recent cycle of policy renewals has reflected a "hardening" of the market, and expectations of improved returns on capital have reduced the discount to book value of some names. We exited Aspen Re (AHL), a name we've held for a couple of years as it reached 85% of adjusted book value. We added to AIG though, which has the potential to be a good story with improving underwriting profitability and the exit of the Federal government rendering the current price at a 45% discount to book value attractive. We think their cash generating ability will allow continued substantial share buybacks over the next several quarters.

SL Advisors, LLC focuses on identifying securities that are trading at a discount to intrinsic value.

We invested in Bed, Bath and Beyond (BBBY) which is an appealing way to participate in a recovering housing sector. At 11 times earnings and with improving margins we think the threat of online competition is more than fully reflected in the price.

We initiated a position in JCPenney (JCP) over a year and a half ago at much higher prices. We didn't anticipate the marketing missteps of 2012 nor the extent of the sharp drop in sales following the removal of promotions and coupons. However, we still believe the business transformation to a store of many individual shops is the right strategy for the long term. We have been encouraged by the cost savings achieved, the performance of the initial shops opened last August, the demand expressed for shops from vendors, and the announcement of the return to promotions. With manageable debt, substantial non-core and real estate assets that could be monetized and $2.5 billion in liquidity, a crisis is not imminent. Furthermore, two thirds of the shares are owned by people we assess to be long term, high conviction investors and therefore the current record short position of 64 million shares (30% of shares outstanding) is around 90% of actual available float (i.e. shares outstanding less long term holders). A revaluation may occur without many shares changing hands. We increased our position in January.

Income generating sectors bounced back following selling pressure going into year-end. While investment tax rates rose the final outcome was not as bad as many had feared. MLPs in particular had a very strong January following a fairly muted result in 2012. Although January's performance was equivalent to a plausible one year return, we don't attempt to make tactical trades in the MLP sector, which would generate taxable realized gains as well as run the risk of being under-invested during a strong market. So we remain fully invested in MLPs and believe the long run outlook remains good although January is often seasonally strong and this January was exceptionally so.

Dividend yielding stocks also bounced back nicely, and our Hedged Dividend Capture Strategy delivered a solid month. Investing for income is still a challenge facing the vast majority of investors, and this theme is likely to be important for a long time to come.