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In Pursuit of Value

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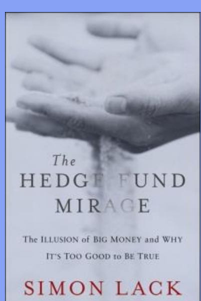
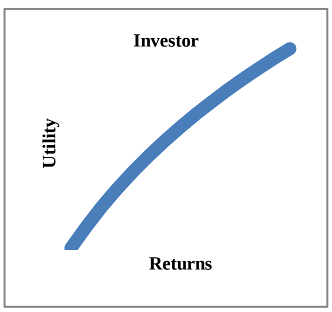


Finance Behaving Badly

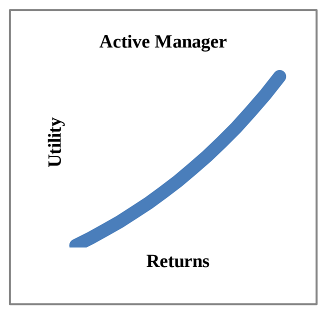
Behavioral finance can be a fascinating topic for anyone interested in how investing decisions are made. For the theoretician, people have an annoying tendency to make decisions that don't fit within conventional models. Although there are few activities more suited to objective analysis than valuing securities, emotions play a significant role particularly over the short term. In the long run prices go where economics dictate, but the long run is always a long time away and as Ben Graham once said that "in the short run the market is a voting machine but in the long run it's a weighing machine." It's much easier said than adhered to of course.

I'm currently reading a book called, "Minding the Markets: An Emotional Finance View of Financial Instability" by David Tuckett. The author interviews a number of money managers to understand their thought processes as they make different investment decisions. Professor Tuckett utilizes his background in psychoanalysis to take a scientific view of how professionals process information and reconcile changing market prices with their own insight. It's quite fascinating, and I found it striking how much emotion is involved even for people who spend all day in markets.

One feature of the real world of investing that falls outside conventional financial theory is the "principal-agent" problem. In this version, investors are the principals while their advisors, money managers and brokers are agents. They can have different and sometimes competing goals; most obviously, investors care directly about returns while agents are paid from fees. Agents clearly want their clients to make money, and over the long run one might assume that investment results and performance are strongly linked. In the short run the connection can be more tenuous.



A more subtle feature of the principal-agent problem lies in the different utility curves both face with respect to investment results. This is especially true where the investment advisor isn't personally invested alongside the client. Most people value the next dollar slightly less than the one they have (i.e. the first $Billion you make is the hardest). This declining marginal utility seems rational to me and is why most investors derive more pain from losing money on an investment than pleasure from making a profit. This can lead to common inefficient investing techniques such as dollar-cost-averaging, a wholly understandable way of avoiding buying the high price in an asset but at odds with the logic that if you think something has a positive expected return the economically rational decision is to make your investment now.



People who manage money on the other hand can have a quite different utility curve with respect to the performance on their clients' assets *if they are not significantly invested themselves*. The issue is neatly summed up in what's known as the "Low Beta Anomaly". In plain English, while more risk should provide more return (and the Capital Asset Pricing Model assumes it does) the real world doesn't work that way. Active money managers tend to take more risk in their portfolios than the benchmark. A compelling possible explanation is that active managers have more to gain from outperforming a rising market (through gathering more assets) than they have to lose from underperforming in a falling market (since there are far fewer inflows)[1]. In this framework, active managers not personally invested in their own strategies face different utility curves than their clients. As a result, more risky stocks tend to underperform their "beta-predicted" return because they are in greater demand and therefore expensive. Similarly, "boring" stocks that lag a rising market over time generate better returns. What's more, these low beta companies are indeed less risky providing significant outperformance in severe market declines, making them an ideal candidate for a loss adverse investor's portfolio.

We incorporate this into our investing approach. Our Deep Value Equity Strategy holds some low-beta, stable names such as Microsoft (MSFT), Kraft (KFT) and IBM that we think are attractive investments but will not typically lead a strong equity market such as we've seen over the past six months. Our Hedged Dividend Capture Strategy similarly holds names that we expect will provide adequate returns with very little day-to-day excitement. And of course I'm personally invested in everything we do, so at SL Advisors there is only one utility curve because we're invested together.

When I was in London in December I had the opportunity to meet Dr. Paul Woolley of the London School of Economics. Dr. Woolley believes that current financial theory is all wrong, and is pursuing a new model to explain security markets in a framework that better reflects what actually happens. He believes the principal-agent problem described above manifests itself at many levels and is the main explanation for what he describes as the failures of academic theory revealed in 2008. He has an ambitious goal; most would agree that there's room for a new theory, and Dr. Woolley is as equipped as anybody to construct it.

[1] Betting Against Beta, Frazzini and Pedersen, 2010

Investing in precious metals at a discount: Coeur d'Alene (CDE)

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

We've never been big believers in owning gold and silver. Warren Buffett's comment (most recently in his 2011 letter released on Saturday) that all the gold in the world could be exchanged for "all U.S. cropland (400 million acres with output of about $200 billion annually), plus 16 Exxon Mobils…" with $1 trillion left over" is one of the more eloquent ways to describe the value of gold. Most gold is expensively mined, moved and buried again in a vault somewhere. It seems a wasted effort.

The New York Times noted recently that interest expense on the Federal debt is roughly where it was in 2006 even though the debt outstanding has doubled; the government is setting its own interest rates at levels too low to provide a real return to savers, and as such the budget's sensitivity to higher interest rates is more acute. If the Federal Reserve does ever raise rates their analysis will need to incorporate the increased fiscal drag of higher interest expense, perhaps resulting in negative real rates for longer than might otherwise be the case. And the latest LTRO operation by the ECB has created another 500BN Euros or so of liquidity. So it's not difficult to construct a dark, inflationary outlook.

That's not our central view, though it is a real possibility. But you don't need to be an extreme gold bull to find value in mining stocks. Coeur D'Alene (CDE) is a name we've owned (in small to modest size depending on valuation) for a couple of years. They are one of the few pure silver miners around, although gold is becoming an increasing percentage of their output. Silver supply is quite inelastic because most silver is produced from non-silver mines, so silver supply is driven by the price of nickel, copper or whatever is the primary output of a given mine. Demand is similarly inelastic because silver is a vital but tiny input into many manufacturing processes from consumer electronics to medical products. So the price has to absorb changes in supply and demand, making it very volatile.

Gold has less industrial demand and "investment" (i.e. speculation) has been growing. Figures from GFMS (used in some research published by JPMorgan) reveal that gold jewelry demand has still barely rebounded from its 2008 trough of 1,800 tons (2012 estimates are 2,120 tons compared with 2001 demand of 3,000 tons). The big swing factor remains speculation (around a third of 2011 demand). Using CDE's proved reserves of 51 million silver ounces and 830K in gold ounces and assuming modest decreases in capex from 2012 guidance, 3% annual increases in extraction costs and current prices values the company at $30, around its current price. We think of this as our Downside Case. In the Upside Case, if all their probable reserves were successfully mined the same analysis results in a $50 price. CDE is cheap to the NPV of its likely production assuming no new discoveries. They also represent a levered way to invest in gold and silver because if precious metals prices rise their operating leverage will result in more quickly increasing profits.