The Long & Short of It

Quarterly Newsletter
First Quarter 2010

One Year Later - Half Way Back

For value investors, there are two items that determine the attractiveness of an investment opportunity: 1) an assessment of intrinsic value and 2) the degree to which consensus has made current pricing deviate from that assessment. In the long run, intrinsic value matters most. In the short run, shifts in consensus dominate. As a result, stock prices fluctuate significantly, reflecting the ebb and flow of investor emotions while remaining loosely tethered to the anchor of corporate wealth creation.

One year ago, as we wrote this letter, there was a pervasive feeling that the world was ending. At that time, we wrote:

> *Our research shows that valuations such as these have taken place before for most companies that we follow, albeit rarely. Typically, investors only read about moments such as these, as well as fortunes that were made by those stalwarts unshaken by the turmoil. Our research tells us that, at these levels, we should be very optimistic about the long-term prospects for client portfolios and the opportunities before us. We have to admit that this is difficult to do while having access to a media outlet. Nonetheless, this is the position we will take. The companies in our client portfolios are higher quality and more attractively valued than at any time in the last 17 years. In our view, these stocks are as attractively positioned as they would have been near the bottom in 1974. The return to civilization will surely be a bumpy road. We suggest it may be well worth the trip.*

Well, we were wrong about it being bumpy…so far. As markets started to function properly, investors began to feel that, while the world would still end, at least it would happen with government support. What followed was the doubtful rally – climbing the wall of worry. Today, with stocks some 50% higher than a year ago, the consensus is shifting. The investment media has recently professed amazement at the rise and followed with claims that “the path of least resistance is higher.” Bullish consensus is forming. Frequent support is offered for the bullish argument – usually based on the claim that there remains no bullish consensus – a point on which everyone seems to agree. So, let the bumpy road begin. The ten-year AAA corporate bond yield is now below that of the 10-year U.S. Treasury – a fact that may reflect as much on the confidence in companies as it does the nascent loss of confidence in the credit quality of the U.S. government.

RVM’s Contrarian Value Equity Composite Portfolio Fundamentals *as of 3-31-10*

	RVM Equity Composite	S&P 500
Number of holdings	33	500
Wtd. Avg. Mkt. Cap. ($B)	68.9	86.6
Price/Earnings Ratio	13.9x	17.4x
Price/Book Ratio	2.7x	3.0x
Price/Cash Flow	7.0x	8.8x
Dividend Yield	2.9%	1.8%
Return on Equity	21.5%	21.0%

Valuations are also generally less attractive than they were a year ago. The largest shifts in valuations (recent best performers) were focused on a few sectors. Industrial/basic materials sector companies rose significantly on expectations of continued economic recovery and growing demand from emerging countries. Banking/financial sector firms recovered from their historic sell-off on the expectation that they would profit from the steep yield curve for the foreseeable future. The last group (and the most unusual to observe) was the overleveraged companies, near death one year ago, that were saved by the Federal Reserve's unprecedented liquidity provisions.

In the majority, global leaders with great brands, franchises, balance sheets and income statements remain under-appreciated – especially the domestic variety. It's true they have recovered somewhat, but investors have been programmed over the last decade to believe that the best is over for the U.S.A. During the past ten years of near-zero returns for U.S. stocks, book value, earnings and revenues have continued to climb. In light of the current low interest rates and possibilities for inflation, one cannot know that these stocks will be great investments. However, to us they appear very attractive for long-term investment when compared to alternatives like cash and bonds.

Credit Ratings Agencies at It Again

The tarnished reputation of the credit ratings agencies was not improved by their role in fueling the sub-prime credit bubble. And in an effort to make things better, they are at it again. Traditionally, these agencies maintained a separate scale for rating municipal debt, one that was slightly more stringent than the one used for all other types of debt. Recently, S&P decided to move to a single ratings scale for all credits. In March 2010, Fitch and Moody's detailed plans to recalibrate some 70,000 municipal ratings to their global ratings scale. On average, state and local general obligations ratings will be adjusted upward two notches if currently rated A, and one notch upward if rated A+ or higher.

With huge, growing liabilities for pensions, post-employment healthcare and deferred maintenance on infrastructure, municipal credit problems are at their worst levels since at least the 1970's. These credit upgrades are happening at a most unusual time. If the reasoning still escapes you, just know that the move is welcomed by members of the House Committee on Financial Services, including Rep. Mike Capuano (D-MA), who said: "*For years municipalities across the country have been forced to pay billions of taxpayer dollars to insure bonds that have* ***nearly no chance of defaulting*** [our emphasis]. *I'm pleased to see the industry step up to the plate and make these needed changes to the way they rate cities.*"

The ratings agencies were technically free to choose between bringing the ratings of the municipals up to the universal scale versus bringing the ratings of the universal scale down to the municipal scale. But they continue to have an incentive to keep the ratings strong so their clients can issue more debt and pay more fees. We are not suggesting what should have been done but rather observing that, once again, their clients' needs for better ratings have won out over more rigorous standards, enabling them to issue more debt more cheaply. Today, among municipal bond brokers, the most frequent claim we hear is that municipal bonds are *"super-safe"* and that *"No city can ever afford to default or miss a payment. In the end, they'll just raise taxes."* Let us not forget the claims of safety that surrounded the securitized sub-prime instruments.

Need a Healthcare Quote?

So, the landmark legislation intended to be the first step in healing our healthcare system is now law. It is a bit early to report on its impact on pricing, so we searched for quotes from other exchanges, finding several from Yogi Berra (YB).

"You've got to be very careful if you don't know where you are going, because you might not get there." –YB. For the last forty years, we have squeezed the common sense of the everyday consumer out of our healthcare system. With only a premium to pay, most of which is typically

covered by an employer, and little in deductibles or co-pays, the consumer has had little incentive to monitor the price paid for any medical product or service.

"It's like déjà-vu, all over again." –YB. With the healthcare law, the country moves further in this direction, as described in a March 27, 2010, *Wall Street Journal* interview with Gary Becker, Nobel economist and co-founder of the Chicago School of Economics.

> *Drafting a good bill would have been easy, he continues. Health savings accounts could have been expanded. Consumers could have been permitted to purchase insurance across state lines, which would have increased competition among insurers. The tax deductibility of health-care spending could have been extended from employers to individuals, giving the same tax treatment to all consumers. And incentives could have been put in place to prompt consumers to pay a larger portion of their health-care costs out of their own pockets.*
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> *"Here in the United States," Mr. Becker says, "we spend about 17% of our GDP on health care, but out-of-pocket expenses make up only about 12% of total health-care spending. In Switzerland, where they spend only 11% of GDP on health care, their out-of-pocket expenses equal about 31% of total spending. The difference between 12% and 31% is huge. Once people begin spending substantial sums from their own pockets, they become willing to shop around. Ordinary market incentives begin to operate. A good bill would have encouraged that."*

Seems like common sense? Well, try to remember, *"There are some people who, if they don't already know, you can't tell 'em."* –YB. We just hope they don't *"make too many wrong mistakes."* Thanks, Yogi.

Our position remains that the new law will drive more revenues into the healthcare sector but do little to keep pricing in check. Whenever the government moves into an industry to help those who cannot afford it, the first result is growth of that industry. Today, healthcare finds itself where housing was ten to twenty years ago. Baby boomers are positioned to drive demand growth, and the government is increasing its long-standing and semi-successful subsidy to those who need a little help. For the first several years of the new plan's implementation, the healthcare industry should benefit. But ultimately, a healthcare bubble looms.

The Federal Reserve "Stands Ready"…

In searching the Federal Reserve publications over the last three years, we found numerous assurances made by the governors behind the curtain.

August 31, 2007	...to take additional actions as needed to protect the wider economy from the current turmoil in the markets.
October 11, 2007	*Standard & Poor's 500 Stock Index peaks at 1,576.09.*
January 10, 2008	...to take substantive additional action as needed to support growth and to provide adequate insurance against downside risks.
January 17, 2008	...to take substantive additional action as needed to support growth and to provide adequate insurance against downside risks.
October 6, 2008	…to take additional measures as necessary to foster liquid money market conditions.
November 23, 2008	...to backstop residual risk in the asset pool through a non-recourse loan.
December 1, 2008	...will carefully monitor the conditions of all key financial institutions and stand ready to act as needed to preserve their viability in this difficult financial environment.

December 16, 2008	...to expand its purchases of agency debt and mortgage-backed securities as conditions warrant.
January 28, 2009	...to expand the quantity of such purchases and the duration of the purchase program as conditions warrant.
March 6, 2009	*Standard & Poor's 500 Stock Index bottoms at 666.79*
April 8, 2010	…We monitor inflationary developments closely and stand ready to respond quickly and vigorously should the need arise.

Source: The Federal Reserve

Throughout the evolution of this crisis, we heard "The Fed stands ready if needed" to avoid undesirable outcomes. In the end, the Fed was quite active and creative in unprecedented ways. But early on, throughout 2007 and 2008, the crisis worsened while the Fed allowed the money supply to shrink by 1%. With each pronouncement, we wondered when "standing ready" would give way to sufficient action. So, what comes next?

The government will tighten interest rates at some point, if for no other reason than that it cannot afford a significant rise in interest rates. In 2009, 18% of total federal tax receipts, or 36% of income tax receipts, were used to service the interest on federal debt. Without any increase in the debt levels, a 3% rise in the average interest rate charged on federal debt would increase these statistics to 36% and 71%, respectively. With the large amount of debt outstanding and an aging population, restrictive Fed policy actions will likely prove surprisingly effective, while stronger medicine will be needed to sustain economic growth. The steady drumbeat of rising crude oil and other commodities grows louder, while employment, prices of real estate and prices of many other final goods remain weak. Productivity gains, excess capacity, and monetary and fiscal stimuli may be on a collision course with limited basic resources. Stay tuned.

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