January 31, 2013

The following is an abridged version of that sent to clients of CT Capital

Commentary

This month's feature holding was Life Technologies, which apparently tired of taking all its yearly cash flows from operations to repurchase its undervalued shares, and just went out and placed itself up for sale, propelling its stock up 23% for the month at which time the position was, as is our practice, sold. If their investment bank is successful, which I believe is likely given the consistency of their free cash flows and return on capital, **this will mark the 7th time in the past year one of our holdings was acquired.**

And yesterday, a news story from Reuters claimed holding Endo Health Solutions was in talks with potential buyers, although the muted rise in its shares (+11%) leaves some doubt. I will update next month.

Our analysis of free cash flows and cost of equity capital (risks to prospective free cash flows) is, I am confident, superior to both the credit rating agencies and other investment advisory firms. Unfortunately, however, often it seems as we need a special event for investors to wake up to many of our holdings, despite their superior metrics. And this is frustrating, I recognize, especially when a stock flops based on a disappointing single quarter or two, despite its maintenance of superior normalized financial metrics.

A few years ago, portfolio holding EBay, now selling near its all-time high, reported that it had missed the fourth-quarter consensus estimate by just one penny and saw its share price plunge 22 percent. Barely a reporting season does not elapse without a few of our holdings seeing double digit declines in their shares values. Is it any wonder so many CEO's clamor at the idea of taking their company out of public hands?

Short-term results are why I normalize financial metrics. **I like to know what I, as an investor, can reasonably expect**. While short term results can in fact carry important changes in information, more often they tend to obscure the true long term financial performance. Firms can take actions which may either reward or penalize short-term free cash flows and return on capital, such as under (over)funding pensions, pushing sales into a recent quarter, adjusting various costs including capital spending, stock options, or taking on risky financial instruments offering high current yield. Such normalized

adjustments have been borne out in the literature as well,[1] but takes the patient investor to reap the added return.

Long-term superior results most often emanate from a diversified portfolio of firms which add to their capital base and, in turn, are able to produce a return on that capital greater than its cost. And we will never deviate from such written in stone" policy, regardless of our short term performance results. For instance, when EBay's share price fell, I recognized its metrics were not well understood and its stock was being dominated by short-term thinkers. The same is true of Bed Bath and Beyond's recent fall from grace. And as we saw the past year, **our stocks "pop" one at a time**, **rather than in a systematic fashion similar to the market at large**. For it were not as if our acquired holdings were hot topics of conversation prior to their acquisition, as the jump in their market values attest.

Reach for Yield-Déjà Vu 2007

For the opening month of the year, investors stepped up their purchases of riskier assets; this was a worldwide phenomenon as credit spreads narrowed around the globe in search of return and yield. Junk bond yields in the US are yielding below 6%, lower, in fact, than the median free cash flow yield of our investment portfolio, which offers strong prospects for growth in that yield.

The worldwide corporate bond default rate is historically low, and as they say at the Pentagon, "In times of peace, prepare for war." Investors should not rely on the Fed's laurels when evaluating credit quality, including the current "artificial" cost of debt capital—they must look to the past and prudently determine how cash flows and credit quality will be impacted when setting a normalized equity cost of capital. To not do so would artificially elevate the worth's of many firms, especially given the historic monetary easing here in the US. I am seeing many investors push up the shares of firms in the dividend reach, with almost reckless regard to the stability metrics. Often, what is traditionally defined as free cash flow has been re-tailored by the firm to place them in a favorable light, making it appear as if their dividends are safer than is actually the case.

The rally in the riskier fixed income segment extended to the equity markets, as we have seen by the aforementioned bank stocks. Not only were risker assets bid up, many high quality equities surrendered earlier gains despite reporting acceptable results. As we saw a few years ago, when investors reach for yield, sooner or later, they are let down as credit problems appear, as is inevitably the case. The figure below illustrates the motivation for the acceptance of taking on instruments whose underlying assets intrinsically come with volatile cash flows; but for the time being at least, credit amnesia is prevailing.

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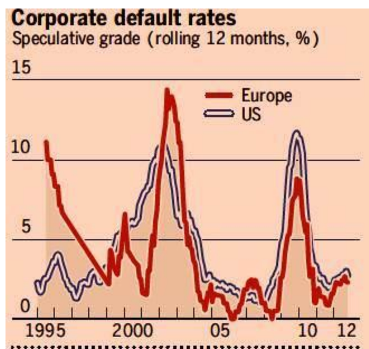
[1] See Bin Jiang and Tim Koller, "The myth of smooth earnings," mckinseyquarterly.com, February 2011. The article shows why firms that have more volatile earnings are not penalized by investors over time.



Source: Standard & Poor's

Odds and Ends………

NuSkin Enterprises, which I wrote on last month, as its shares dropped when a vocal hedge fund operator went massively short another firm in its sector, rose 14.1% this month. The owner of the hedge fund hired two law large firms to "twist the arms" of regulators at the state level and at the FTC. Multi-billionaire hedge fund operators with big egos should concern every investor, as seen by the volatility of this holding.

Lowering the corporate interest deduction would certainly benefit many of our holdings which have small or zero interest expense and pay close to, or sometime above, the 35% statutory rate. The UK is lowering its corporate rate to 23% in April, and has already attracted some multinationals as a result.

An article in the Financial Times this month discussed whether the economic data out of China is believable. This is an issue I have known about for a few decades, and therefore have always treated "official" releases with a grain or two of salt. I wrote of this issue a while back. The only believable data is that I hear directly from those companies I have followed for a long time and whose financial reporting I trust by virtue of their consistency, auditor (including length of association), cash and tax stability, Board, and accuracy of remarks during investor presentations and other public filings.

The huge $14 billion write-downs by non-holding Rio Tinto resulting from several past acquisitions should motivate investors to understand such risk. Listening potential Dell investors? CT Capital raises cost of capital for firms which have undergone significant acquisitions, as measured by market value, assets, debt, employees, or other relevant factor. Firms which have consistently made value-adding acquisitions see their cost of capital lowered.

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