February 28, 2013

Investors Should Never Be Complacent, Especially During Bull Markets

I always preach risk; during bear markets it is obvious to everyone, thusly I address risk with increasing strength in direct proportion to a rise in share prices. Later in the report and in subsequent writings I will write on the metrics good managers need to focus on to analyze and quantify cost of capital risk, an easy subject to slight with the strengthening in previously weak financial and industry sectors.

Over the past two years, the financial markets have been led by sectors which, over time, have not produced superior returns, such as banks, airlines and leveraged firms. One day, the Federal Reserve will go to a normalized position from their current $85 billion per month of bond purchases, and banks will be left with their restrictive business models, higher cost of funds, greater public scrutiny, and for many large institutions, legacy assets (i.e. BankAmerica).

As almost 90% of our portfolio is engaged in manufacturing, McKinsey estimates the global consuming class will continue to grow, requiring more manufactured goods. While they estimate the demand in manufactured goods will continue to drive upward--in fact double over the coming 15 years-- our holdings, being worldwide manufacturers, are ideally suited to take advantage of the anticipated trend, given they already exhibit superior financial metrics, have world class facilities and supply chains, and operate under low cost of capital. Also, the manufacturing sector has always, and should continue to reap, tax benefits, due to its impact on job creation.

Economies in the European Union, including Russia and the UK remain weak or in recession. The rest of Europe is on some form of austerity program. Japan and South America are also seeing growth slow while in the US, current monetary policy is hiding a lot of weaknesses, while government spending on defense is shrinking, and payroll taxes and taxes on medical companies are rising, along with energy prices. Sovereign risk (later section), therefore, should be gaining investor attention, more so than it has by investors, in general.

Many firms have been able to refinance debt at historically low rates while other firms, which might have a higher risk of default, have also been able to tap into a willing credit market. **As the historic default rate of 4.5% is reached, our holdings will be in a strong relative position, both as free cash producers, and having balance sheets with large flexibility, and, as was the case in the last go-around, firms with low cost of capital outperformed the indexes by a very wide margin.**

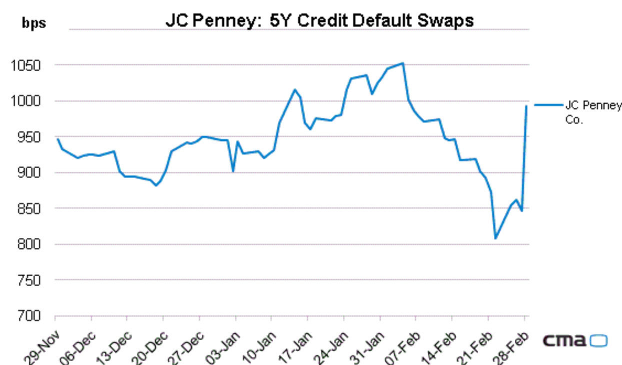
Looking forward, the capital structures of our holdings are significantly stronger than the median of any benchmark index. What's more, these firms have a proven record in acquisitions, providing an essential and discriminating advantage in an era where organic growth is hard to come by. What's more, their financial flexibility and low cost of capital places them in a strong competitive position which will unfold in the form of higher valuation multiples.

Default risk in general, is low—as shown by credit spreads; in fair value equity analysis, **investors are currently fixated on the numerator**—the expected free cash flows—often with little thought or appreciation to the risks associated with those cash flows. But as we know, credit risk ebbs and flows, being an inevitable part of the investment cycle. So, while "the south may not rise again", credit defaults certainly will.

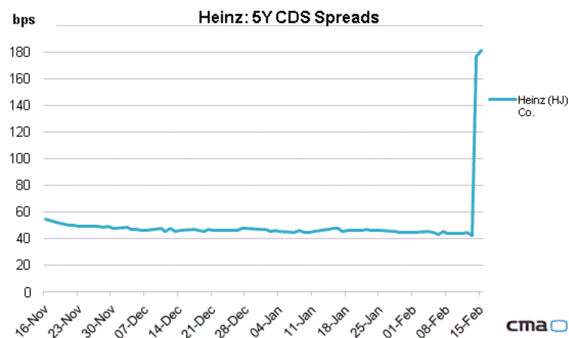
I bring up the role of yield spreads as a metric in the cost of equity in light of the recent Justice Department suit against McGraw-Hill's Standard & Poor's unit, whose shares we sold last year. I have long felt the rating agencies do a good job but are lacking in some critical areas, including the use of real time data which is not part of their central analysis and conclusions. Also affected by the suit was non-holding Moody's, which if not for the competitor's lawsuit, would be a buy list candidate. I mark-up cost of equity as the legal ramifications against the primary rating agencies could be large, making prospective free cash flows uncertain, despite the strength of their current business. Recall a number of years ago when asbestos litigation placed previously high quality firms such as Armstrong World Industries into bankruptcy.

Yield Spreads

When firms announce disappointing results, their yield spreads normally widen. For example, when JC Penney announced its results this week, its CDS swaps jumped, reflecting default is clearly a possibility.



Likewise, when a strong credit is being acquired by a lower credit, its CDS spread will widen, as was the case with Heinz this month. The 180 basis points in the figure represents the annual cost of protection against default based on the nominal amount of the bonds. If one of our firms, which is often the case given their free cash flows and strong flexibility, makes a significant acquisition financed with debt, we raise cost of capital, even though the purchase may be thought of as value adding.



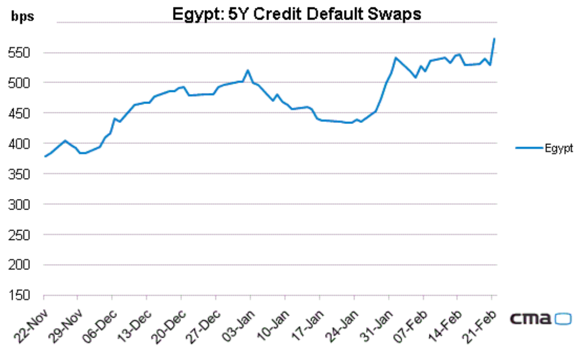
In our credit models, which are an important component of the cost of capital, we include many factors aside from yield spreads, all of which could impact prospective free cash flows. Had S&P Ratings been including derivative pricing, especially CDS prices, it would have been crystal clear so many financial intermediaries, including the mortgage insurers, were in distress during 2007. Even though valuations are often wrong, they must still be included in cost of capital, and for financial companies it is vitally important as regulatory capital is in good measure determined by equity.

Sovereign Risk

The chart at the end of the section reflects a factor—CDS swap spreads— in our sovereign risk analysis. We look at and quantify many such variables, including inflation, risk of terrorism, poverty, unions, form of government, unemployment rate, currency, expropriation risk, and accounting standards. The ultimate impact to cost of capital is based on an entity's revenues or inputs derived from that particular country or region. In Japan, for example, where we have one domestic holding (Canon), credit spreads have been tightening. On the other hand, it would take a miracle for us to buy a firm which derives a significant part of their free cash flows or inputs from Argentina or Egypt.

Venezuelan stocks would also present to us a high hurdle, as the country doesn't have an active currency exchange, so companies can't hedge against movements in the bolivar; portfolio holding Visa moved as much currency as it could out of the bolivar prior to its devaluation.

On the other side of the sovereign risk spectrum is Sweden, where the annual premium to insure against a default, based on the nominal rate, is just 20 basis points —by way of comparison it is 37 basis points for the debt of the US—and a whopping 527 basis (see chart) for Egypt, meaning we would mark up cost of capital for firms controlled by an Egyptian company, by at least 500 basis points for this variable alone. Sweden carries less sovereign risk than the US, meaning we would mark down the risk free 10 year US Treasury rate for firms deriving a greater share of cash flow there relative to the US.



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