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In the last month we have witnessed a reintroduction of heightened market volatility and economic uncertainty. Concerns over the Greek debt crisis, some uneven economic data and increasing government regulation have been the primary impetuses. The S&P 500 has traded off more than 12% from its highs in late April. We wanted to take this opportunity to revisit our current investment framework and share our strategy.

What is happening in Greece? In short, they have too much debt outstanding and not enough incoming revenue. Their debt-to-GDP ratio is forecasted to reach 150% (the US is still below 100%) and their annual budget deficit is in excess of 10% of GDP per annum. Moves toward fiscal austerity have been met with strikes and protests by citizens. Any drastic decrease in government spending would likely depress economic activity and tax revenues, making a balanced budget incredibly hard to achieve. Most importantly, unlike the US, Greece does not control the currency (the Euro) in which its debt is denominated. This means that government officials cannot print money to pay off the debt (i.e. inflate the debt away) or devalue their currency. The EU has stepped in with a large financial aid package, but the plan does not appear to provide a long-term solution. The probabilities of success in such scenarios are difficult to gauge – financial crises can quickly become self-fulfilling prophecies, which become difficult to arrest. If investors flee markets en masse, contagion could develop.

The Greek crisis is illustrative of the “deleveraging process” that we have been discussing for some time. Last year it was US subprime borrowers, this year it is weak Eurozone countries. Such developments will likely (a) decrease aggregate demand, reduce monetary velocity and constrain credit creation, thereby holding down interest rates and inflation and (b) lead to potential bouts of risk aversion in global financial markets, where all risky assets, regardless of context or origin, face selling pressures.

We always stress to investors that our key concern is security valuation, not macroeconomic forecasts. Financial markets have faced many threats over the last century (WW I and II, the Cold War, the 1970's oil crisis, September 11th, etc.), but continued to create shareholder wealth throughout. Attempts to time markets based on macroeconomic risks have largely been unsuccessful. Now financial engineers are capitalizing on investor fears by touting products and efforts designed to “control risk.” We think parents have more luck controlling teenagers. Risk is difficult to measure and tough to predict. Risk is embodied by what is seen and unseen. For example, widespread fears of a Greek default “surfaced” a month ago, although the risk certainly existed prior to that; market participants just didn't recognize it.

We use primitive measures of risk. Instead of trying to “control” risk, we attempt to gauge the potential returns offered by the market as compensation for taking risk. If compensation is poor, it doesn't make sense to accept risk. When stock valuations are low, the market offers high prospective returns for the willingness to bear risk. Across the investment spectrum, potential risk-adjusted returns are mediocre. With bond yields around 3-4% and forecasted stock returns of 5-8%, investors are not being compensated well for what our primitive measures suggest are comparatively elevated levels of risk.

Given heightened risk considerations and fully valued investment markets, it is prudent to examine current strategy. We aim to ensure that lessons from the last financial crisis are not quickly forgotten:

- In our bond portfolios, we stress high quality issues and diversification. While bond yields are low, the near term threat of inflation is remote and the fixed coupons that we receive will retain or increase their real value if deflation or financial crisis emerges. The purpose of our fixed income portfolio is to protect investment value during periods of market stress. As such, we don't deem it prudent to stretch for an extra 1% of return at the cost of relatively high incremental risk – in other words, the potential return doesn't justify the incremental risk.

- We have built positions in what we call absolute return strategies. We expect these strategies to perform relatively or absolutely well if a market selloff materializes. Such strategies include market neutral equity, managed futures and diversified arbitrage.
- We have refrained from adding too much exposure to our inflation protection strategies. While the long-term risk of inflation is high, we think that deflation is the immediate threat and asset classes such as real estate and commodities could struggle over the short-term. We have a small allocation to these investments and will look to add more when prices fall and/or inflation threats begin to materialize.
- We have trimmed our stock exposure over the last couple of months. We are below our long-term targets for equity allocation. Within our stock portfolios, we continue to stress high quality companies that we think are relatively cheap. We do not believe that it is prudent to drastically cut equity exposure for reasons discussed below, despite global risks.

There is a dichotomy of attitudes towards the stock market among investment managers – some are bullish, forecasting that a strong US economic recovery will drive equity prices higher, while others are bearish, arguing that debt problems and extended valuations will eventually lead to a market selloff. When asked to forecast the stock market, the legendary financier J.P. Morgan simply said “It will fluctuate.” At this point, we are underweight equities because of our concern over valuations coupled with our views on macroeconomic challenges, primarily lingering debt levels and sustained unemployment.

But we won’t jump ship altogether. Consider Johnson & Johnson (JNJ), a large, blue-chip company founded in 1886. JNJ is regularly regarded as one of the most respected companies on Wall Street. For the last 15 years, JNJ has grown earnings at 13% per annum with remarkable consistency. Although the company’s size (\$170 billion) will make matching that growth rate difficult going forward, analysts forecast future earnings growth of 6-12%. JNJ has \$18 billion in cash and short-term investments on their balance sheet versus only \$12 billion in total debt. JNJ trades at a price-to-earnings multiple of just 13.0x compared to a historical average of 20.0x. We calculate that the current price represents a cash flow yield of

over 8%. What does that mean? For every dollar of capital an investor puts to work in JNJ, he receives an 8% annual return on his money – 3.2% is returned in the form of a dividend, while the other 4.8% is invested at an internal rate of 15-20%. Compare this to returns on money market accounts of around 0%, returns on 30-year US Treasuries of just over 4% and cash flow yields on typical stocks of 5-6%. This all despite the fact that JNJ is a high-quality, low-risk company. JNJ won’t hit the ball out of the park, but it looks like the shares are undervalued. A similar analysis can be done for other blue-chip companies. Market commentator Jeremy Grantham argues that high quality companies (defined as those that generate high, consistent returns on capital) are the cheapest they have ever been relative to the broader stock market since he began tracking such data in 1965.

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So yes, we have made a concerted effort to decrease the risk profile of our portfolios over the last few months. But we aren’t making a wholesale shift to take all risk off of the table here. A decision to avoid stocks like JNJ assumes that shares will trade meaningfully cheaper in the future. While that is certainly a possibility, it is not one that we will bet all of our chips on. And we don’t want to sit around with all of our funds in money market accounts earning nothing and bonds earning a fixed 3% to wait and see. However, this means that portfolios are exposed to some downside risk in the event of a market selloff. We will most

likely not begin to sell stocks if the market begins to move down meaningfully. A depressed stock market is a time to buy, not to sell. If investors are not prepared to withstand stock market volatility, then it makes sense to revisit asset allocation assumptions immediately.

The last two years have been an incredibly difficult investment environment. Unfortunately, things don’t look like they will get much easier anytime soon. However, we maintain a strong conviction that disciplined, value-oriented investment management strategies that are focused on creating long-term value will reward investors over the long haul. As always, we appreciate your continued confidence.

Sincerely,

Michael D. Axel, CFA
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