January 15, 2013

Lethargy bordering on sloth remains the cornerstone of our investment style.

Warren Buffett

Looking back at the activity in our Model Portfolio* in the past year, one might think we were disciples of Buffett's sometimes slothful investing style. And in fact, we are. There were three changes in 2012, consisting of selling half of our position in Kinder Morgan Energy; eliminating our entire holding in Federated Investors; and in September, buying a half-position in Weight Watchers. With Kinder Morgan, we took a profit in a company we continue to admire but whose stock price had escalated to a level that made us want to be opportunistic. Our Federated Investors commitment continued to be mildly disappointing, with their money market accounts yielding next to nothing in a low interest rate environment. And we acquired our half-position in Weight Watchers after our analysis led us to believe the price was at a steep discount from its intrinsic value.

In his 1998 letter to shareholders, Buffett wrote, "In allocating capital, activity does not correlate with achievement. Indeed, in the fields of investments and acquisitions, frenetic behavior is often counterproductive." For us and our clients, the past year consisted mostly of riding herd on the ideas we had come up with three or four years earlier during a time of tremendous worry and uncertainty. When we bought our Walt Disney shares in October of 2008, the stock market was in the final stages of a free fall. Disney was off about 30% from its high, but it continued on down to a total decline of 57%, close to the same percentage decline as the overall market. By following the numbers we found Disney was selling at a deep discount and we were convinced we were getting a dollar's worth of value for 50 cents. Robert Iger, the company's chief executive, said at the time that this was "the weakest economy in our lifetime." Buying its shares then was a lonely experience.

Ten days later we followed up by buying a half-position in eBay, again at a big discount of 74% from its all-time high. It continued to decline by 30% from our acquisition price before turning dramatically higher after the market reached its low in March, 2009. And then, three months past the market bottom, we added a full position in Stryker. Here was another fine business that had fallen 58% from its 2008 high; sadly, we waited too long by a few months, just missing buying it at its lowest point in a decade. Still, we had again adhered to our discipline of researching and buying wonderful companies with rock-solid balance sheets at half their intrinsic value. If this sounds like we indulged in an uncharacteristic spell of frenetic activity in 2008-09, we did.

It is different four years later in 2013, when the number of bargains is much reduced. Still, there are pockets of value that keep us engaged and enthusiastic—computer software, natural resources and financial services, among others. The Standard and Poor's 500 stock index today sells for 12.9 times projected earnings, below its long-term historical average of 14.8 times. The overall market is not even close to overpriced, and the reasons are several. First, the average person is apprehensive or cynical about investing in stocks after experiencing two mega-meltdowns in the past twelve years, and it may take a prolonged bull market to demonstrate that stocks are a safe place to put precious retirement funds (but then it may be too late). Second, our elected representatives in Washington have done little to inspire confidence that they can agree on anything, let alone deal with our long-term fiscal problems. Erskine Bowles and Alan Simpson, founders of the Campaign to Fix the Debt, wrote on January 1 of this year that, "In order to reach an agreement, it will be absolutely necessary for both sides to move beyond their comfort zone and reach a principled agreement on a comprehensive plan which puts the debt on a clear downward path relative to the economy." According to the International Monetary Fund, a long-term solution will require an immediate and permanent 35% increase in all taxes and a 35% cut in all benefits. Further reinforcing investors' doubt about the stock market is the fact that our economy, four years past the end of the last recession, is barely expanding and the jobless rate remains stuck at 7.7%.

While they seem overwhelming, all these negatives have been thoroughly publicized in the media and chewed over and regurgitated. Their potential to surprise us further is low and has already been priced into the markets. But the resulting fear has kept both individual and institutional investors alike in a defensive posture on the sidelines, staying in the perceived safety of near-cash, bonds and fixed income funds.

Even if we now see relatively fewer opportunities for profitable investing in the stock market, being patient and possessing cash eventually bears fruit. Major market dislocations seem to arise every five years or so, each time providing us with another chance to indulge in our favorite and most profitable activity.

Best regards,

Noel F. Bennett

**The Model Portfolio is not a real cash portfolio. It represents the core direction of our portfolio management strategies. Individual client portfolios are managed in accordance with the clients' specific investment objectives and constraints. Historical results are available upon request.*