

July 15, 2013

A central concept in value investing has always been the certainty that the longer a trend has been in place, the more people believe it will persist forever. Life, as in investing, is cyclical and full of surprises and unexpected reversals. A prime example is the bond market, where the party of the last 30 years now appears to be ending. The three decade gradual decline in interest rates was not as wild and uninhibited an affair as the tech stock extravaganza of the 1990s, but it was very well-attended, lasted much longer, and was remarkably profitable. We have experienced several major bull markets in the last thirty years (Japanese stocks and real estate, U.S. stocks and real estate, art and collectibles), but none were as steady and long-lasting as the U.S. Treasury bond bull run, nor were they anchored by the certainty of the full return of our principal. The rewards created by them were extraordinary and so were the expectations. Today we are left with the reality that it will almost surely be more difficult to obtain an acceptable return in the fixed income side of our portfolios, and will require a greater amount of research and discipline to do so. Money market funds, currently yielding around 0.01%, do not fit the bill.

An important subject of debate in our meetings and conversations revolves around how long the U.S. stock market can continue its bull market rise from the low in March 2009, at the same time that the underlying economy continues to grow only at an anemic 2% per year. For most of the past four years Wall Street has been in a “risk off” mode. Despite the tremendous recovery in the stock market over the last few years, we do not see evidence of euphoria or “irrational exuberance,” but the rise in market valuations has not made Peak’s task easier when we look for companies to buy for the stock portion of our accounts.

We made one change to our Model Portfolio* so far in 2013. In April we sold our position in Kimberly-Clark, primarily because we felt the price had exceeded our estimate of intrinsic value. If the market were to drag the price of Kimberly-Clark back down, we would happily repurchase it since it is an easily understood business (paper towels, Kleenex tissues, Huggies diapers) with a rock solid balance sheet, a steady and increasing cash flow and a strong dividend yield. Simply, this fine but unexciting company and its management did exactly what we wanted since we first started buying it ten years ago. While we were pleased with our investment, it posed a classic value investor’s problem—what to do when a strongly rising market takes business valuations upward along with it.

A significant area of focus for us is the historically unprecedented effort of the Federal Reserve under Ben Bernanke’s leadership to force-feed liquidity into the U.S. financial system following the near catastrophe of 2008. One result, until two months ago, has been record low Treasury bond yields and the rock bottom mortgage rates with which everyone is familiar. Another is that banks have slowly begun relaxing their lending standards, and only recently appear again to be willing to lend to businesses and individuals. Corporate profits and balance sheets have dramatically improved; businesses

have figured out how to do more with less in a moderate growth environment. Residential housing markets have begun a recovery, new housing construction has picked up and there has been a strong resurgence in domestic automobile sales. The Federal Reserve has succeeded in stabilizing the economy and improving the condition of the stock market, helping create a feeling that spending money and making business deals after a long drought may be admissible and even enjoyable. The question remains how long it can continue its force-feeding and what happens when it stops. Time will tell.

One other positive influence deserves mention: North American energy. The chief executive of URS, a large infrastructure contracting business, said in a recent *Fortune* interview, "The dynamic of the U.S. becoming energy independent by 2020 is a complete game changer. It gives our manufacturing industry an enormous boost. You can imagine the advantage of manufacturing with the cheapest energy in the world in a political climate that is more reliable than other countries." This new development may have the greatest potential of all to be a driver of our economy over the long term.

And yet the macroeconomic debates continue: Will the efforts of the Federal Reserve fall short and result in our descent into a Japanese-style deflationary abyss? Or has Bernanke's forcing of interest rates to artificially low levels stoked up the stimulus too much, with the effect that in five years we will be fighting the fires of inflation, as we did in the late 1970s and early 1980s? Experts forecasting polar opposite outcomes are not at all unusual in our business, but both sides can't be right simultaneously.

The S&P 500 is currently trading at 13.9 times projected earnings for the coming year, slightly below its 10 year average of 14.1. The latest manufacturing report shows an expanding economy, but only barely. The Federal Reserve's actions or the (in)actions and intransigence of Congress could help tilt the outcome one way or the other. But if eight years of the Bill Clinton presidency, ending in 2001, demonstrated anything, it was that political gridlock in Washington sometimes provides fertile ground for a bull market. At Peak, we continue our discipline of trimming overpriced investments when we need to while combing sectors of the markets for bargains wherever we can locate them.

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.*