

July 15, 2014

After two historic crises in the past 15 years starting with the tech bust of 2000 and ending with the financial meltdown in 2008-09, the market prosperity we are now enjoying seems almost too good to be true. The S&P 500 finished the second quarter of 2014 having gone 51 straight sessions without closing up or down more than 1%, the longest such streak since 1995, according to the Wall Street Journal. The CBOE Volatility Index, a measure of swings in stock market sentiment, hit its lowest level since 2007. And the Dow Jones Industrial Average has had 32 months without a correction, defined as a 10% decline, the fifth longest run on record (also from the Journal). Although this has left us feeling pleased and prosperous, we must remind ourselves that the ensuing recovery has been slow, uncertain and painful. Fortunately, complacency and self-satisfaction are not part of our makeup at Peak. Our attitude is more in line with that of Yvon Chouinard, the founder and CEO of the outdoor clothing and equipment company Patagonia and a falconer from age 14, who said his firm “remain(s) in *yarak*, a falconry term derived from Persian and meaning ‘superalert, hungry but not weak, and ready to hunt.’ ”

We continue to look favorably on the 20 companies in our Model Portfolio*. 13 of them have Value Line’s highest Financial Strength rating of A++. Barron’s listed eleven of them in a recent compilation of the world’s 100 most respected companies. Eight of the remaining nine that didn’t make the list have had, in our opinion, a healthy appreciation of their prospects since we first purchased them. Canon, our one black sheep, continues to underperform our expectations, despite its pristine balance sheet and healthy free cash flow.

Looking forward into the next few years, one of our businesses, McGraw Hill Financial, faces a barrage of litigation, as its often shoddy job of rating complex financial products contributed in some degree to the 2008 meltdown on Wall Street. We have asked ourselves hard questions about whether to continue holding McGraw Hill in view of the negative publicity the cases will generate as they proceed through the courts. My answer is a qualified yes, since it is rare to find a business with a cash flow as consistently strong as McGraw Hill’s. Just as important, its ownership of the Standard & Poor’s franchise places it directly at the center of the burgeoning and profitable trend toward index-based investing.

The most pressing questions we as money managers have faced in the past months have to do with “big picture” issues. When will the Federal Reserve begin to raise interest rates and how much will it raise them? Should we be worried about inflation or deflation? The Fed has provided limited guidance and itself shows a pronounced lack of conviction. How much attention should we be paying to the new hyper-Islamism sweeping through the Middle East and Africa? We are less concerned about it now than we would have been 10 years ago, with advances in horizontal drilling technology perhaps ultimately providing our country with some measure of energy independence.

And the most consistently recurring internal debate of all is what percentage of our portfolios to commit to stocks. The Chairman of one of our companies, Warren Buffett, said, “Opportunities come infrequently. When it rains gold, put out the bucket, not the thimble.” With the benefit of hindsight, this is priceless advice from the world’s best investor who at 84 now approaches the end of his career. But maybe he should have added a caveat: As often as not, just when the bucket is getting full some ignoramus comes along and knocks it over, scattering the gold in every direction. For Buffett, with a stratospheric net worth, that’s not a problem. But an entire generation of average people has entered adulthood with the conviction that the stock market will always be topsy-turvy, frustrating and even corrupt.

That mistrust, to me, provides some direction. When most Americans finally lose their skittishness and become convinced that the stock market once again has regained its proper place as a dependable and profitable investment vehicle in which to secure their financial futures, it will be time for us to cut back on equities and begin deploying our and our clients’ funds elsewhere.

Until then, we will be like Yvon Chouinard’s falcons.

Best regards,

Noel F. Bennett