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One of the less-pleasant aspects of being a value investor is an almost constitutional inability to fully enjoy market prosperity.

Value Investor Insight 11/27/2013 newsletter

2013 was a year of mixed blessings. We were pleased to see the S&P 500 rise by 32% for the year, but the number of bargains in the stock market shrank. The portion of our own and our client portfolios committed to equities performed better than we had reason to expect, but we watched our bonds, or "safe money," experience one of the worst years in recent memory.

Despite the exceptional performance of the S&P 500 in 2013, there are indications this positive trend can continue. A study published by Davis Advisors showed that since 1928 every 10 year period of poor stock market returns has been followed by a decade of strong performance. From 1928 until now, there have been 10 periods of anemic returns followed by 9 periods of excellent returns (the current decade remains a question mark). For example, the difficult time of 1969-78, when stocks returned an annualized 3.2%, was followed by a striking recovery in 1979-88, when the S&P 500 returned 16.3% annually. The same study shows a weak annualized 2.9% return from 2002-11; what will happen in the 10 years until 2021 is anybody's guess. Instead of conjecturing, though, interpreting statistics helps: according to Lipper's data service, the amount of money that flowed into stocks in 2013 exceeded outflows for the first time since 2005, but only barely. The painful losses Main Street America experienced in the middle of the last decade eroded confidence in stocks in a lasting way. What will it take to make the average investor relax his defensive stance and start feeling positive about buying shares of companies again? Maybe another year like 2013.

A look at the financial strength of the businesses in our Model Portfolio* reveals a fortress-like solidity that I have never seen in my 24 years in the business. *Value Line* rates the strength of 18 of our Model's 21 companies as A or better, with 14 of them at A++. We have always focused on conservative balance sheets when we make purchases, but generally it is only in bear markets like 2008-09 that we are able to buy this kind of quality at reasonable prices. It is also during difficult times that we are most likely to pick up companies run by managers we trust and admire. In general, such managers have delivered years of strong cash flow combined with rising profit margins and healthy returns on shareholders' equity. Our chief executives now include Warren Buffett, John Chambers at Cisco Systems, Frank Blake of Home Depot, and Apple's Tim Cook. If these and our other company heads could keep performing as well in the future as they have in the past, the intrinsic value of the businesses in our Model would continue to escalate.**

The financial crisis of 2008-09 reiterated the importance of financial strength of individual companies and confidence in management. This includes not only confidence in the management of the companies we buy for our Model Portfolio, but also in the investment philosophy and discipline we employ at Peak in selecting these investments. When optimism and bullishness deteriorate into fear and insecurity, investors call everything and everyone into question, from the abilities of the heads of the Federal Reserve and Treasury Department down to the quality of money market funds. With that in mind, we are emphatic about our companies weathering the next financial storm in good shape.

At the end of last year we sold our half position in JP Morgan Chase bank from the Model Portfolio and used the proceeds to buy a full position in Wells Fargo. The reasoning behind the move was this: banks are extremely difficult to analyze, particularly when one looks at their hedges and holdings of complex financial products. In a rising market like the one leading up to 2008, the people in the money centers who invented, sold and invested in these instruments were brilliant, creative and highly paid innovators. After the financial panic they looked more like criminals. John Stumpf, the head of Wells Fargo, said, “It is interesting that the industry has invented new ways to lose money when the old ways seemed to work just fine.” I am grateful to Jamie Dimon, the CEO of JP Morgan, for being able to navigate the 2008 crisis and take advantage of its turmoil to make some large and potentially profitable acquisitions. But after a decade of watching JP Morgan and its culture and comparing its executives to Stumpf and the other higher-ups at Wells Fargo, with their small town, Midwestern-bred attitudes, we decided to make the switch. I recently spoke with Stumpf in Denver and was struck by how strongly his leadership style resonated with me; I am clear that I would rather put our money to work in shares of a bank whose culture I understand. Knowing it was Warren Buffett’s largest public holding by market value didn’t hurt either. There is no shame in admitting that many of our best ideas are and always have been derived (or stolen) from others.

I believe the price we paid for the Wells Fargo purchase was a relative bargain, but banks tend to stay in that range due to the difficulty of analyzing their loan portfolios, and if they have derivative and trading businesses it’s even harder. There are other areas of the market where we are finding cheap stock prices—natural resources, commodity companies and oil well services. In the year ahead these are likely sources from which we may be picking the additions to our Model. Unless, of course, a large correction sinks the stock market back into the range where we are once again able to use our stores of safe money to take advantage of widespread fear and pessimism.

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 client’s specific investment objectives and constraints.*

***Past performance is not a guarantee of future results.*