StaufferWilliams
ASSET MANAGEMENT · LLC

AUGUST 2013 INVESTMENT COMMENTARY

PLAYING TO WIN HAS BEEN A WINNING STRATEGY

In April we wrote extensively about a momentum shift, much like athletes experience during a hard fought game, beginning to take hold in the stock market. We said, "If we are right about this momentum shift, it is time for "the market" to abandon the game plan, which resulted from the shock of the financial crisis period, of play-not-to-lose and begin to again adopt the confidence inspired, time-tested, play-to-win strategy". We also highlighted a couple investments that we were making in companies that we believed would be transformational, one was Tesla Motors and the other was Facebook.

LIKING FACEBOOK STOCK FOR THE RIGHT REASONS

In a July 27, 2013 article from BusinessInsider.com entitled "Mark Zuckerberg Has A 27 Year Plan For Adding Another 5 Billion Users On Facebook" written by Jim Edwards, he states "Facebook's big increase in Q2 revenue — it was up 53% to $1.81 billion — took investors by surprise this week. It should not have. CEO Mark Zuckerberg has, refreshingly, spoken in plain English about exactly how Facebook's revenue will grow, and where its new users will come from, for months now. The company has been very clear that its user base is switching from desktop to mobile, and that is where growth will come from. It's just that most people weren't listening – literally".

At StaufferWilliams we do not count ourselves among the "most people" that Edwards was referring to. Facebook stock has been highly scrutinized since its disastrous IPO last year. In last year's June Investment Commentary we wrote, regarding Facebook's controversial IPO, "avoiding this IPO is something that we are proud to say we did, as we did not count ourselves among those who believed that Facebook should be valued with a market cap that is $20 billion greater than The Disney Company". However, we went on to write "we are not inherently anti-Facebook or anti-IPO; in fact we believe that Facebook is a transformational company".

When we decided in April of this year to buy Facebook shares for the first time, we wrote about how we had concluded that Facebook and Tesla Motors are transformational companies with visionary leadership, and we were comfortable as investors to make what was intended to be long-term commitments to these companies at current valuations. Although market sentiment toward Facebook at the time of our investment was skeptical to say the least, we did not have any unique insight that others could not have had, had they just been willing to be objective.

Unlike many investors, in the case of Facebook, our ability to process information was not biased by the recent memory of getting burned by Facebook's disastrous 2012 IPO. We were also not swayed by the optics of whether or not Mark Zuckerberg wears a hoody or not. We were able to see Facebook as a company that has accomplished what no other company has ever been able to accomplish. We also have great confidence in the strength of Facebook's Board of Directors, a group of internet pioneers and veteran executives from media, consumer products, biotechnology, and government. For much of this year the sentiment surrounding Facebook stock was one of skepticism and outright distrust regarding usage trends of Facebook among U.S. teenagers. What we were objectively cognizant of was the durable advantage having 1 billion plus worldwide Facebook users was and the positive trends that existed in overall usage (PC and mobile). Additionally, we were convinced that company's intensive focus on making sure that they capitalized on the migration of users from the PC to the smartphone as a primary portal for social network interaction was the correct strategy and would be successful.

Choosing to not participate in the market mania that surrounded Facebook's IPO last year and then confidently taking a position in the stock approximately a year later, at a time when mania had morphed into irrational skepticism, is emblematic of how we approach security selection across the board.

We have said many times that we tune out market noise and the herd mentality of the financial media. Our experience with Facebook over the last year is a prime example of doing exactly that. When we chose to take a pass on one of the largest and most hyped IPO's in history, we knew that we were risking ridicule had the IPO resulted in large gains for investors. However, we were not focused on the hype or reputational risk; we were focused on the valuation metrics and the myriad of unknowns at the time. When we took a position in Facebook earlier this year and announced that decision in our commentary, we again willingly took another reputational risk by going against conventional sentiment at the time. That conventional sentiment was that Facebook's business had essentially peaked and that management was not up to the task of monetizing the vast social network. With strict focus on competitive advantages, management capabilities, we were able to see that business metrics pointed to the successful monetization and continued growth of the world's largest social network. We did not see any deterioration of overall usage that was the prevailing rumor at the time. This led us to making the right decision for our clients.

We write this commentary each month in order to provide transparency into our process. Our process is inherently difficult to define compared to more narrowly defined investment approaches, such as large-cap value or small-cap growth. Intentionally, and by design, our approach is much more unconstrained, allowing us to seize on opportunities across the equity spectrum as they arise. Due to our flexibility we are typically led to opportunities within the small and mid-cap space, as these equities are generally less followed, and thus are priced more inefficiently. However, like Facebook, some large companies become "unloved" for reasons which are not necessarily fundamentally based. When these situations arise, we are more than happy to do the necessary research and consider these unloved giants for portfolios.

WE WENT BIG -- BUT NOT FOR VERY LONG

Beyond Facebook, a good example of being led to a large-cap opportunity is Microsoft. Having largely avoided the stock for most of the past 10 years since it ceased being a growth stock; buying Microsoft earlier this year is noteworthy. The stock has languished for more than 10 years between $23 and $32, while the stock's valuation metrics became ever-increasingly more attractive as earnings continued to grow. Late last year we decided to consider Microsoft stock for purchase based upon its attractive valuation, its dividend, and what we believed was an increased likelihood of a meaningful restructuring of the company. In January we purchased the stock between $26 and $27 in both our Core and Dividend Growth strategies. A few short months later, the company's long-time CEO told investors that he would be making a major announcement concerning a corporate restructuring. After this announcement, and an encouraging first quarter earnings report, the stock appreciated to over $32 per share. By the time the restructuring plans were made public in late June, the stock had appreciated to a high, not seen for over 10 years, of $35 per share. The restructuring announcement did not turn out to be nearly as material as we had hoped and it certainly was not transformational. Surprisingly, the stock received the news well and did not sell-off due to disappointment. Because we were looking for something much more impactful, such as a splitting of the company into two separate entities, we began reducing the size of our positions. As the company's second quarter earnings release approached, our research into the company's growth drivers (Surface Tablet and Windows 8 software) raised our concern that these new product sale trends were likely to result in disappointment. Just days before the earnings release the stock was still trading above $35 per share and we eliminated it as a Core strategy holding. As we feared, the company reported disappointing financial performance for the second quarter and the stock immediately sold-off almost 15%.

WE SAW VALUE AND M&A ACTIVITY VALIDATES OUR FINDINGS

Our last example of how our equity selection process works is Onyx Pharmaceuticals. Onyx was a $5 billion dollar market cap biopharmaceutical company with two successful oncology drugs on the market when we added it to our Biotech Strategy accounts earlier this year. As more data became available on the potential to expand the company's drug Nexavar into treatment areas such as breast cancer and thyroid cancer, and we became more comfortable with upcoming new drug approval prospects, we added Onyx to our Core equity strategy at around $78 per share. We viewed the company as under-valued based upon the prospects for its currently approved drugs to get expanded use and the promise of its deep developmental product pipeline in the area of oncology. These attributes led us to conclude that the stock faced two potential near-to-intermediate term catalysts: (i) share price appreciation based upon sales trends and product approvals or (ii) the potential that they would become an acquisition target.

On June 28th Onyx was trading at approximately $86 per share and a report surfaced that Amgen had made an unsolicited offer to buy Onyx for $120 per share. The rumored acquisition offer moved the stock on Friday, June 28th to almost $120 per share. Over the weekend Onyx confirmed the rumor and announced that it had rejected the offer as insufficient. The stock opened up on Monday, July 1st over $130 per share as investors cheered on the prospect that a bidding war could develop for the company. Throughout July the stock traded between $126 per share and $135 per share. In our Core strategy we initially reduced our position size by selling shares when the stock price was above $134 per share. Ultimately, we decided to exit completely from Onyx in the Core strategy as we became convinced that the company would be unlikely to be bought out for much more than $140 per share. Therefore,

with the stock trading in the low-to-mid $130's, the upside potential was less than 10% and that could not outweigh the downside potential of more than 20% if a deal did not materialize. We were very happy to lock a partial year gain of more than 70% for our clients based on February purchases.

UNABASHED PROPONENTS OF AUTHENTIC ASSET MANAGEMENT

We are always pleased to be the bearer of good news, and the aforementioned successes are just part of a portfolio management process that we are proud to be able to offer individual investors. We believe that too much of what passes for investment management today is akin being a general contractor who subcontracts out 100% of the project to others. This process works in some instances when building a house if the subcontractors are highly experienced. But this use of subcontractors only makes sense if client pays the general contractor and that compensation also covers the cost of the subcontractors. Unfortunately, in the case of investment advisors who subcontract out the work, the client pays the general contractor (advisor) 100% of going rate for portfolio management, but the client also pays for the work of the subcontractors (mutual funds/separate accounts & ETF's) on top of that. Therefore, if this same payment practice was applied to home building, a new home would cost double what it does today.

We will continue to build our clients' financial security day-by-day, security-by-security, scrutinizing each decision, and adhering to a fundamentally grounded discipline that has stood the test of time. Our process does not guarantee 100% success all of the time, but it engenders confidence because it is not only transparent, but is also rooted in an easy to understand principal. That principal is that investment management should be driven by the desire to be objective, the willingness to be forward –looking and opportunistic, and last, but not least, the pledge to offer this service at a cost that does not undermine the clients' success.

As we begin the second half of 2013 and many of our equity opportunities entered into over the last six to twelve months have exceeded our expectations, it is vitally important that we must continually identify new opportunities. This process brings with it a heightened level of trading activity. Trading is not something that we seek in excess, but it is inherent in the process of active management in order to adhere to a sell discipline.

Looking ahead to potential challenges over the balance of the year, Washington D.C. will again test the financial markets as partisan battles begin to heat up again this fall over passing a budget and extending the debt ceiling. As in the past, these battles, if handled in good faith by both sides, can be reconciled without dysfunction and adverse market reactions. However, we are mindful of how this process has played out in the recent past and are prepared for the reality of how partisan politics can create unnecessary market volatility come fall.

We sincerely hope that everyone has enjoyed the summer months as much as we have. Balancing work and family is a constant, but when work is as rewarding as it has been over the last couple months, it makes that time spent with family all the better. If you are a client, we look forward to sitting down with you in the near future, and if you are a non-client, please reach out to us to learn more about StaufferWilliams Asset Management.

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The author of this commentary and/or clients of Coastal Investment Advisors owned the following positions discussed in this commentary when it was published: Tesla Motors (TSLA) and Facebook (FB).

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