StaufferWilliams
ASSET MANAGEMENT · LLC

MAY 2013 INVESTMENT COMMENTARY

WHAT'S REALLY BEHIND THE MEDIA'S SIREN SONG OF SHORT-TERM TRADING?

The last 30 days should serve as a good reminder that focusing on the most basic tenets of long-term investing, rather than on "the market" or the apparent brilliance of celebrity short-term traders, is what truly drives wealth creation over time. The most common weakness that most investors fall prey to is the mistaken importance of the near-term direction of the market. This tendency to assign a high level of importance to the short-term market direction seems to be reinforced by most market oriented media broadcasting these days. Our experience leads us in an entirely different direction. It leads us to a long-term focus on wealth creation, underpinned by a fundamental value discipline.

Charles Schwab is running an advertising campaign showing a seemingly successful man sitting behind a dual screen computer, talking about how the Charles Schwab trading experts helps him successfully trade chart patterns. He brags to his wife how "when he spotted that double bottom, he jumped on it". Over dinner, at a high end restaurant, his wife gleefully tells him that "she loves it when he talks chart patterns". The implied message is that the recipe for successful investing depends on capitalizing on short-term market opportunities that can only be exploited by using the sophisticated technology and tools of the online brokerage companies. In our opinion, this type of advertising by Charles Schwab and virtually every other television ad by online brokerage companies does a huge disservice to the investing public.

CNBC programs such as Fast Money, Mad Money and even the long-running Squawk Box are no better. They combine to produce very little for viewers in the way of providing valuable information and analysis related to actual investing. These programs dedicate a majority of their broadcast to trading strategies based on market momentum, employing options strategies around upcoming earnings releases, or they regularly feature hedge fund managers, who have a room full of traders who use arcane proprietary trading schemes when managing billions of dollars. Although sometimes interesting, none of this programming serves the interests of the long-term investor.

Over the first weekend in May, Berkshire Hathaway held its annual meeting, which has become a mini Mecca for Berkshire investors and Warren Buffett disciples alike. Motley Fool wrote an article called 5 Buffett Quotes on Investing From the 2013 Annual Meeting. In this article, the author, Matt Koppenheffer, selected the following quote from Warren Buffett, "if they try to time their purchases they will do very well for their broker and not very well for themselves." Koppenheffer, went on to write "for some investors the siren's song of short-term trading is strong. Surely, if an investor can only jump out of the market before dips and get back in before jumps, vast riches will soon be in hand. Buffett thinks there will be riches generated, but they'll be for the broker charging fees for those over-active trades, not the trader." It is no wonder that Ameritrade, Charles Schwab and Interactive Brokers spend so much money advertising on CNBC.

All investors should have taken notice over the span of the last month what happens when that "siren song" that we constantly hear from the financial media gets louder following an economic report such as the March BLS Employment Report that was much weaker than expected. Immediately upon hearing that report the television talking heads began to warn everyone that the economy was rolling over again like it did in 2010, 2011 and 2012. The problem with that type of knee jerk reaction is that initial BLS Employment Reports, as with many other government economic releases, are subject to revision for at least the next two months.

It is foolish, but it does not stop hyperactive traders and sensationalized financial media hosts from concluding from such a report that our economy is going to fade again in 2013 as it has for the last three years. It somehow makes sense to traders, that the largest economy in the world is predisposed to weaken between March and September each year. Foolish or not traders are instinctually addicted to looking for patterns. Patterns in terms of investing can be very dangerous because causality is usually ignored. A discussion on causality requires a level of complexity that does not fit into the typical sound bite manner of discussing the market that has become the norm. But really, how hard would it be to question the validity of a pattern by mentioning that in the Spring of 2009 we experienced the simultaneous shock of the Deep Water Horizon Gulf Oil catastrophe and major fears over the future of the Greece and the European Union? In 2010, the world economy was stunned by the unprecedented Tsunami that brought the world's third largest economy a screeching halt, and in 2012, a U.S. Presidential election filled with economic hyperbole, along with the uneasiness about Europe centered on Italy instead of Greece and that these events certainly contributed to slow economic growth.

The search for patterns dumbs down investing and plays on many investors' insecurities, leaving brokers to capitalize on this insecurity in order to convince investors that investing can be condensed to trading these so-called patterns. Let us state once again why brokers and traders don't just give it to us straight like Warren Buffett does—transactions equal profits. Transaction fees are the primary source of revenues of online brokers and large Wall Street investment banks. Brokers, traders and their enablers--the financial media, force feed the public a useless diet of technical and option trading ear candy in order to condition investors to think that investing is a day-to-day game of chance. This is not to say that we do not look at patterns, which we prefer to call trends. But we do not look for trends to justify trading, but instead we look for longer term trends in order to provide an underpinning for our investment strategies so that we can largely ignore short-term noise and the unproductive trading that accompanies it.

The aforementioned March BLS Employment Report released on April 5th showed that only 88,000 new jobs were created in March. This was far short of consensus expectations of 125,000 new jobs. During the weeks that followed, major stock U.S. markets stalled and interest rates, which had been trending higher, reversed and fell to levels consistent with pre-recession levels. This one report changed the tone. One preliminary report changed the tone in the financial media and the expectation of traders. So it was off to the races to convince investors that they should take profits in stocks, buy option protection and go long once again in bonds. As we fast forward to May 3rd, the BLS Employment Report for April showed that jobs created in April were better than expected at 165,000 jobs and more importantly, the March's job creation was revised up from 88,000 to 138,000—oops, all that slowdown talk that occurred in April, forget about that. Furthermore, February's strong 268,000 jobs number was revised up to 338,000. All of the sudden, "reality" as defined by the financial media and traders was rewritten and the stock market immediately rebounded strongly. All of those "risk off" transactions encouraged by traders and broadcasters on CNBC were for naught, but it sure was a nice boost in revenues for the brokerage and trading companies.

The public gets duped into believing that reliable patterns exist and that if you are paying attention to the right indicators, or listening to the right people, the future can be predicted with a high level of certainty. This is simply not true, and furthermore believing this fairy tale can do great harm to one's financial future.

At StaufferWilliams, we focus very little attention on month- to-month economic releases or any other short-term change in market psychology or price action. We rely upon what is known as the mosaic approach to the analysis of information. A mosaic is a picture made up of many small images that by themselves bear no resemblance to the composite. When viewed from a distance all of the seemingly unrelated images create a vivid cohesive image. We require many months, or even quarters, of varied economic and corporate activity related indicators in order to produce a reliable picture of economic or fundamental business trends.

We strongly believe what Warren Buffett spoke of this past weekend when addressing the counterproductive behavior of overly active traders. With that in mind, our managed portfolios will not look and act like the market. A good example of this is our recent modest performance relative to the highly followed major large-cap U.S. stock market indices such as the S&P 500 and Dow Jones Industrial Average. Our portfolios are currently lagging not because we are poor stock pickers, but because we exercise prudence in our stock picking. The S&P 500 and the "Dow" are reaching new highs, led mainly by high dividend paying utility and consumer staple stocks. It just so happens that these stocks represent companies that are the slowest growing companies within those indices, but are currently the highest dividend paying. Because so many investors are indiscriminately buying stocks in order to generate income from dividends to replace yield not currently available in bonds, these stocks have been driven to historically high valuations—which means that future stock performance of these companies' stocks are likely to be disappointing.

For example, Proctor and Gamble, the consumer staples giant, is trading at a forward price to earnings ratio (P/E) of 18, while annual earnings growth over the next 5 years is expected to be at an annualized rate of only 7.75%. When the P/E ratio is divided by the earnings growth rate, the result is a PEG ratio of 2.48—representating a significant premium above PG's historical valuations, and many other stocks in today's market with superior growth outlooks. The contrast is a stock that we are currently very enthusiastic about owning, Avago Technologies Limited, which is expected to experience earnings growth of 11.42% annually over the next 5 years, and is currently trading at a forward PE of 11.43. Avago's PEG ratio is only 1.00. Avago also happens to also pay a 2.34% dividend.

Procter and Gamble, long prized for its ability to consistently demonstrate relatively unexciting, but steady growth in earnings and dividends, is a just one example of many companies within the consumer staples and utilities sectors that have morphed into momentum stocks in today's world. This momentum is largely due to Federal Reserve quantitative easing policies, which have in effect eliminated "safe" yielding fixed income securities options for investors. What this means is that the Federal Reserve's monetary policy is creating security price inflation in equity sectors of the market that have traditionally offered investors seemingly "safe" yield—high dividend paying stocks. The pricing of high yield corporate bonds and some REIT's have also been affected in much the same way. It is our job to avoid the temptation of jumping on this monetary policy juiced momentum train. Instead it is our responsibility to identify value for our clients and invest in securities that represent value relative to expected growth in earnings and cash flow. This approach is designed to build wealth over time, not to capitalize on short-term market momentum trades.

It is this wealth creation approach that enabled us to identify companies such as Tesla Motors. We can find value in such a company in spite of the fact that Tesla will be posting its first quarterly profit when it reports earnings this month. Tesla Motors' stock has a forward PE ratio of 40 and a projected annualized five year earnings growth rate of 46%, thus a PEG ratio of less than 1.00. In other words it looks like a value stock in our opinion. We purchased this stock in March, when the valuation was even more attractive at around $44 per share. As we write this commentary it is trading between $54 and $61.

In last month's commentary we spotlighted our new investments in Tesla Motors and Facebook as two examples of transformational companies, epitomizing the unique strengths of American capitalism, built on the foundation of innovation and entrepreneurial risk taking. The recent performance of Tesla is but one piece of the mosaic that depicts the transition we wrote about last month of market participants beginning to "play to win" by viewing the investment horizon opportunistically rather than defensively.

To us, perhaps most significant of all the data making up our mosaic, which paints a picture of a continuation of a steadily improving U.S. economy is the strong recovery occurring in the housing sector. Since its trough in early 2009, the steady recovery in housing starts has meaningfully strengthened during the past several quarters, meanwhile the pace of household de-leveraging has also slowed. Despite the improvement in housing starts, current levels still remain well below historic average levels of household formation since the data series was initially recorded in 1959, despite a near doubling of population in the U.S. during that same time period. Housing starts increased 28% to 781,000 from 2011 to 2012, but 2012 was still the fourth lowest year of housing starts on record. The U.S. has averaged approximately 1.5 million new housing starts annually since 1959. Current demographic trends point to a need to get back up to that level or above over the next few years. Historically, housing starts have been a very reliable forward economic indicator relative to U.S. economic strength. We see the recovery in the domestic housing market continuing to improve. Due to the way growth in household formation ripples through the economy with a multiplier effect, we are increasingly more optimistic that the current tepid economic recovery has staying power and the wind at it back.

There are many ways to capitalize on investment opportunities resulting from the improvement that we expect and they are reflected in our clients' portfolios. In past commentaries we have mentioned our successful investments in timber REITS (Plum Creek Timber and Rayonier), and more recently our focus on Walton International, a non-traded direct investment limited partnership in pre-development land, reflects our confidence in the durability of the housing recovery.

Walton continues to be a very compelling story. Due to the timing of Walton's opportunistic land purchases post financial crisis, and its long history of working with zoning and governmental agencies, we believe that this unique investment represents a direct manner for many of our clients to participate in the historic recovery that we see taking place in the U.S. housing market.

We will remain focused on long-term value creation and risk management for our clients. That requires tuning out media and market noise that serves as little more than a distraction to investors whose focus is rightfully on the future and not the present.

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