

# INVESTMENT STRATEGY LETTER

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## Bonds for the Long Run

We begin the new year in what is hopefully the aftermath of the usual flotsam and jetsam about what is to come in 2010, a process that seems to get more and more painful to endure every year. If there is one obvious point that should have been staked into every investor's heart and mind last year, it is that near-term forecasting remains a nonsensical fool's game. Given that there are few eyes in the world that have seen the variety of the unusual financial conditions in which we find ourselves today, now is not really the time to whip out your crystal ball and hang up a shingle and glass beads.

Which of course brings us to the sublime beauty of value investing. We don't have to concoct all sorts of wonderful themes and then look for things to buy; instead we react to Mr. Market's pricing and it nudges us in the appropriate direction. In some ways we don't really look for investments, they find us. For those who cling to fashionable ideas, such thoughts should present themselves with Twitter-like brevity. We will start this letter with the following: unlike the early part of 2009 when the poor and huddled masses of abandoned equities camped on our doorstep, the Great Rally, like many great rallies, has reduced the absolute

attractiveness of many stocks to a reasonable holding state.

This sense of fair value, which we see in many stocks fed into our research maw, reflects the overwhelming sense of ambiguity about the intermediate economic direction

of the global economy. While we hate to repeat ourselves and we have been warned by several clients not to reload the "Jim Grant vs. David Rosenberg" debate, the fact is that not a lot has changed in the last six months except the grudgingly upward movement in asset prices. There are simply a lot of very odd imbalances in the financial world that frame our respect for inventory cycles, a near vertical yield curve and the very tangible year-over-year and sequential signs of economic improvement on the ground. In many cases, the equity markets are neatly pricing in this balance and as a result, we have become more defensive than we were a year ago, as our discipline is the process of pricing uncertainty and we are simply not getting paid

as well for it. We have often noted that there is nothing wrong with debating whether the glass is half empty or half full, but it is highly likely you will die a slow death if you dogmatically cling to the notion that the glass is

Percentage of Periods When Stocks Outperform Bonds and Bills

Holding Period	Time Period	Stocks Outperform Bonds	Stocks Outperform T-Bills
1 Year	1802-2006	61.0	62.0
	1871-2006	60.3	64.7
2 Years	1802-2006	65.2	65.7
	1871-2006	65.4	69.9
3 Years	1802-2006	67.2	70.2
	1871-2006	68.7	73.3
5 Years	1802-2006	69.2	72.6
	1871-2006	71.3	75.0
10 Years	1802-2006	80.1	80.6
	1871-2006	82.4	85.3
20 Years	1802-2006	91.9	94.6
	1871-2006	95.6	99.3
30 Years	1802-2006	99.4	97.2
	1871-2006	100	100

Source: Jeremy Siegel, *Stocks for the Long Run*

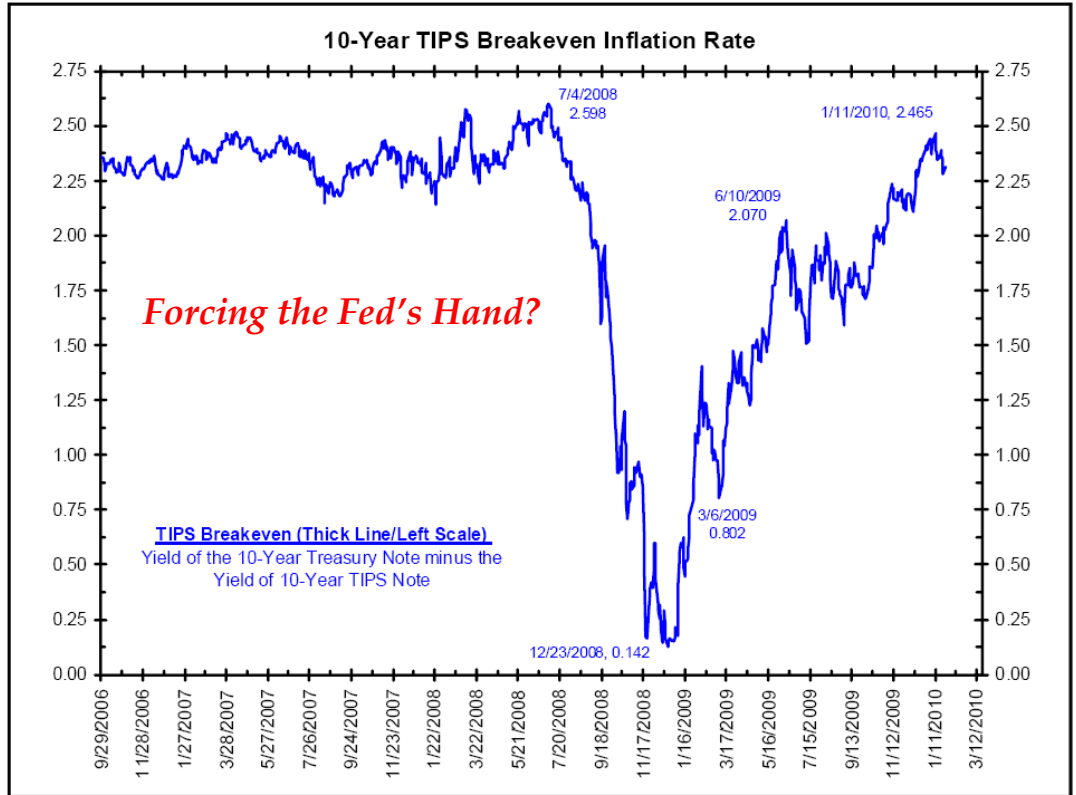
completely empty or overflowing. And as the 17th century mathematician and philosopher Blaise Pascal noted, "All men's miseries derive from not being able to sit in a quiet room alone."

The one thing that we do feel very comfortable stating is that equities as an asset class will outperform investment grade bonds of almost any stripe over the intermediate and longer term using January 2010 as our starting point, and we would be willing to take side bets on the near term. "An investment operation is one which upon thorough analysis promises safety of principal and a satisfactory return," states value father-figure Benjamin Graham. It is extraordinarily difficult to argue that Treasury bonds fit that bill in almost any maturity, and the continuing contraction in spreads in the investment grade and the higher quality non-investment grade world have diminished their attraction as well.

Exhibit One is the table on the front page. And for those paying attention, updating the chart for the past two years doesn't materially change the math. It is simply a fact that it is extraordinarily rare for bonds to outperform stocks over long periods of time. The explanation really centers on what is the ultimate tailwind for equity investors - the ingenuity and intrinsic growth potential of profit-seeking human beings in a relatively free world combined with government policy whose DNA defaults to inflation. Both remain directionally correct truths we consider self-evident. While one can torture data many different ways, nothing is more important than your starting point and this picture is worth at least \$1000. Ask noted finance professor Jeremy Siegel who published Stocks for the Long Run in 1994, which was the intermediate top of the long run numbers in the stock vs. bond horse race. A bad starting point will kill you every time; hence, our enthusiasm for equities for the long run grows as we see more and more headlines about "The Lost Decade" for equities. If anyone bothers to check, January 2000 was as lousy a starting point for measuring equity returns as you can dig up in 130 plus years of published equity data. Using that as your starting point for an

investment process is as ridiculous as using March 9th, 2009 and expecting 60% annualized returns going forward.

We have seen a variety of reports bemoaning current equity valuations and many seem to default to the standard incorrectness of looking at current year "expectations" in isolation, a process which not only incorporates the historical *fact* that analysts are miserable at estimating near term earnings, but it also produces a high probability of



Source: Bianco Research, LLC

misinterpreting or underestimating rates of change from economic inflection points. As an example, using 2010 earnings or trailing 2009 earnings will suggest many stocks are expensive, but the argument is very strong that 2010 does not nearly approximate the cash returns many companies can achieve in a normalized environment. Thus, even in a "new normal" that is lower than the old normal, many stocks have room to move over the next few years as economic returns continue to revert upward. If this process happens in the back half of 2010, which a quiet minority calls for, equity returns are likely to be stronger than anticipated. If it takes until 2014, then the Great Rally has run its course for some time.

With equities seemingly valued to do "okay," much of the help in the equity/bond analysis will come from bonds themselves. Yes, it is possible that we are in the midst of another ten years of pain à la Japan, and the bet is therefore

that a 3% handle in US Treasuries is the relative value. And there are many who seem comfortable with this risk/reward, and a number of them actually have business cards that don't have the word blog printed on them. Their argument is also based upon facts, as in deflation is the grinding, over-indebted, asset-selling, huge overcapacity global big picture, versus the opinion that we may have an inflation problem in the future. The "China is Dubai with Mark McGwire's Trainer" is an addition on this theme.

But as noted in the chart on the left, our inflection point may be here, and I wish we had as many stocks with this kind of exponential price chart. One could argue that we are much closer to a problem in fixed income than many think. Contrary to much consensus thinking, the Federal Reserve and the Treasury cannot sit on short-term, lower than zero interest rates at will – if there is an inflation problem brewing, the market will sniff it and make its presence felt in a very big and rapid way, similar to how stocks changed on a dime in early March 2009. That will not be a good week for fixed income, and its near-term effect on equity markets will also be interesting.

There is a massive experiment being conducted around the globe in fiscal and monetary policy, the scale of which is simply unprecedented. Speaking first of our great nation, we have thrown money at admittedly very serious issues over the past year in forms and sizes that are unprecedented in scope. The spending, which includes any variety of guarantees, credit-backstopping, insurance, and the out and out torching of taxpayer dollars was hatched in the darkest nights of fear and political expediency, an environment which is not normally associated with well-reasoned strategic plans. It can be argued that it was necessary in some form, but it still left the sticky issues of what will follow and how it will play itself out, and, as articulated every week in a contradictory fashion by any number of branches and departments of our elected and appointed officials, there simply is no exit strategy to wean the patient off life support. Given the historical propensity of government officials in any political system to concoct elaborately incorrect plans to address financial issues, it does not seem like an outlandish statement to suggest that there is a very small chance that our federal officials will be able to neatly extricate the largest sum of money ever thrown at a non-military problem without some form of market instability. And we will make the brave leap and say that the direction of interest rates in this transition period is unlikely to be lower.

A recent article in [Pensions & Investments](#), notes that the "big money" (which is a lot different than smart money) is

piling into liability driven investing strategies and selling stocks to fund the wonders of low single digit fixed income. "The equity party is over. After two brutal stock market crashes, investors are questioning the conventional wisdom that stocks outperform bonds. They're systematically pulling back from equities and Wall Street will never be the same." This neatly mimics "small money" as investors put a record \$320 billion dollars into bond funds in 2009 and equity funds were net flat for the year, trends that persisted all year as stocks moved incessantly higher. We feel highly confident in saying that in both camps, money chases past performance, and these past few sentences are probably the best gut argument we have in favor of equities. Okay, we will throw in [Time Magazine's](#) selection of Ben Bernanke as Person of the Year, a clear sign that 2010 has a reasonable likelihood of haywire-like moves in interest rates and what could be a record in short-termism if Bernanke makes it through the year with a job. And if you are still clinging to the joy of 3% 10-year bonds, we will close with everyone's favorite financial mind, our very own Sen. Barbara Boxer, a senator from one of the lowest bond rated state in our fine nation. Senator Boxer stated recently that she plans to vote against Bernanke's reconfirmation as Federal Reserve Chairman. "It is time for a change - it is time for Main Street to have a champion at the Fed."

The awfulness of that statement stands on its own two feet and we have digressed at length in previous Strategy Letters about the horrendousness of a politicized Fed, no matter who its leader. What we will add in this edition is that "Blame the Central Bankers" is a much more relevant theme than "Blame the Private Bankers." Recent pronouncements out of Washington in regard to the banking system and its constituents as to structure and remuneration, which like healthcare reform to date, are merely pronouncements and are so vague and so, well, political (i.e., devoid of any practical economic common sense), that it is difficult to read morning newspapers, wherever they still exist. To reiterate, most banks did *not* need TARP, they were coerced into TARP and it does not matter how many times you use the word bailout, it does not make it a fact. As of this printing, the taxpayers are solidly in the black on TARP and money is being paid back every day. The only lost money is likely to come from the decidedly non-financial auto firms and at this point, AIG is a toss-up, although one anonymous Federal Reserve official was quoted in the [Financial Times](#) as saying "The Feds have made a killing on AIG CDO contracts."

By the way, Lehman Brothers, Bear Stearns, Goldman Sachs, Morgan Stanley, Fannie Mae, Freddie Mac, and the

FHA, to name a few, are not "banks." To punish any number of "banks" for the collective sins of what is increasingly looking like a credit-based Agatha Christie novel is unproductive at best. If the regulatory geniuses could not see anything as obvious as even one of the credit crisis issues in advance, then how are they going to separate the idea of proprietary trading from customer trading? What is too big of a financial services company and why should the 51st largest bank have an advantage over the 50th largest bank? Does anyone realize that "banks" don't invest in private equity? Bank holding companies do, and what have they done wrong except generate a decade worth of low returns? Is someone in Washington actually arguing that banks should stick to a core strategy of simply lending to real estate owners and developers? Sadly, we will return to this subject in future letters, but we consider much of the new bank proposals as "The JPMorgan Tax Program," which our investors feel personally. And as Warren Buffet recently noted, are we taxing Congresspersons for Fannie Mae, Freddie Mac and the FHA, a trio whose combined losses are likely to exceed the total spending on Iraq and Afghanistan?

Moving forward, the real fun in 2010 will be how investors react to the possibility of higher interest rates driven by a stronger than expected economy. Directionally like many of its predecessors, this equity rally was driven from spectacularly low valuations by cheap Federal Reserve money and the promise/threat of government stimulus spending. There has been definitive economic improvement almost no matter where you look, but it will be interesting to see how investors weigh the possible loss of free money in the short run with tangible cash flow improvement. This applies to many asset classes, not just equities.

On the home front, we continue to pursue a balanced mix of value-oriented opportunities, as current pricing truly does not seem to push us strongly in either of the directions explored in the preceding paragraphs. In our large cap strategy, recent purchases include ITT Industries and Loews Corp. ITT is a set of world class industrial businesses whose valuation is being punished by an equally world class defense business, the fear being defense spending is poised for an epic set of budget cuts. Loews is an under book value holding company with 55% of its assets in energy, 25% in a perennial underperformer CNA Insurance, and deployable cash and liquid investments. We think the energy assets are cheap and CNA, with a new CEO that hails from Chubb, has a management team with a long record of risk adverse value creation. In small cap, we bought a handful of regional banks that have subsequently rallied smartly and, under

the heading of a new and lower normal, still create significant upside from book value or below. We have also reloaded a number of industrially spring-loaded companies like Spartech that have fallen from recent highs. Internationally, we started new positions in Aflac and Brookfield Asset Management. The former is a world class insurance company with substantial market share in Japan, which will be an attractive market for numerous secular reasons over the next several years. Brookfield is a Canadian company with extensive real estate and energy infrastructure assets which remain undervalued following the credit crisis of last year.

RCB had a superbly gratifying year in 2009 and more importantly, we have the same team in place that has put up solid numbers for several decades. We went through what I would call two odd years, and we would re-state to all existing clients and all potential new clients our long stated investment goal is to be competitive in rising markets and out-perform in down markets. That is the core principal of successful investing of any kind and our portfolios are structured as such.

If there was one thing we have learned from the last two years, it is the importance of working with the right clients. We want our clients to be very aware of who they are hiring - a high integrity, focused value manager with 30 stocks who by definition is *not* going to be tracking an index carefully over the short run, but who adds value over most intermediate and long run periods. A great long-term relationship starts with a good foundation of both trust and knowledge, and we will not hesitate to spend the time and effort to work with like-minded institutions and individuals.

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