The Long & Short of It

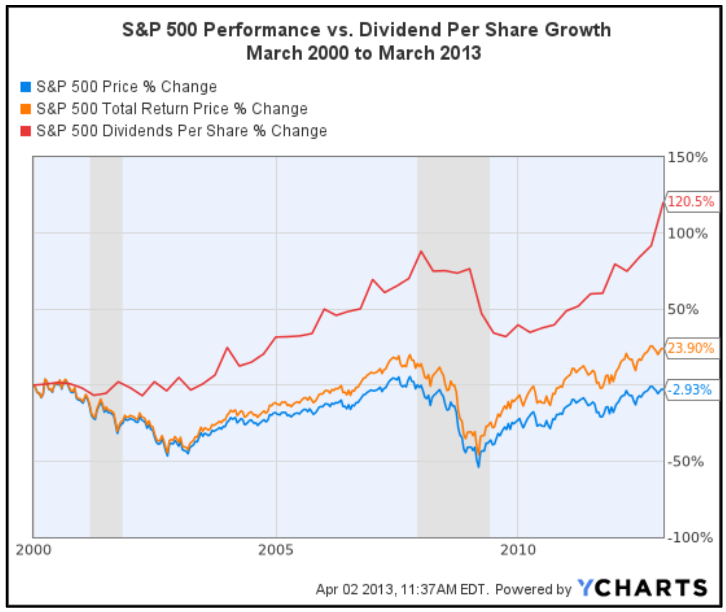
Quarterly Newsletter
First Quarter 2013

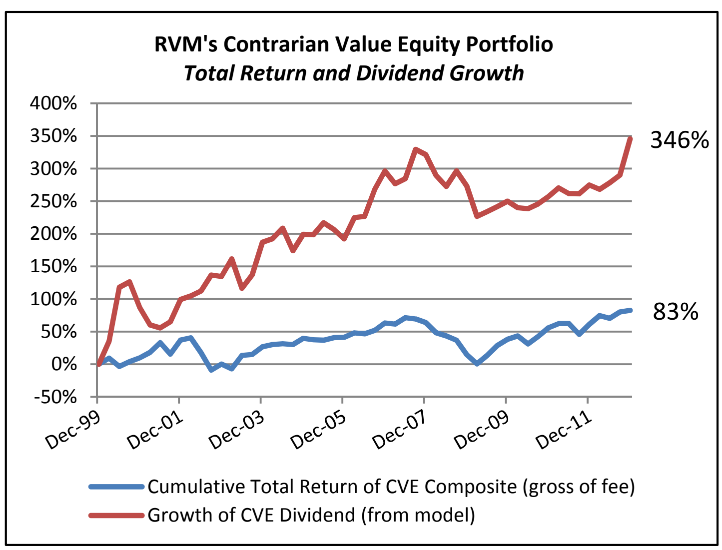
Tortoise vs. Hare

The first quarter brought to mind the old fable of the tortoise and the hare. As we all remember, in the short term the hare seems to have more fun but, in the end, slow and steady wins the race.

First Quarter 2013 was such a quarter, where the hares seemed to have the run of it. Cash and bonds returned close to nothing while stocks had one of their better quarters with the S&P 500 returning 10.6%. Domestic equities turned in better performance than international stocks. Moreover, due to their limited footprint and domestic focus, small cap stocks turned in the best performance of any category.

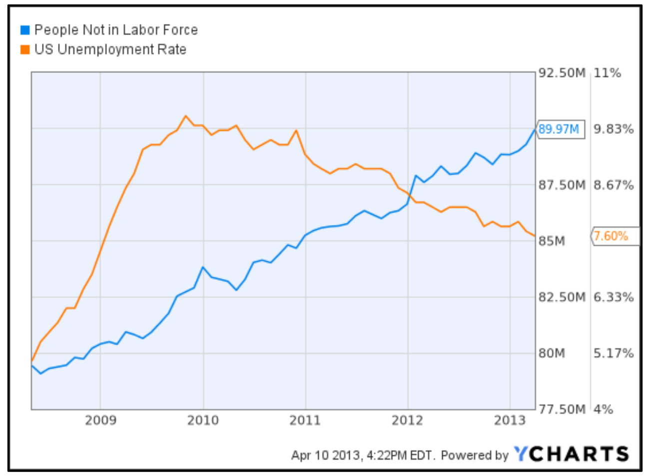
Our domestically traded, global leaders made good money during the quarter, but not as much as the broader market. Their tortoise-like results are to be expected in environments where the market moves up abruptly. In addition, after a great year last year, our tactical strategy had a difficult quarter. Though disappointing, it is an expected pattern as the strategy is intended to stabilize returns of equity portfolios while outperforming the market in the long run. This strategy looks for investment opportunities created by government policies that are damaging to equities. In Q1 2013, the federal government implemented new policies to slow the growth of fiscal spending while engaging in unprecedented liquidity creation. This policy combination was just what was needed by depressed equity investors looking for something to sustain stocks. The unusual actions of the Federal Reserve are now driving a new thread of research that should be beneficial for our tactical portfolio strategy.

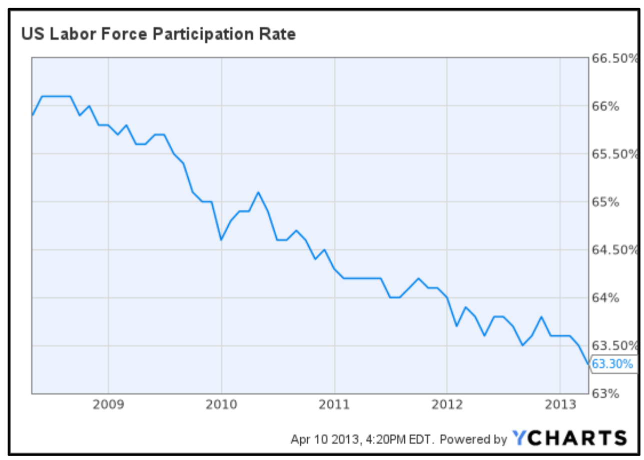


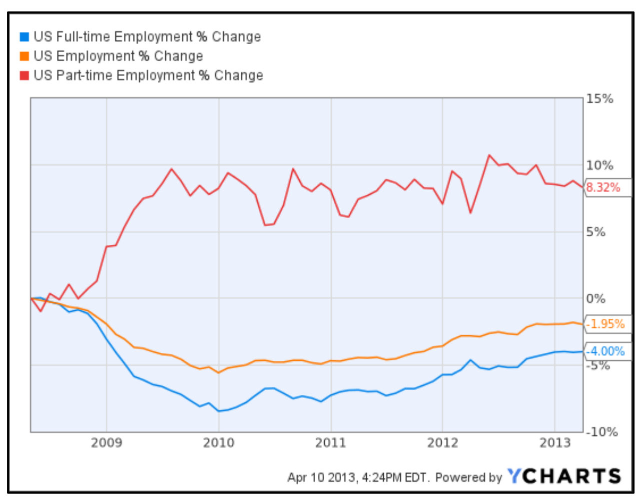


For our part, we cheer the tortoise. The rabbit may be willing to step out in front of a raging bull, but the turtle's protective shell helps him deflect the onslaught of the herd. Our portfolio of companies pays solid dividends that provide income today and, unlike bonds, pay even more income in the future. The dividend payout grows over time, providing relative stability as the portfolio grows. Our companies have not over-leveraged their balance sheets. Media exposure for them is hopefully moving from peak negativity to merely unfavorable. When markets rise quickly, these companies rarely rise as much. With the market rising about 70% of the time, the risk-averse investor must get used to lagging most of the time. As investors, this is a difficult proposition. Yet, in difficult markets, the same holdings decline less. In the long run, losing less seems to add up to more.

The emotions of this approach to investing are most difficult during, and especially at the end of, strong moves in the market. Patience and fortitude are required at these moments. Better still is a firm resolve that embraces the methodology just when it nearly cannot be borne for another moment. When a risk-averse investor's path reaches the height of frustration (best described as "gut-wrenching"), the temptation is to change strategies in disgust. Yet it is typically that moment when it is best to embrace the approach more completely, taking profits in recent performers and moving proceeds into the holdings that have hurt the most. Presuming the investment thesis and balance sheet remain sound, this dedication and discipline is what our clients have come to rely upon. At Robinson Value, we understand the stock market reflects volatile opinion in the short run but intrinsic value in the long run.





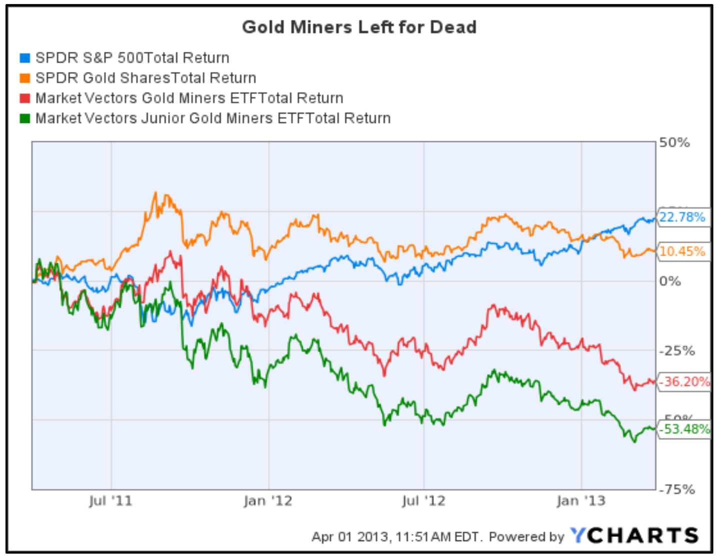


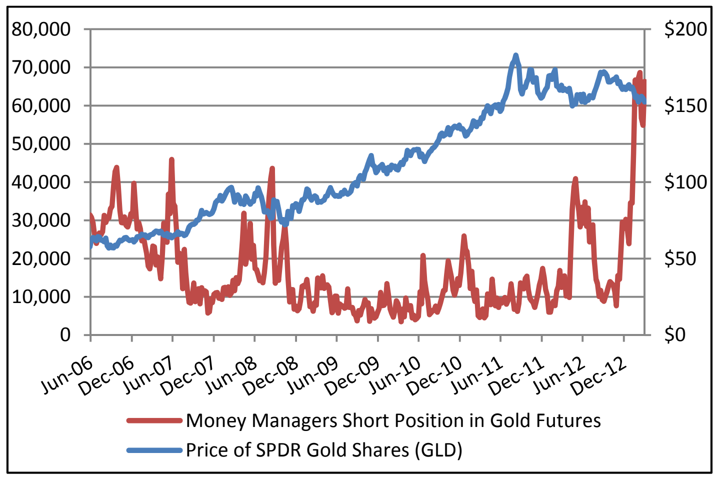
Runners Dropping Out of the Race

In *The Wealth of Nations*, Adam Smith cites several key factors that determine a country's ability to create wealth. Among these are labor specialization, ease of trade and transaction, and labor utilization. The US economy faces an uphill climb regarding labor utilization. The recovery in labor continues to move forward at a reasonable, but moderate pace, producing new jobs and seeing improvement in the overall unemployment rate as seen in the first chart to the right. Looking beneath the surface, we find that more workers appear to be leaving the labor force, creating a decline in participation. In addition, rather quietly, large numbers have moved from full time to part time employment, as illustrated in the second two charts. If we ignore the growing number of people who have chosen not to participate, can we claim a good turnout?

Reach for the Gold (Mining Stocks)

Over the last two years ended March 31, 2013, the price of the S&P 500 rose nearly 20%. The SPDR Gold Shares (GLD) ETF that tracks the price of bullion rose more than 10%. Meanwhile, the Market Vectors Gold Miners ETF (GDX) declined almost 40% and the Market Vectors Junior Gold Miners ETF (the smaller companies) fell almost 60%. A decade of poor stewardship by the management of mining companies, along with the popularity of the bullion-tracking ETF, has resulted in gold mining stocks becoming deeply out of favor. Money managers and speculators have recently grown aggressively negative on bullion, ramping up short positions in futures contracts beyond anything seen in recent history. Gold does poorly in a Goldilocks economy, where economic growth is stable and positive. Here at the Bear's house, we anticipate that "too hot" or "too cold" will be served regularly and always when we least expect it.





Having reduced exposure to the miners in August of 2011, our last quarterly letter mentioned the increasing attractiveness of the miners. There are several signs that our renewed interest in gold miners may soon be rewarded with a profound opportunity. The recent decline in gold first reflected growing investor optimism that real economic growth would accelerate and less money printing would be required. As economic growth has not been forthcoming and pricing has remained weak, the optimism is morphing into some margin and liquidity-based selling; a bit of a fear which means an end to the move is near. This selloff will clear out those who are "visiting" the gold trade, and create a consensus that "only idiots would own gold," a necessary part of putting in a meaningful long-term bottom. As government works to reduce deficits through either spending reductions or new taxes, the Federal Reserve will expand the money supply by whatever means necessary to offset the resulting deflation. When sufficient policy steps are taken by the Fed, gold mining stocks will move rapidly higher.

Where Will the Race Lead Now?

More and more, the economic landscape is created and maintained by the federal government through two policy tools: monetary and fiscal. As for monetary policy, with the advent of Quantitative Easing 3 (QE3) in January, the Federal Reserve entered uncharted territory. The Fed has moved beyond extending the maturities of its balance sheet (buying up short-term debt and issuing long-term debt) to using cash to purchase the banking system's riskier debt (long-dated treasury bonds and mortgage debt) at a rate of about $4 billion per business day. Let's call that approximately $1 trillion per year of money printing.

As for fiscal policy, it is appropriate for the government to run deficits and carry debts. Not being quite the balanced budget types, we still deeply want Congress to be prudent. As with any company or household, debt levels should remain at levels that can be digested and should not grow faster than the growth of wealth. When households and businesses take on too much debt, the consequences are usually not pretty.

In the four years from 2009-2012, the US federal budget deficits averaged $1.4 trillion per year. And while we are worried about Federal debt levels exceeding GDP, we are more concerned about the effect of deficit spending on the average investor’s sense of what is ordinary. Nearly 10% of 2012’s $15.1 trillion Gross Domestic Product in the US was accounted for through deficit spending. With GDP expected to grow between 2%-4% in the long run, our $13 trillion in public debt could sustain deficits of as much as $0.4 trillion, growing with GDP at 2%-4% per year. The remaining $1 trillion of our $1.4 trillion deficit spending (7% of GDP) is unsustainable. Much of the money the government spends is then spent by others, creating what economists call a “multiplier effect” of around 1.5x for deficit spending. As a result, over the last four years, about 10% of GDP has been unsustainably conjured through deficit spending.

For decades, leverage and deficits have increasingly been the “wings” on which our federal government has lifted economic growth. Over the last four years, about $1 trillion in unsustainable annual deficits have been used to create 7%-10% of our $15 trillion in gross domestic product (GDP). Adding another $1 trillion of money printing through QE3, the United States economy is now officially on government assistance. Simply put, 10%-17% of economic output is now being conjured through unsustainable policies of the federal government. Like frogs in a pot coming to a boil, citizens and investors are unaware of how good life has been for all of us or how far purchasing power may fall for the unprepared when Icarus loses his wings.

Being Prepared

Having a portfolio that is prepared for the future has never been simple; it is now quite challenging. We are worried, but taking appropriate steps to benefit, and certain precautions to protect against threats to our clients’ purchasing power. With all of this depressing data, remember that though stocks are volatile, they provide an ownership stake in real and productive assets that hold and improve their value over time. The prices of these stocks have virtually tread water for the past decade as their fundamentals (dividends, earnings, etc.) improved by 2x–3x. Domestic US stocks remain relatively cheap and as such positively influence our expectations for returns over the coming years. On the whole, we remain optimistic about equities for the next decade.

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