October 4, 2013

Beware of Mistaking a Symptom for the Cause

"If you can heal the symptoms, but not affect the cause, it's quite a bit like trying to heal a gunshot wound with gauze." – Trey Anastasio, Phish

Reflections on 5 Years Past

The month of September marked the five-year anniversary of the Lehman Brothers bankruptcy. For many, especially those in financial circles, September 15, 2008 is "a day that will live in infamy" for bringing to the fore the fragility of our financial system. Yet here we are five years later, and the anniversary of the event itself is convincing proof that we as a society have not learned the appropriate lessons. Nearly every mainstream news outlet featured a "5 Years After the Financial Crisis" headline (Washington Post[1], Fox Business[2], Bloomberg Businessweek[3], Forbes[4]), insinuating that the crisis started punctually upon Lehman's collapse. While not every outlet shared the same message, they all made the same crucial mistake: the collapse of Lehman Brothers absolutely, positively did not cause the financial crisis; it was a symptom of a crisis set in motion several years prior.

In *Fooled by Randomness*, Nassim Nicholas Taleb taught us that often what seems a tight connection is merely coincidental, with the randomness mislabeled until it's too late.[5] Lehman Brothers wasn't even the first casualty of the financial crisis (Northern Rock fell before Bear Stearns), so how could it possibly be the cause? Some might argue had Lehman survived that fateful weekend, the crisis would have been less bad, though we caution that such a claim is impossible to prove. Moreover, with the placement of Freddie Mac and Fannie Mae into conservatorship, the government and Federal Reserve Bank's intervention in AIG, Merrill Lynch's sale to Bank of America and the accompanying stock market panic all would have taken place with or without Lehman's failure.

In fact, even at the time, and in hindsight, one of the most shocking facts of the Lehman failure was how much of a slow-motion train wreck it all ways. The failure of Lehman seemed inevitable the moment Bear Stearns writing hit the wall, with the only "out" being a sale of the company, something CEO Dick

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1 http://www.washingtonsblog.com/2013/09/5-years-after-the-financial-crisis-the-big-banks-are-committing-more-crimes-than-ever.html

2 http://www.foxbusiness.com/personal-finance/2013/09/16/5-years-after-financial-crisis-meet-new-consumer/

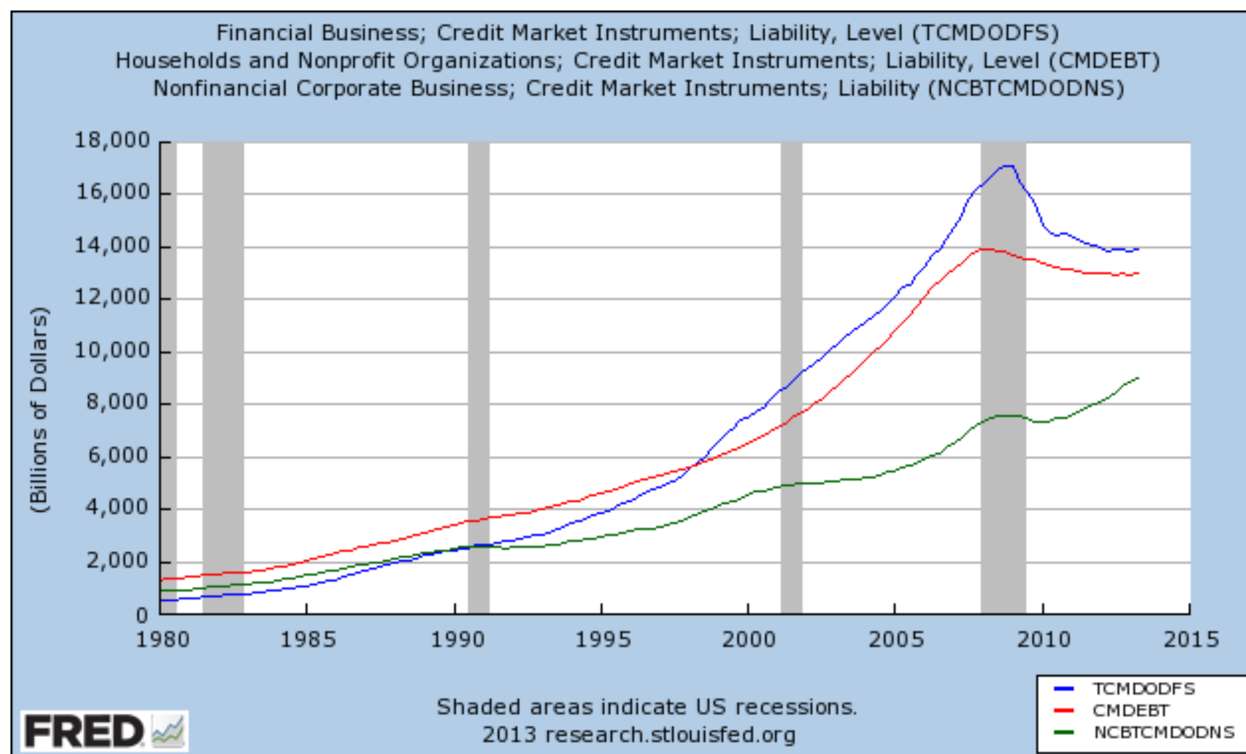
3 http://www.businessweek.com/features/financial-crisis-anniversary-2013/

4 http://www.forbes.com/sites/greatspeculations/2013/09/29/debt-still-bedevils-economy-five-years-after-financial-crisis/

5 http://www.amazon.com/Fooled-Randomness-Hidden-Chance-Markets/dp/0812975219

Fuld viewed as unfathomable. It is maddening and frustrating to hear talk to the contrary and for the crisis narrative to shift to where these five years of economic stagnation would not have happened were it not for Lehman. This new narrative is designed purely to suit the political desires of certain constituencies and Wall Street interests whose own messages and business models would face severe disruption were we to acknowledge the true nature of our financial system's problems.

Lehman's collapse was due to the excessive buildup of leverage in our economy, and the financial sector in particular. Households also took on leverage, but it was the concentration of leverage in financial institutions that really blew things apart. In chart form, this is most clear on both the way up, and the way down:



The blue line represents total debt in the financial sector, the red line represents household debt, and the green line non-financial corporation debt. We can clearly see that the blue line has the steepest trajectory on both the way up and the way down, yet it still remains the dominant domicile for the concentration of debt in our private economy. Since the onset of the crisis, we can also see that households have deleveraged (please note: the deleveraging of both financials and households would be

more pronounced shown as a percentage of GDP, we are looking merely at gross values), mostly by flat lining in terms of total liabilities outstanding. Non-financial corporations have been the biggest beneficiaries of the low interest rate environment by issuing increasing amounts of debt.

Our point here is rather simple: **leverage had gotten extreme in our financial sector, Lehman was one of the more levered financial institutions, and as such, its failure was merely a byproduct of a deeper systemic problem.** To make matters worse, leverage was simply too high throughout our private sector of the economy and had to be brought down (with the government stepping in to fill the gap, though this is a discussion for another time).

Lessons learned for investors

This distinction between symptom and cause is an important one, for how can we learn any lesson if cause and effect are reversed? In markets, the relationship between causation and correlation is inherently tricky business. One fact is clear: even with the crash, those who focused on investing in sound businesses performed far better than those who relied on trading or market timing strategies. Even people who invested in indexes have once again earned a positive return from the pre-dawn of the crisis up to today, while many who anticipated and sold before the crash have missed out on more gains than losses saved. It was those who invested with leverage, or those who could not handle the behavioral element that is a prerequisite for risking capital in financial markets who suffered the worst fates.

In our January 2013 Investment Commentary[6] we highlighted the concept of "myopic loss aversion" whereby investors cost themselves a significant portion of their long-term return by checking stocks too frequently and reacting too emotionally to volatility. **While one of the core foundations of the Efficient Market Theory holds that volatility is risk, in actuality, the human response to volatility is what makes for risk, not the volatility itself**. One of the easiest ways to mitigate this risk is by separating our analysis of a business from the idea of the "stock market" itself. We will speak to this point directly below, but first it's important to digress and ask ourselves, what exactly the existential purpose of markets is? In a broader sense, we all know that markets are about the allocation of scarce resources.

Insofar as the stock markets are concerned, the answer is far more nuanced and many may disagree; however to us the answer is abundantly clear. Stock markets are here to provide companies a means through which to raise capital in order to invest in their businesses, and investors to allocate capital in

[6] http://www.rgaia.com/january-2013-investment-commentary-high-yield-corporate-debt-markets/

order to generate a return. Many argue that markets are a “zero-sum game” meaning that one participant’s gains (loss) is another’s loss (gain). In essence, this is simply not true. When companies use markets to raise capital, they can (and should) benefit their existing investors and new investors alike. It is only in the more abstract world of short-termism and trading that markets are zero-sum.

In the decade leading up to Lehman’s collapse, the proliferation of trading-based strategies became completely distorted and abstracted from the basic purpose of markets themselves. **Many were making more money trading spreads and leveraging minimally profitable strategies while appearing to generate enormously safe returns without ever acknowledging that the former was merely supposed to be a lubricant for investment, not to be mistaken with investment itself, and the latter was merely the magnified effect of leverage.** We speak of these two in the same sentence, because things went most wrong where the two phenomenon of trading and leverage were combined, like in Long-Term Capital in the late 1990s, and Lehman Brothers a mere five years ago.

The existential question is a particularly important one because markets have moved so far past their intended purpose that most fail to even acknowledge the role of boring, old-fashioned business investment. That’s precisely what we’re here for.

Where we stand in the Long Run

Here we must take a second digression before getting to the real question of what it means to invest in businesses as separate and distinct from the stock market. In our 2012 Investment Outlook, we highlighted how the Dow Jones Industrial Average’s long-term total return since 1925, even when counting both the Great Depression and the Great Financial crisis was 6.58% annualized. Since that time, the Dow’s annualized return from 1925 to today has improved to 6.74%. There is an important connection to make between the market’s average P/E of 15 over the long run, and the market’s long run return. **Another way to think about a P/E ratio is as an earnings yield, (we calculate this by taking the inverse of the number, i.e. E/P, or in this case, 1/15). It just so happens that the inverse of the market’s long-run P/E ratio is 6.67%, amazingly close to the 6.74% long run return experienced since 1925.**

We find the market’s earnings yield particularly important, as it is the best proxy for conceptualizing a stock investment like one would a bond. The 6.67% earnings yield is analogous to a coupon on a bond, and given this relationship, as the earnings yield and long-run return are strikingly close, it seems clear that the bond-like element of stocks is the generator of long-run returns, not capital appreciation (aka the rise in share prices) as many would suspect.

Interestingly, despite periods of deflation and inflation, the market itself has generated a fairly consistent annualized yield for investors. While 6.74% is the long-run return, there have been years with returns far in excess of the mean (this being one of them) and years that not only fall short, but destroy significant amounts of capital if not handled appropriately(like 2008). Investing for the long run is the greatest hedge against a bad year, for a conviction in your timeframe affords the opportunity to capture the easy part of the return the market has to offer. Meanwhile, within all of these years, there is substantially wide dispersion between stocks themselves, and not all stocks rise and fall in unison, to the point where prudent business analysis can make a big difference in mitigating the depths of downturns and enhancing the rewards that good times have to offer.

Getting Micro

One fact we feel is significantly underemphasized is the capacity of sound businesses (thought of as separate and distinct from the market) to generate meaningfully better returns than the market itself. Over the past decade, which covers the tail end of the dot.com bust and the full extent of the Great Financial Crisis, **455 stocks in the Russell 2000 have returned at least 15% annualized. That means that nearly 1 in 4 stocks in our broadest market index have over doubled the market's annualized long-run return**. While it would take a significant stroke of luck and at least modest skill to have a portfolio full of only 15% annualized returners, we do think it's possible for a portfolio to be heavily weighted towards the big gainers and we think there is a tried and true method to doing so.

To that end, we never think of ourselves as buying "stocks," rather we think it's our job to analyze and buy fractional interests in businesses. This requires far more analysis, diligence and patience than does investing in strategies that try and capitalize on fluctuations and speculations in the market. It involves a holistic analysis into the drivers of a business, its industry situation, relationships with consumers and suppliers, management's incentive structure and the price that financial markets are offering us compared to a rational intrinsic value.

Not every investment in every company will work according to plan, and that is where the benefits of building a diversified portfolio of businesses plays a role in mitigating risk. We purposely seek to build a basket of businesses, each exposed to disparate risk factors and unique reward catalysts, operating globally and in geographic niches, with short and long durations. **Our favorite businesses are those with a solid valuation, with the consistent ability to compound capital, and the added chance for something to go asymmetrically right.** This added idea of asymmetric opportunities is important, for it is what over the long run can set apart a great portfolio from a decent one.

We are not alone in this pursuit, and our philosophy is founded on the principles of investment greats like Benjamin Graham, Warren Buffett, Phillip Fisher, and more, though we are constantly surprised by how many would rather base investment decisions guesses on policy direction in Washington, and presumptions about where other speculators will move their money next. To that end, when we want to know how our companies are performing, we never check the price of a share first; rather, we check the results of the business itself against our investment thesis. If the results are sound and reflective of our thesis, though the market itself has not moved higher, our conviction increases as the price to buy is more attractive; while alternatively if the market price of our stock rises and the fundamentals have not followed our expectations, our conviction diminishes and we are likely to sell. **The point here again is quite simple: when we follow a business, we first and foremost follow the performance of the business as an owner would, and only secondarily look at the stock's chart.**

What do we own?

With the 3rd quarter in the history books, it's time to continue our glimpse into your portfolio by looking at the leaders and laggards during the quarter, and how their respective stock performances stack up to our fundamental thesis.

The Leaders:

Given Imaging Ltd. (NASDAQ: GIVN) +37.16%

After buying Given towards the end of the second quarter, the stock wasted no time impacting our portfolios in a positive way with three excellent catalysts. Given makes a swallowable capsule (called the PillCam) designed to take images of the gastrointestinal tract in a more comfortable, minimally invasive method for patients than traditional processes. The first catalyst was approval for the PillCam's use for colonoscopies in Japan, the second largest market for colonscopies in the world, followed by better than expected earnings, and lastly, by the approval of a newer generation of the PillCam in US markets that should offer improved and expanded functionality for doctors.

Given embodies the type of company discussed above with a solid valuation and the potential for asymmetrical returns. The valuation is justified based on its existing status as the first-line treatment for diagnosing GI bleeding, and its asymmetry comes from the potential to reinvest earnings into improving the technology with the aim of completely disrupting the colonoscopy. While this will take time, this quarter, the company demonstrated tangible steps towards making the asymmetrical possibility a reality.

ING Groep (NYSE: ING) +24.86%

ING was one of the laggards in our first installment of "What do we own" from the first quarter.[7] Since that time, ING has recouped all of its losses and then some. This quarter's strong performance was on the heels of an improving macro-environment in the Eurozone (see last month's commentary on one year since our foray into European investments[8]), on improving earnings at ING itself, and on the successful evolution of ING's plan to restructure around core European operations in order to pay back the bailout money provided by the Dutch government.

During the quarter, ING completed the spin-off of its U.S.-based asset management business, ING U.S. (NYSE: VOYA). The company took in nearly $550 million in cash proceeds that will be used to shore up its balance sheet and build up a stash to repay the Dutch government. As VOYA shares have risen steadily since the IPO (up 52.8% to-date), ING has divested itself of yet more shares, bringing its total ownership interest to 71%. By the end of 2014, ING will sell yet more shares, targeting an ownership stake of less than 50%, at which time, the company will also have repaid the full extent of its bailout. Once this is done, ING should be able to reinstate a dividend and commence buybacks, offering further opportunity for upside.

Siemens AG (NYSE: SI) +21.92%

Siemens was another laggard in our Q1 report who has been a leader of late. While also a beneficiary of Europe's resurgence, Siemens did have some news of its own. During the quarter, the company warned on its annual profit and margin goals, then proceeded to fire CEO Peter Loescher before replacing him with CFO Joe Kaeser. Kaeser has a long history with Siemens and thus far has been perceived by the market as the right person to restore many of Siemens operating segments to industry average profit margins. While only time will tell whether this judgment by the market is correct, should Kaeser succeed, the company will be worth well in excess of our present fair value targets.

Siemens is a diversified conglomerate, which under Kaeser will continue its focus on shedding non-core and non-performing divisions. In the past quarter, the company spun off its lighting division—Osram—and sold its joint venture interest in Nokia Seimens Networks. Both initiatives took loss-generating divisions out of the company's responsibility, and should help a focus on improving operational efficiencies in the remainder of the company.

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[7] http://www.rgaia.com/march-2013-investment-commentary-what-do-we-own/

[8] http://www.rgaia.com/july-2012-investment-commentary-europe-one-year-later-our-conviction-remains/

We love the role a stock like Siemens plays in our portfolio. The company has a really stable non-cyclical business that is a stellar sector in and of itself (healthcare), a well-positioned, but underperforming cyclical businesses (Cities and Infrastructure), and although there is substantial European exposure, the company has a global revenue base.

The Laggards:

Cree Inc. (NASDAQ: CREE) -5.70%

Some context is necessary in Cree's place as a "laggard," for the stock is up 77.13% on the year, and was our top leader in the first quarter's *Leaders and Laggards*. There is little new to add to our points made on the company in the past. We simply need to reiterate that the fundamentals in this stock continue to move in the right direction, though it's clear that in the short-term the stock's price had accelerated ahead of the growth in intrinsic value. This is not a company we would call "downright cheap," though it is one that is a worthwhile hold for positions established in the 20s and 30s. All along we have been anticipating 2014 as the year for acceleration in LED demand, and Cree's technological prowess has pulled forward some of this demand into 2013. This is a great thing, for when we discount cash flows, money earned today is worth more than money one year hence and 2014 remains on track to be a breakthrough year for the LED lighting industry.

Berkshire Hathaway Inc. (NYSE: BRK.B) -3.70%

Berkshire has been a slow and steady gainer for us. During the quarter, we took the opportunity to trim from a high conviction 5% position in core accounts to a 3% normal sized allocation. This was simply due to the stock's appreciation towards our estimation of fair value. We are all familiar with Berkshire, and of course, its Chairman and CEO, Warren Buffett. We view Berkshire as one of the penultimate collections of supremely high quality businesses, across diverse sectors of the U.S. economy and expect the company's culture to drive continued compounding of shareholder capital regardless of when old age catches up with Mr. Buffett. In the meantime, we will remain patient with the stock as a normal-sized, core position.

Teva Pharmaceutical Industries (NASDAQ: TEVA) -3.62%

This is Teva's first appearance in the laggard's section, though on the year, it has been our single most disappointing investments. The pharmaceutical sector has enjoyed a quiet resurgence, while Teva has been left behind. Despite this, our conviction has not wavered on the company and we view this stock as a form of time arbitrage, where we are essentially paid to wait. Teva has an earnings yield on its

equity of greater than 10% and will use half of that money to return capital to shareholders in the form of dividends and share repurchases.

The company's shares continue to suffer under the pressure of replacing its lead product—Copaxone—once its patent expires. We think the market is overly punitive in its estimation of the loss of earnings from Copaxone. Moreover, Teva remains the largest global manufacturer of generic products, and in the hands of new CEO Dr. Jeremy Levin, we think the possibilities for improved results are tremendous. Dr. Levin is one of pharma's premier capital allocators and is one of the key reasons why his former companies, Novartis and Bristol-Myers Squibb find themselves better positioned than other large-cap pharmaceuticals in the face of the dreaded "patent cliff." Dr. Levin's experience as a doctor, a business-model innovator in pipeline development and as a private equity-based biotech investor make him the perfect guide for Teva's transition from a growth company to a value-based steward of shareholder capital.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail. You can reach Jason or Elliot directly at 516-665-7800. Alternatively, we've included our direct dial numbers with our names, below.

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