February 11, 2014

Emerging Markets

"To establish the right price for a stock, the market must have adequate information, but it by no means follows that if the market has this information it will thereupon establish the right price."

– Benjamin Graham

Heading into January, the biggest story in the financial arena was the accelerating U.S. economy. During the month, most data points confirmed this belief. Yet despite this confirmation, the two big stories coming out of January were the escalating troubles in Emerging Markets and the awful weather experienced throughout much of the United States, ranging from drought to "Polar Vortex" to feet of snow. In our 2014 Investment Outlook we declared "it is quite possible, almost probable that 2014 will be a better year for the economy than it will be for the stock market." After one month, this "almost probable" looks increasingly likely.

January 2014 is a tough month to write about for many reasons. Year-end, generally speaking, is an arbitrary metric at which time people make their larger reflections, judgments and projections. In this regard, we are no different than the crowd having recently offered our more in depth expectations for the calendar year ahead. And during January, nothing changed to warrant any deeper consideration of our views. It would be nice to wax eloquently about the Emerging Market troubles while arguing some profound point with conviction; however, there are only two very simple points worth making about "troubled" areas: 1) they are called Emerging Markets because they are prone to troubles; and, 2) there is little risk of contagion from Emerging Markets hurting the actual economy here in the US. Since we know these to be truths, then why are markets moving so violently based on "Emerging Market" fears? The answer to that is also quite simple: markets had a great 2013 and needed any excuse to cool off for the time being. Secondarily, there are large, multi-national funds that have exposure both to the developed world and Emerging Markets. When these funds realize severe losses in one area, they must trim exposure in the other area in order to protect themselves from further losses.

In our July commentary, we made the following claim with regard to Emerging Markets which we believe rings as true today as it did then[1]:

---

[1] http://www.rgaia.com/2013/08/

> We can see a path to Emerging Markets regaining favor, though we approach this part of the globe with far more suspicion and uncertainty than we did Europe.
>
> There are several unquantifiable risks, including serious questions about the rule of law in some domains. As such, we pursue exposure to these areas primarily through U.S.-based multinational firms that enjoy earnings leverage to Emerging Markets, without risking permanent impairments to earnings should Emerging Market growth not play out as planned.

While we subsequently did commence one single position that is an "Emerging Market" stock, it has moved minimally amidst this recent fit. We continue to scour those parts of the world for opportunity with ample doses of skepticism.

Beyond this brief conversation about Emerging Markets, there are two further points we want to emphasize coming out of what is amongst the weakest market months in two years: when everyone acknowledges some reality in markets, it's a near certainty that the point being made does not matter for future stock performance; and, markets and the economy do not necessarily move in tandem. Each point comes with its own corollaries that deserve further explanation.

Mr. Market Discounts the Obvious

When people say that "markets are efficient" they are asserting the fact that markets incorporate all known information into prices. In these commentaries, we have often talked about areas where market efficiency breaks down. This is only natural, for we seek out such situations in order to find attractive investment opportunities and we do think there are ample inefficiencies worthy of our time and attention. That being said, with the big questions facing the economy and to a lesser extent, the questions facing widely followed stocks, the market is incredibly efficient in incorporating widely understood information. Stated another way, it takes an unanticipated surprise (an redundancy of sorts) in order to seriously move the price of a market or stock.

All this serves as a long preface to a rather simple idea: when everyone knows something to be true, so too does the market. Known information gets fully incorporated into market prices, and as such, there is little advantage for an investor to act upon that point of fact.

This was the underlying reasoning behind our assertion that the year would be better for the economy than the stock market. As far as the economy goes, it was so widely asserted in the analyst and financial press communities that the economy would accelerate in 2014 such that there was little, if any value in acting upon this belief. Conventional wisdom is just that, conventional. It takes special insight, analysis or temperament to actually achieve a different outcome.

The Reality/Performance Divergence

Oversimplifying is often helpful, so here goes yet again. There are two basic sources of return in stocks: the yield of the equity and changes in the multiple.

A slight digression is necessary before moving further. When we talk about the yield on the equity, we are referencing something akin to the stock's earnings per share divided by the price by share. Each year a company makes money. As earnings come in, that value accrues on top of what shareholders already own. Companies can do several things with that money: pay it out to shareholders as a dividend, use it to buyback stock, or invest to grow the business. When we say yield, we mean all of a company's profit, not just its dividend.

Every year, the yield on the equity accrues to shareholders as a source of return. Let's say a stock earns $2 per year and is priced at $20. That stock would have a yield of 10%. At the same time, that stock's multiple would be 10x, meaning the stock trades for ten times its earnings. The yield of the equity and the multiple are related in that they are the inverse of each other.

When you buy a stock, you will earn the yield insofar as the earnings continue to come in, but the multiple is subject to change. At the end of a year, shareholders would "capture" that $2 in earnings, and the stock in theory should be worth $22 at the end of the year, assuming the earnings stream was not growing. Were the company to pay out 100% of its earnings as profits, then a shareholder would still own a $20 stock, but have the $2 in his/her pocket, thus also effectively "owning" $22 in value. However, at the end of the day, there is no guarantee that the multiple will stay at 10x. Perhaps investors believe the company's future outlook is better than the recent past. In that case, investors would be willing to pay a multiple higher than 10x, and the stock price would rise accordingly without any actual change in the level of earnings. Alternatively, perhaps investors fear a competitor will steal business from the company. Then, investors might only be willing to pay a multiple that is 5x earnings and the stock price would drop accordingly.

Since the multiple is driven by confidence and expectations, it is inherently prone to behavioral biases. Further, the multiple tends to be far more volatile than the actual trajectory of the underlying earnings themselves. Herein lies the reason why reality and performance often do not move in tandem.

Where does this leave us today?

As of the close of January, markets are throwing a hissy-fit and everyone is searching for reasons. We think the most obvious reason is that markets had a great year in 2013 anticipating the improvement in

the real economy that is starting to play out in 2014. Considering the economy is improving, and the risks of recession remains fairly low, the stock market should experience a much-needed correction without entering into a more concerning Bear-market.

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 – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-7800. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

Jason Gilbert, CPA/PFS, CFF
Managing Director
O: (516) 665-7800
D: (516) 665-1940
M: (917) 536-3066
jason@rgaia.com

Elliot Turner, Esq.
Managing Director
O: (516) 665-7800
D: (516) 665-1942
M: (516) 729-5174
elliot@rgaia.com

Past performance is not necessarily indicative of future results. The views expressed above are those of RGA Investment Advisors LLC (RGA). These views are subject to change at any time based on market and other conditions, and RGA disclaims any responsibility to update such views. Past performance is no guarantee of future results. No forecasts can be guaranteed. These views may not be relied upon as investment advice. The investment process may change over time. The characteristics set forth above are intended as a general illustration of some of the criteria the team considers in selecting securities for the portfolio. Not all investments meet such criteria. In the event that a recommendation for the purchase or sale of any security is presented herein, RGA shall furnish to any person upon request a tabular presentation of: (i) The total number of shares or other units of the security held by RGA or its investment adviser representatives for its own account or for the account of officers, directors, trustees, partners or affiliates of RGA or for discretionary accounts of RGA or its investment adviser representatives, as maintained for clients. (ii) The price or price range at which the securities listed in item (i) were purchased. (iii) The date or range of dates during which the securities listed in response to item (i) were purchased.