StaufferWilliams
ASSET MANAGEMENT · LLC

DECEMBER 2013 INVESTMENT COMMENTARY

THE MEDIA'S BUBBLE VERSUS A FUNDAMENTAL REALITY

Everything that I read today involving the markets seems to be warning of bubbles forming in both stocks and bonds. Maybe I have a higher threshold regarding what constitutes a bubble, because I do not currently see ominous bubbles in any of the broad asset classes. For something to constitute a bubble by my definition, it is not simply over-priced, it's valuation has become completely disconnected with fundamental measurements of its value. Noteworthy examples would be newly formed dot.com stocks in 1999, or Southeast Florida condos that were being bought off spec before they were built and then flipped for a quick 30% to 50% profit in 2006. Financial asset bubbles are not inflated with air; they are inflated with the animal spirits of greed and speculation.

Today I do not really see any worrisome speculative bubbles. The only areas that may be experiencing something akin to a speculative bubble involve some social media IPO's and certain private M&A activity in that area. There are of course individual stock situations in which speculation fueled buying momentum can propel a stock price into bubble territory. One company that we owned briefly this year, Tesla Motors experienced this type of price action. Although we purchased the shares originally at $44 per share and sold them at approximately $85 per share, Tesla stock experienced a brief period of strong momentum buying that pushed the stock above $190 per share, before it finally sold-off by almost 40%. It's valuation is still a stretched in my opinion, but not in bubble territory any longer. Beyond these examples, which represent a relatively small subset of the capital markets, speculation does not seem to be driving values to what I would consider bubble valuations.

However, the capital markets have witnessed a steady "melt up" in equity valuations over the last 12 months and the resulting valuations certainly warrant caution. Earnings multiples are materially higher than they were a year ago, a time when earnings were actually growing much faster. Continued low interest rates and low equity volatility have motivated/lured many conservative investors into high yield areas of the capital markets. That means that many high dividend paying stocks, master limited partnerships, and high yield debt securities are exhibiting valuations that are not supported by fundamental drivers of value that prudent investors look at. I do not however believe that it is responsible to call these stretched valuations a bubble. In the case of certain equities that have a stretched valuation, they will need to either trade within a narrow trading range for an extended period of time or they will need to experience a correction of 10% to 15%, followed by modest price appreciation over a period years. The "when and how" of this correction of stretched valuations will almost entirely depend upon the market perception of Federal Reserve monetary policy.

The bottom line for me, when determining whether or not a security or asset class is experiencing a bubble valuation is the degree of greed and speculation that is being exhibited. Greed and speculation are a natural and healthy part of the price discovery mechanism within the markets. However, when the level of greed and speculation crosses into a stratosphere where the price paid to own a particular security becomes severely disconnected from a fundamental valuation based upon high probability outcomes, this characterizes a bubble. Facebook, upon its IPO in 2012, was priced at a bubble valuation based upon my assessment at the time. Within 6 months of the IPO, the stock had lost 50% of its value. Once a bubble security loses its initial mania driven momentum, it is very difficult to determine how much the security will fall in price. This is because fundamental valuation techniques do not work when dealing with hope instead of a rationally supported set of projections. When hope is your investment strategy, delusion becomes your base case.

I wanted to address the idea of investment bubbles in order to create a frame of reference regarding what I see as a 2014 conundrum. The conundrum is that I do not fear a bubble that is just about ready to burst, but I do have a lot of concern caused by valuations becoming stretched. Stretched valuations are prevalent within certain areas of the market and, after such a strong advance among many of the equities held in StaufferWilliams' portfolios this year, many of our holdings are pushing up against the upper limits of "fair value". The "melt-up" conditions within the broad market this year can lead to complacency among investors. I am not experiencing this complacency; in fact I am experiencing the opposite. My expectation is that over the coming two months, I will take action that will lead to combing through portfolios and reducing or eliminating positions that have a limited upside based upon fundamental valuation metrics. With sensitivity to tax considerations as we approach the end of 2013, these positions will be replaced by new positions that exhibit a more attractive risk/reward relationship and/or an increase in the allocation to non-traditional investments. I have already begun this process with new positions in a large international mining company and one of the survivors among the large bond insurance companies. These positions represent companies which have not participated in 2013's melt-up, but offer very attractive earnings multiples and dividend payouts. We deem both of these companies to possess significant barriers to entry, superior management, and businesses which can benefit from rising interests rates and reflation.

It is certainly very possible that the current "melt-up" market condition will continue through the end of the year and possibly well into the early part of 2014. However, in my opinion it would certainly be unlikely for this type of low-volatility stock market advance to persist much longer, especially given the valuation conditions that have developed and the modest economic backdrop. I believe that the beginning of the infamous "Fed Taper" of quantitative easing (bond buying) will occur sooner than later. On that note, I believe that such a taper has a higher probability of beginning this month than what is being forecast by most economists and Fed watchers.

I probably do not have to remind clients that I do not engage in attempting to time the market. However, many times when I find it increasingly challenging to find equities that meet my relative valuation criteria, this is a harbinger of an over-bought market. This will happen more frequently to a traditional value manager who simply looks at P/E's, P/B's, etc. versus historical averages. When it begins to manifest itself with portfolio managers who utilizes a much more flexible, "relative value" criterion, the overall market is likely getting over-bought. Back in late 2008 and early 2009 the opposite occurred, extreme over-sold conditions led to the most significant divergence between relative value and market prices that I had ever witnessed. Traditional value managers did not necessarily see the opportunities because P/E ratios actually increased as earnings collapsed during this time. Looking at a multi-faceted valuation model, I saw a grossly over-sold market and this led me to a full or over-weight equity allocation very early in one of the longest and highest return market advances in the history of our markets. The current over-bought conditions are in no way comparable to extreme opposite conditions that existed five years ago, but nevertheless, valuations do appear stretched to varying degrees among the majority of U.S. stocks.

I will keep my comments relatively short and end by saying that, like 2008 and 2009, today again presents a set of market conditions when active portfolio management most significantly preserve and build long-term wealth. I wish everyone a healthy, safe and happy holiday season.

CURT R. STAUFFER
717 877 7422