4th Quarter Commentary

January 2016

An Important Time

This review has double significance. One wants, of course, to review the past year: how we are invested and what the next 12 months might bring. However, this is also a moment in the longer sweep of time when investors are well advised to take pause and be particularly thoughtful about how their long-term financial assets are positioned. Because the financial markets now have all of the earmarks of a serious change in valuation – not a good one. First we'll briefly cover the factors that brought the stock market to this juncture, what stock valuations really look like, what can happen if our concerns are borne out, and what might make it happen. Then, how we are adjusting our investment posture, some examples of what we continue to own and why, and of what else we might wish to own when the time is right – because we think those opportunities will be extraordinary. Also: opportunities in non-traditional income producing securities, because it's starting to become that time again.

From the 3rd quarter review: For the better part of this year, we have been gradually reducing or eliminating various positions…the cash balances have been building, and that is by intent. Depending on the strategy, cash could now be 20% or more of a typical account. You can be assured, though, that other than for statistical relative-performance purposes, 20% or even 30% cash will not radically improve your mood if the market declines by 25%. Because that's not the purpose of the cash. The cash is for afterwards.

Why Do We Write So Much?

Well, there's so much *to* say. On the other hand, it ultimately boils down to a few simple observations, just as might one day appear in some paragraphs of a history textbook. Over the last few years, we've traced the massive shift of investment capital away from individual stocks and active management into baskets of securities: over $1 trillion into ETFs and indexed mutual funds while a half-trillion dollars left equity mutual funds. There was a natural instinct behind this flight from risk after the 2008/2009 financial crisis, and there is a legitimate foundation for indexed-based investing: passive participation in the long-term results of basic asset classes like equities, real estate, and bonds. But activity in financial markets does not occur in a vacuum.

First and foremost, in any marketplace, whether for 1-bedroom apartments in mid-town Manhattan or for rock concert tickets, enough demand relative to supply will alter the pricing. Enough demand to alter pricing will attract middlemen: real estate brokers, ticket brokers. That's reality. And Wall Street attracts some of the best and brightest – or, at least, some of the most motivated. And their motivation is to collect fees, which are maximized by gathering more of the assets on which fees are earned.

Second, the behavior of the middlemen themselves affects the market: in response to the obvious demand, an enormous industry was created to promote ETF investing. At a certain point in the competition for assets, some providers began to reduce fees for mainstream products such as the S&P 500 and Russell 2000 ETFs. Lower fees, though, equal lower profits. To counterbalance fee compression, there began a wild proliferation of more exotic sub-categories of ETFs for which higher fees could be charged.

But so much money poured in that the ETFs themselves forced securities prices upward, and with that a deceptive reduction in volatility. This was a critical transition because it means that for some time the indexes have lost their legitimacy: how can they be relied upon to measure the results of an asset class, judge a manager, or provide passive participation if they are in fact responsible for changing the prices of the securities in the index? The terminology is the same, but indexation has become something else – the opposite of what it originally was.

Two of our previous colorful examples, from among the exotic ETFs: Russian Federation 15-year bonds, in the iShares Emerging Markets High Yield ETF, trading at 3.7%, the same borrowing cost as IBM; or the iShares MSCI Frontier 100 ETF having a beta 1/3 lower than the S&P 500, meaning that a combination predominantly of Kuwait, Nigeria and Pakistan is much less risky by Wall Street statistical measures than the U.S. Those were easy examples to propose, without counterargument, as evidence of excessive, even bubble-level fund flows and valuations. Not so easy, though, to find acceptance of that warning about the familiar S&P 500 or Russell 2000.

But the time for that has come, too. It was helped along by the latest round of ETF exotica: the momentum funds. These have gathered billions of dollars of assets, using various formulas to purchase more of that which has already outperformed; some also sell short securities that have under-performed. Ergo, the accompanying large-font table, featuring Netflix, Inc., about which we'll say no more.

Large-font zone – do not ignore	
Netflix Inc. share price (1/8/16):	$111.39
Stock market capitalization:	$48 billion
Consensus earnings estimate for 2016:	$0.26/share
Change from earnings in 2015:	+23.8%
Full acceptance of analysts' thesis:	
- Continued 24% annual growth for a further 5 years, to Dec 2021 (2nd term of Trump or Clinton) results in:	
Earnings/share for 2021:	$0.76
And a P/E ratio in 2021 of:	**146x**
Or 11-year 24% growth rate, **for a 2026 P/E:**	**50x**

So Where Are We Now?

One of the outcomes of this process has been that money has flowed into ever fewer securities. In the early years, in order to be able to accept more assets, ETF providers required stocks with ample trading liquidity. This separated the market into stocks on the right side of the ETF divide, which receive automatic bids whenever new money is received, versus those not in the ETF sphere of influence. An ever-widening valuation differential was created. Recently, with intensified marketing focus on risk statistics like Beta, and via robo-advisers as well, and with the rise of momentum indexes, the market has become extraordinarily narrow.

This is how narrow: in 2015, the S&P return was 1.4%, but the best-performing 10 stocks – 2% of the names in the index — and which account for less than 10% of the value of the S&P, had an average return (weighted by index position size) of 44%. Without those ten stocks, the S&P 500 return was *negative* (2.7%), not positive. Incidentally, the average revenue growth of these companies was only 10% in 2015. So if someone asks how the market has done, it's kind of important to ask which market? The Netflix market, which has a P/E of 100x or 50x the earnings it might have in 5 or 10 years? Or the rest of it? Unfortunately, much of the rest has the same issues; they're simply not screaming as loudly. Even Hormel Foods, a prosaic producer of luncheon meats, gelatin products, sugar substitutes and the like, a business with certain obvious limitations on its growth and profitability, albeit, with a creditable 10-year revenue growth rate of 5.5%, is trading at 27x estimated 2016 earnings. Would you – should you – pay 27 years' worth of earnings for such a business? Let's see.

The 2015 market is reminiscent of the era of the Nifty Fifty. These were 50 growth companies that in the early 1970s were considered so assured of virtually permanent rapid earnings growth that traditional valuation measures were felt to be irrelevant. Some of those names are still familiar, some less so: Disney traded at 82x earnings, Polaroid at 91x, and McDonalds at a P/E of 86x. At year-end 1972, the Nifty Fifty traded at 42x earnings, even as the P/E of the S&P was less than 18x. In the market decline of 1973-1974, the Nifty Fifty declined by 62%. Disney fell by 91% from its high to its 1974 low, Polaroid fell by 91% and McDonalds by 64%.

Year 2015 Top 10 Contributors to S&P Return	Total Return
Amazon.com Inc	117.8%
Microsoft Corp	22.7
Alphabet Inc Class A	46.6
Alphabet Inc Class C	44.6
General Electric Co	27.5
Facebook Inc Class A	34.1
Home Depot Inc	28.5
Starbucks Corp	48.2
Netflix Inc	134.4
McDonald's Corp	30.4
Weighted average return:	44%
Contribution to S&P return:	**245%**
S&P 500 Index return:	1.4%
S&P return without Top 10:	-2.7%
Revenue growth (simple avg.)	9.9%

Source: Factset, using iShares Core S&P 500 ETF as a proxy for the S&P 500 Index

Here is how 2016's high-P/E companies differ from those in 1972: today's high-P/E stocks will not enjoy the same decades of fiscal stimulus, since governments are now overindebted, and unlike the Nifty Fifty, have already accomplished their international expansion. Here's how they are similar: the 10-year Treasury rate rose from 5.9% at the beginning of 1972 to over 14% by the end of 1981[3]; and the price of the S&P 500 rose a cumulative 3.8% over those 9 years; substantially all of the return came from dividends. Today's interest rates, a policy-engineered anomaly, are the lowest they have ever been and can only go up.

The Temporary Loss of the Value Investor

There is another 'market', though. Investable funds are a somewhat finite quantity. When money flows excessively to one sector, ultimately it must come from somewhere else; great excess in one portion of a market suggests a great deficit in another. One of those somewhere elses has been stocks outside the major indexes and ETFs, those that might appear attractive to active managers and value managers: managers who might be indifferent to share price statistics like Beta or whether a stock trades in large volumes, but who are specifically interested in financial statement information that might suggest the presence of a hidden asset like a large tax shield or undeveloped land that is being prepared for sale.

[3] https://research.stlouisfed.org/fred2/series/DGS10

To get a handle on this other 'market', take a look at a partial list of the most successful and renowned active and value investors of recent decades: Mario Gabelli, a 2000 inductee into *Barron's* All-Century Team of most influential mutual fund managers; Bill Gross, who co-founded PIMCO and managed the largest and most successful bond fund in the world; Bruce Berkowitz of Fairholme Fund, named Manager of the Decade in 2010 by Morningstar; Warren Buffett, whose Berkshire Hathaway has the best long-term track record of a public company; Carl Icahn, whose multi-decade returns in Icahn Enterprises well exceed those of the market and even of Berkshire Hathaway; Bill Ackman of Pershing Square; David Einhorn of Greenlight Capital and Greenlight Reinsurance. Unusually for an insurer, the Greenlight Reinsurance investments are managed as a long/short portfolio, with a substantial short position. All them underperformed the market by 10% to 20% in 2015.

	2015 Return	Versus S&P 500
Gabelli Value 25 A (GABVX)	-9.5%	-10.9%
Fairholme (FAIRX)	-11.5%	-12.9%
Berkshire Hathaway (BRK-A, B)[1]	-12.1%	-13.4%
Icahn Enterprises (IEP)[2]	-15.5%	-16.8%
Pershing Square Holdings[3]	-20.5%	-21.9%
Greenlight Reinsurance[4]	-20.1%	-21.5%
Royce Micro-Cap (RMT)[5]	-13.6%	-15.0%
Janus Global Unconstrained Bond Fd (JUCDX)[6]	-0.55%	-0.78%

[1]Share price return; 9-mo. book value +3.4%
[2] NAV change; public share return (28.8%)
[3] NAV per share change
[4] NAV change to Sept.; public share return, 2015: (42.7%)
[5] NAV change; share return (16.1%)
[6] Versus its benchmark, 3-month USD LIBOR
Source: Morningstar, Bloomberg, Manager websites

By itself, this data does not lead to conclusions. It only leads to questions. Let's just list the questions.

- First, how can so many famous, and even brilliant, investors underperform the S&P 500 by this magnitude, all at the same time?
- Second, how did this occur when, for the most part, they actually correctly gauged the most important sector decisions, which were to dramatically underweight oil in particular and commodities in general?
- Third, why would Berkshire Hathaway shares decline by double-digit percent if its shareholders' equity rose over the prior year? Was it overvalued one year ago? If it was overvalued, how is this possible, given the prominence of its $300 billion market capitalization, its extensive financial disclosure, and the fact that every move the company makes is closely scrutinized? Why shouldn't a stock like that be fairly priced?
- Fourth, a) what could these investors have done differently in order to outperform? This is the one question for which the answer is knowable. They would have needed to purchase the momentum stocks like Amazon, Facebook, Netflix, Google, etc.
- Fourth, b), though, what would have made anyone imagine on December 31, 2014, that Netflix was more than 150% undervalued? This is especially true since the insiders have been heavy sellers of the stock.

This brings us to, if not conclusions, then a statement of contrast. The earlier example of Netflix was a partial demonstration of a preposterous phenomenon, preposterous because even if the analysts' maniacally optimistic earnings projections are actually realized (the 35 analysts who cover Netflix anticipate a 5-year earnings growth rate of 24%) and even extend that to 6 years, the application of a 30x P/E ratio in 2021 would result in a loss of 80%. The ETF buy decisions may be contrasted with those of a disciplined value investor, who would never undertake such an investment. However, since value investors have been underperforming so consistently and egregiously as this environment has taken over, they are being dismissed. And in its dismissal, the market has lost an important valuation sensibility that was historically visible among the other sets of participants.

That brings us to the next question: where do we go from here?

And Where Do We Go From Here?

A natural question relates to the ETF flow of funds into the largest and most liquid companies: why shouldn't that continue? Here, we get back to the business of Wall Street.

This entire phenomenon is built upon a continued flow of funds into index products. Any cessation and the history unwinds: overpriced shares stop moving up, the relative return and volatility statistics weaken, and the very same index rules that required their purchase will require their sale (as we saw in last quarter's example of the iShares Biotechnology Index). That will be helped along by proprietary traders and hedge funds, who will know which stocks to sell short, since the ETF rulesets for dropping a stock are fully disclosed. The daily trading volumes even of a plain vanilla fund like the iShares Core S&P 500 ETF are 35x greater than the trading volumes of the S&P 500 companies themselves. The exit door is very narrow. Still, what causes a cessation of demand?

One is self-interest: the inevitable consequence of the competitive fee compression that has been occurring among the ETF providers. In November, BlackRock announced that it would expand the iShares Total Stock Market ETF (ITOT) from 1,500 to 3,800 companies, encompassing just about every subset in the market. It is also reducing the expense ratio by more than 50%, to 3 basis points. That is 3 one-hundredths of 1%. That is, essentially, free.

That announcement marks a seminal moment in the business of indexation and changes the equation. Here's one reason: ITOT has $2.9 billion of assets, of which $1.1 billion was raised in 2015. For a variety of reasons, it is likely to continue gathering assets. But even if ITOT were to gather $100 billion of AUM, making it *the 2nd largest ETF in the U.S.*, then on the 1 basis point that BlackRock is likely to retain after administration and distribution fees, it would earn all of $10 million, and that's before taxes. That's for a company with a $50 billion stock market value and well over $3 billion in earnings. It wouldn't amount to even a penny per share.

So, competition for ETF assets has intensified to such a level that it will be increasingly difficult to achieve high profitability unless truly astronomical sums are raised. As the profitability is squeezed out of it, the incentive to practice it is squeezed out as well. Brokers, and their employers, make a living via the management fees. They are not unaccustomed to trafficking in novel products that generate generous fees in their early stages and which ultimately become commoditized. Then they must move on, because why would an advisor devise an asset allocation program comprised of funds with, in practical terms, no fees? There will have to be something new. So that part is not unusual, but it has never occurred on such a massive scale. The incentive structure is being altered for the first time in a decade, to the detriment of the ETF orchestrators. This change will have completely unpredictable consequences, because the ETFs have been driving this valuation-blind investment process. Yet, since the whole world seems to own the same securities and through the same instruments, by what process and at what clearing prices will they reorient their positions?

And How are We Positioned?

So via one catalyst or another, the ETF inflows will subside and the mere contraction of valuations to a reasonable norm could spell dramatic declines in what most people mean by 'the market'. In our various strategies we have been raising cash to have the liquidity to purchase new securities when, for each in their turn, the time seems right. We believe the opportunities will be extraordinary.

Now, about the cash. It is not popular to raise cash. It tends to suggest what we think about the direction of the market, and that is uncomfortable. To some, it suggests that we lack for good ideas. And then there is the proposition that we will collect fees on cash that is earning nothing. Hardly. Cash is not a non-productive asset: in a circumstance such as this it is an active and important asset class investment. And its value is not static – better to think about it as a currency, the purchasing power of which changes in relation to goods priced in other currencies. The purchasing power will increase dramatically as share valuations contract; indeed, the cash in accounts has become more valuable even in the past two weeks. And it is likely to become more valuable still.

As to our existing stock holdings, one can't know what will happen in the interim, and they are not immune to further declines – there has been no natural constituency for them for some time. What can be said of many of our stocks, as well as those of other value managers, is that they have already endured their own bear market in the last two years. Merely to achieve a reasonable valuation on observable assets or operations, the future returns from many of these stocks can be multiples of their current prices. Add in the fact that their underlying assets and operations are, variously, undervalued, in later stages of development or expanding rapidly, and the potential is that much greater. When and why would a constituency develop? First, it's not as if these companies were always ignored; they used to have a natural constituency before the index movement entered its later phase in the past few years.

Second, once the index mainstream stocks fail, there will be an energetic search for that which is different, because the index providers must find a product that can be marketed and that can support a reasonable fee. And the formerly ignored, the 'other market', which contains the discounted stocks, those idiosyncratic securities with true statistical diversification characteristics, will stand out. For those already there, the far more limited liquidity will be one more benefit on the upside.

Three Stocks That Have Already Had Their Bear Market

Silver Wheaton Here's one. It is a counter example to a Netflix (or Hormel). Just as those valuations cannot, on the facts, be accepted as sustainable, the trading price of Silver Wheaton strikes us as unsustainable and should ultimately result in substantial price appreciation. This example can be applied to the other precious metals royalty companies, such as Royal Gold or Franco Nevada. Silver Wheaton, the world's largest precious metals royalty company, now trades at the same valuation as the lowest price it attained during the 2008/2009 financial crisis. Silver Wheaton was then both profitable and quite solvent, as it is now.

Silver Wheaton's business is simply to acquire a portion of mining companies' future production; it provides cash to a miner to develop or expand a mine, but at a deeply discounted price. Example: in November, it purchased a roughly one-third interest in the silver production from one of Glencore's mines for the life of the mine; Silver Wheaton will purchase the silver at 20% of the market price as it is produced. That's an 80% discount. Despite over $600 million in revenues, Silver Wheaton has only 33 employees. Its September quarter free cash flow margin was 65%. Yes, 65%. Find a company in another industry with that level of profitability. Some other unusually high pre-tax operating margins: Facebook: 32%; Google: 25%; Microsoft: 28%. Netflix doesn't make it.

The price of silver is down about 20% this year. As might be expected, Silver Wheaton's run-rate revenues/share in the September quarter are down, though only by 12% versus 2014, since it does acquire more contracts. The Silver Wheaton share price is down more than 50%.

Valuation: the shares trade at 1.0x book value. This essentially presumes that its contract portfolio, which as we saw is in fact highly profitable, will never produce a profit. At the same time, though, Wall Street consensus earnings estimates are for a 20% increase in earnings this year, to $0.61/share from $0.50 in 2015. Now, in 2009, Silver Wheaton shares traded at an average multiple of 1.69x book value; the lowest price during that year was 0.94x book value. So it's already had its bear market debacle. Yet, aside from its profitability, Silver Wheaton is a growing company: its book value at September 30th is almost double what it was in 2009. Its expected contractual share of production in 2015 is 44.5 million, which may be compared with 17.4 million in 2009, and its 2019 expected production will be 23% higher than in 2015. As recently as 2014, when the price of silver was $20 (versus today's $13), the shares traded at $27, and above $40 in 2012. Today's price: $9.50.

As to the price of silver, it differs from gold in that there is substantial industrial demand. One source of industrial demand, already at 7%, is for the production of solar panels. Solar panel production is increasing at a roughly 30% annual pace and will be making a meaningful impression upon demand. One can see the possibilities.

Icahn Enterprises, L.P. is the primary investment vehicle of Carl Icahn, perhaps the most renowned activist shareholder. It is highly diversified, with exposure to energy, automotive parts, casinos, railcars, and real estate, as well as a $4.2 billion investment portfolio. The investment portfolio has dramatically outperformed the stock market in the 10 years since it was formed. The company publishes its calculation of NAV each quarter. The NAV is based predominantly on the market value of the company's publicly traded holdings, or book value of the non-public investments, so is a relatively conservative figure. IEP's NAV declined 15.5% this year through September; the share price is down 37% through last Friday and, from mid-2014, by 50%. Publicly traded investees such as Federal Mogul, Chesapeake Energy, and Transocean have declined some 25% to 50% since September 30th.

That's the easy-to-see part. Icahn Enterprises also has a unique and very valuable feature. It holds short/swap positions that would benefit from three separate scenarios that could be disastrous for (or reflect a disastrous development in) the financial markets: expanding credit spreads (that is, trouble in the high-yield market), a lower stock market, and/or higher interest rates. These positions are of a comparable or greater magnitude than the company's market capitalization. Some people would call that massive. IEP's net short notional exposure on credit swaps, as recorded on its balance sheet, was $1.4 billion at the end of September. This figure is the balance sheet risk if the credit spreads – that is, the difference in interest rates charged to non-investment grade versus investment grade borrowers – narrow to zero. The upside, which accounting rules don't include on the balance sheet, is based on notional exposure of $7.9 billion. The company's stock market value is currently $7.5 billion.

The company's net short notional exposure to the stock market was $15.6 billion as of September 30 – that's twice the company's market capitalization. In addition, IEP's interest rate swap contracts exposure was $137 million as of September 30. This, too, represents the company's balance sheet exposure calculated on the assumption that rates go to zero. The upside though, also not a balance sheet item, is based on a notional exposure of $16 billion.

The shares trade at 1.0x IEP's calculation of NAV. In that sense, they trade at liquidation value, inclusive of investments made at what were determined by an activist deep value investor to be undervalued prices, many of which have declined sharply from there. The return from this portfolio in recovery mode would obviously be quite large. And the NAV does not include the huge payoff potential from those stock market, interest rate and credit spread hedges and short positions – these truly valuable contracts come for free along with that NAV.

IEP pays a dividend of $6.00 per year, currently yielding 10.3%. Mr. Icahn himself owns close to 90% of the company and chooses to take the dividend in shares rather than cash, so IEP collects considerably more dividends from its holdings than it pays out in cash dividends. One can see the possibilities here, too.

Howard Hughes Corp., a 2010 spin-off, is a real estate company, but not a REIT. It owns a portfolio of very substantial properties. Let's examine just one. When the company was spun off, one of its properties, the South Street Seaport in Manhattan, was on the books for a few million dollars. Travel+Leisure recently named it the 22nd most visited tourist attraction in the world, tied with China's Great Wall and ahead of Paris's Louvre Museum. This is despite having been underinvested in for decades. Following several years of development planning and zoning efforts, the property is now approved for 362,000 square feet of retail space (an additional 700,000 square feet of mixed-use property pending approval), including one high-rise condo tower, with another to be proposed, to be completed in phases, with the first being the redeveloped Pier 17 mall and 3 nearby low-rise buildings. When all completed, if rents generate net operating income of perhaps $200 per sq. ft., with a 5% cap rate, the potential gross value is more than $4 billion – this doesn't include an additional 817,000 square feet of entitled mixed use development in the area. Of course, the company will have to incur significant development costs to complete the project, but once finished it should be highly valuable and generate substantial rental income. The company's stock market value is now $3.8 billion.

Here are some of the other assets. These are not all of the Howard Hughes operating or development properties.

- The massive Summerlin master planned community in Las Vegas, the land for which was purchased by Mr. Howard Hughes in the 1950s. It includes over 22,000 acres and still has 41,000 remaining salable lots. Three months ago, the company completed the first phase of a 326-acre mixed use urban town center in Summerlin. The development will include 1.4 million leasable square feet of retail stores and a 200,000 sq. ft. class A office building. It already has over 250,000 weekly visitors.
- The still larger 28,000 acre Woodlands master planned community in Houston, Texas, the largest in the U.S. ExxonMobil has just completed building its new corporate campus just south of the Woodlands, with 10,000 employees to work there. The Woodlands has acquired an additional 2,100 acres to extend residential sales by 8 to 10 years. Based on occupancy and demand for the Woodlands Town Center and Hughes Landing (which has 1.4 million sq. ft. of office space under construction, along with a 205-room hotel and 390 multifamily units), the company is considering additional projects with over 6 million sq. ft of additional office space, 2,000 residential units, and 3 hotels, among other development activity.
- Perhaps its trophy property, in 2012 Howard Hughes announced plans to redevelop the Ward Centers old-line shopping district in Honolulu into an urban master planned community. This includes 60 acres of oceanfront land within 1 mile of Waikiki and downtown Honolulu. It has received approvals to build 22 condo towers with 4,300 units, just a block from the beach, along with a top-quality mall, and 1-1.5 million sq. ft. of retail space. The first residential tower went on sale in December 2012 and sold out its 204 units in two days, for an average price of $1.6 million. Thus, the Hawaii condominiums alone could be worth $4-5 billion fully developed, at current prices. This development had a book value of just $457 million as of year-end 2014.

Shortly, the cash flows from the Howard Hughes development activities will climb rapidly. When they do, they can be shielded to some extent by the company's $300+ million operating loss carryforwards. However, as its taxable income becomes significant in the next few years, the company is likely to think about both the allocation of that income, perhaps toward paying dividends, and tax efficiency, perhaps toward becoming a REIT. Either or both of those actions could reposition the company into the mainstream of publicly traded real esate. The shares are down 38% from their 2015 high. By our calculations, they are likely worth easily twice the current price.

Any one of these three companies is a large enough position to have a meaningful impact upon portfolio performance. In 'older vintage' accounts, Howard Hughes, for instance, could have a 7% weight. If it were to reach its 2015 high, which is well below our estimate of fair value, that alone could produce nearly a 4% return for an entire account. The reasonable return possibilities for these companies, which are easily on the order of one or more multiples of their current prices, are not due to some serious risk – they are not heavily indebted or at risk of default, they are not loss-making, they are not threatened by product competition or product liability issues. It is actually possible in today's environment to acquire this level of return potential in growing, well-capitalized, well-run, profitable companies. And that is extraordinarily unusual – almost unheard of.

The return potential from more and more equities is approaching the multiple-of-current-price level, not merely a percentage-of-price level. The only way to capture those is to be positioned for it.

A Word About Income

While this review is about equity portfolios, there are times when market circumstances make available opportunities to build income. This can occur even in the midst of the artificially low interest rate environment we still inhabit, where there is insufficient yield available. There are securities outside of the ETF influence, just as for equities, that offer sufficiently rewarding yields. They are also a quite diverse group. A few examples, since these are not what is usually seen:

- One of the precious metals royalty companies has a bond, subtantially its only debt, that is due in three years, so there is little credit or interest rate risk. It is priced at 90, so that aside from the coupon income, it will appreciate by about 3% per year, for a yield to maturity of about 6%.
- There is a timber company, controlled by Brookfield Asset Management, that owns and manages over 2 million acres of land in Maine and New Brunswick, Canada. It collects fees from other firms that harvest timber on its property. It pays a 5.8% dividend yield. Unlike a typical natural resource based company, which must spend substantial sums to replace a depleting asset, timber is self-replenishing.
- There are closed-end bond funds that have maintained relatively short average maturities, in the 5-year range, such that there is relatively limited interest rate risk. A distribution yield of 5% would be typical, but because the average bond price might be as high as 110, the yield-to-maturity of the bond portfolio might only be about 3%. On the other hand, the bond price premiums are compensated for, since these funds trade at discounts to NAV of 5% to 10%. An instrument like this can provide a reasonable intermediate-term return while awaiting higher market yields.

These sorts of securities provide an opportunity to begin to establish long-term income streams, which could once more become, as has not been the case for awhile, a far more important component of future stock and portfolio returns.

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