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Has the financial crisis changed the prospects of Intrinsic Value Investing?

Four years after the 2008 financial crisis (which really started with a weakening of the US housing market in 2006-2007), equity markets remain weak, barely taking stock of good news, while interest rates remain at extraordinary lows, offering very little return to investors. It seems there is nowhere to go to obtain satisfactory returns. Nevertheless, private and institutional investors have made a substantial asset allocation shift away from equities into fixed income securities. Assets allocated to equity based funds have declined substantially¹ and pension funds have shifted their allocations away from equities, which explains why equity prices remain "soft". As summarised by Brad DeLong², an ex-US Treasury official now professor at University of California:

- Many investors are uncertain of the future. They fear another downturn like in 2008 and do not trust current equity prices. This would be typical of individual investors.
- Others, while seeing equity as an attractive option, do not think they can afford to run a downside risk. This would include many professional managers who have to report a return to "clients", be they individuals or a supervisory committee.

In both cases, the key goal of these investors has been loss-avoidance, not profit-seeking.

The major asset class beneficiaries of this movement have been bonds (including high yield or "junk" bonds), yield based equity securities (especially those that are perceived to have a lesser degree of volatility, like preferred shares), and gold.

State of fixed income market

1 As per the Investment Funds Institute of Canada, over the last 12 months assets allocated to equity funds declined by C\$16BN while assets allocated to bond funds increased by C\$17BN (June 2012 report).

2 <http://www.project-syndicate.org/commentary/the-economic-costs-of-fear>

We think that bonds and possibly yield based equity securities (like preferred shares) could become the next "bubble". Today, investors are starved for securities offering both a good yield and good security. This is exactly what is needed for a bubble to take form. Whatever the demand, you can count on the market to deliver a product that at least in appearance will satisfy demand: if money is available, issuers will issue as long as the appetite is there. The problem is that as demand keeps increasing and more and more join the bandwagon, marketing savvy increases while investor scrutiny and product quality decline. Investors (bond holders) forget that lending *is* risky (just ask those who lent to the Greek government). One day enough investors will rediscover that lending after all is risky and that the returns promised may not be delivered. Their early selling will start a reversal which, after a bubble, may become violent. Prices will come down dramatically, and many dreams will be shattered, including many retirement dreams.

Next month we will take a look at the yields currently on offer in different market segments. In the meantime, consider that despite investors' supposed fear of inflation, current long term rates barely compensate (or fail altogether to compensate) for *current* inflation. A 30 year Canada bond pays about 2.4% before tax while inflation is currently running officially at 1.5 to 2%. Something is amiss!

The strong demand from investors for fixed income securities has had the effect of lowering funding costs for borrowers. Today, debt is very cheap. Companies relying on the public market for funding pay little interest. Low financing costs and added leverage improves their profitability short term, and therefore their attractiveness for further funding. However this increased profitability masks a build-up of two risks: refinancing and funding costs. In a crisis, an inability to refinance may lead straight to default. Progressive increases in funding costs act more slowly but may have the same terminal effect: in a leveraged company, higher funding costs quickly lower



profitability. This reduces the company's attractiveness for debt investors, leading in turn to even higher borrowing costs. This can easily become a vicious cycle and may lead to bankruptcy. If a bond/interest rate bubble develops, this *will* be one of the consequences of its bursting.

Gold

As for gold we do not understand it as it has no intrinsic value and no practical use. It is simply a speculation, sustained and justified in the minds of its participants by fears of inflation, talks about lack of confidence in fiat currencies, and the hopeful anticipation of a return to the gold standard.

Consequences for value investors

As it pertains to equity investing, in the past, investors would bid up a security in anticipation of a positive fundamental development. This is not currently the case. In fact, in many cases investors are not willing to pay up even for actual positive developments. Therefore, one cannot currently depend upon the ebb and flow of the public market for liquidity for a portfolio of securities at or close to their fair value. In our opinion, at this time investors are dependent upon corporate transactions by strategic buyers in order to achieve liquidity at fair value for their securities. The implications of this fact are two fold when it comes to considering potential investments:

1. When evaluating possible catalysts for the future recovery of capital (plus a capital gain) from a potential investment, one should weigh catalysts that involve possible corporate action more heavily than catalysts that depend upon the public market.

2. Investors should be even more cautious about companies which are dependent upon the public market for funding.

In line with the above thoughts we continually monitor our portfolio to make sure it keeps meeting the criteria for success described above. We keep monitoring each position for any change, positive or negative, and for any new opportunity.

How long will it take for the market to go back to "normal"?

This is the hardest question of all, and not being soothsayers we can only offer observations as to what is going on.

First, the obvious, very roughly. Up to 2008 world economies were mostly powered by households who were financing their consumption by taking on debts. For the lenders, these debts were assets producing revenues. These assets were piled on the balance sheets of financial institutions whose leverage, because of deregulation, was allowed to increase to unprecedented levels. As explained above, this magnified their profitability while multiplying their risks (which was ignored as models assuming perfect and rational markets were showing risks to be under control). When many of these assets (loans) revealed themselves to be valueless, confidence crumbled. Many financial institutions went technically bankrupt (they did not have enough capital to cover the potential losses) and were saved only by the interventions of governments and central banks (who took the bad assets on their own books).

Since then households have been unable and/or unwilling to keep financing new purchases with debt, reducing the overall demand and economic activity. On the contrary, households have been reducing their debts and saving more, which has limited their consumption further. Governments have been trying to help by lowering interest rates, but maxed out households still did not start borrowing again. Businesses could have taken advantage of the low interest rates and extensive cash availability to invest in their businesses but have been reluctant to do so in the absence of consumer demand. Instead, many have retrenched and laid off workers, which has weakened demand further and added to the debt deflation spiral.

What could be done?

Two ways to look at the problem.

For some, what we have now is first and foremost a lack of demand problem that leaves the economy under-utilized (high unemployment), with the added observation that government debts have been much higher in the past and were still manageable. Sovereign states have characteristics that make them very different from the private sector (i.e., thinking of a state as an over



indebted household is misleading). Currently households and businesses are unwilling to spend. The only remaining actor with spending power is the public sector. States could spend wisely on programs of general interest (like infrastructure) to rekindle demand, which would increase gainful employment which would increase demand further and so on until the economy is durably relaunched.

The main criticism of this approach is that it would add to already high government debts.

For others, the main problem is too much debt. Reduce the debt, confidence will be rebuilt, demand will come back and the economy will start moving again. Hence the austerity programs in Europe and now to some extent in Canada, where governments cut spending and lay off civil servants to forcefully reduce government expenses and budget deficits.

The primary criticism of this approach is that austerity reduces demand further, *adding* to the problem one is trying to solve.

Historical background

The first approach (usually called Keynesianism and in its modern version New Keynesianism) was advocated by Keynes and many other economists after they studied the Great Depression and its aftermath. They observed that demand had remained weak during the 1930s³ and that it took the massive government spending of World War II to relaunch the US economy, which led to the post-war decades of prosperity. For them, the Great Depression was first a demand problem, a problem governments could have solved in the '30s and did solve albeit unwittingly in the '40s.

Since its formulation, Keynesianism has been opposed by those who prefer less government presence in the economy and fear that if successful it might legitimize government interventions.

As applying Keynes' ideas would increase government debt, the counter approach has come to focus on debts, and especially government debts. However, the theories

("neoclassicism") and analytic models that support this approach have the same fundamental flaws that we criticize when talking about current main stream investment practices: they assume perfect markets and rational individuals who always take rational decisions. As per this theory, supplies are always matched to demand because if the market is perfect and people are always rational, they will not produce more than what is required. A lack of demand is therefore impossible. And if demand cannot be lacking, then government intervention to boost demand is wasteful. As the theory does not allow for depressions either, the explanation for the current situation is that markets are "confused". The solution: reduce the weight of government debts, confidence will return and markets will recover.

Where do we stand today?

Debt reduction (austerity) has been tried for a few years now in the Eurozone from Greece to Ireland, but also very voluntarily in the UK. As of today, not only have these economies not recovered but they have kept deteriorating, with really no end in sight.

In the US, the federal government weathered the crisis by introducing limited stimulus, the extent of which was negated by cuts at the level of individual states for a neutral net effect. Economic recovery there looks anemic.

In Canada, the government stimulus of 2008 has helped weather the crisis, greatly helped by the high price of the commodities the country exports. It remains to be seen if the partial austerity now implemented will have a negative impact and to which extent.

Looking at the effects of these policies, it would appear that Canada has done better than the US and the US better than Europe – which might indicate that government stimuli, however weak, have been more beneficial than forced austerity.

However, politically, the trend still seems biased toward austerity – as is the dominant economic orthodoxy.

So, how long will it take before we see the end of the current economic quagmire?

Your answer will depend on which approach you believe may work and what you believe can and will be done by our governments. In the end, it is a very political assessment, especially as the primary beneficiaries will differ depending on the chosen path. That politics are unavoidable is unfortunate though; given the current

³ This is how Keynes described the 1930s: "... it is an outstanding characteristic of the economic system in which we live that, whilst it is subject to severe fluctuations in respect of output and employment, it is not violently unstable. Indeed it seems capable of remaining in a chronic condition of subnormal activity for a considerable period without any marked tendency either towards recovery or towards complete collapse". (General Theory of Employment, Interest, and Money).



polarization of both economics and politics, logic and informed common sense may not be the first determinants for the decisions that will be taken.

For us, we reckon that we cannot have a reliable answer to the “how long will it take” question. Even though we see lack of demand as a major issue, we would not dream of forecasting how the future will unfold – too many possibilities, too many imponderables, too many powerful vested interests at stakes.

How to approach this market: the Intrinsic Value approach.

It is a sound principle of investing that decisions must be taken solely based on what can be reasonably expected from the current position, whatever past expectations may have been. We have to look at the future without being mentally encumbered by the past.

Looking at all the investment opportunities in front of us, we view many fixed income securities as extremely risky due to the very low prevailing rates. Investors seeking higher returns by extending maturities and / or lowering issuer quality play a dangerous game. However, short term securities (in your own currency) remain a good way to protect capital, even though at current rates they do not compensate for the loss of purchasing power caused by inflation.

We see the debts and equity of heavily indebted companies as risky propositions too. We would not invest in anything that would rely on a major future economic expansion for success – it may be a while before the general market resumes its march forward.

Furthermore, because demand may remain low for some time, we will favour companies with low costs of production, and companies that may be attractive to other companies looking to lower their costs / improve their productivity.

In any market there are always unusual opportunities for profit. A bond or a stock will get mispriced, an institution will dump paper onto the market for reasons unrelated to the security they sell, a company will restructure leaving orphan assets behind, the market will go on one of its tangents... It is simply a matter of looking for them and finding them. We are not the only ones looking for such opportunities, but we have the advantage of more than 20 years of experience doing just that, and of being small... which expands the range of available opportunities.

Our portfolios already own several such opportunities. Our flexible mandate puts us in a good position to discover and exploit more of them. We will keep doing so, always with the mantra that we will identify first the possible ways in which our invested capital could be returned to us, with a capital gain of course. To remain successful, investors today have to focus even more on selecting securities in a way that will protect their capital from permanent impairment, avoiding securities that would be irreparably hurt by the kind of “surprises” the current economic environment may generate.

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