The Quarterly Report

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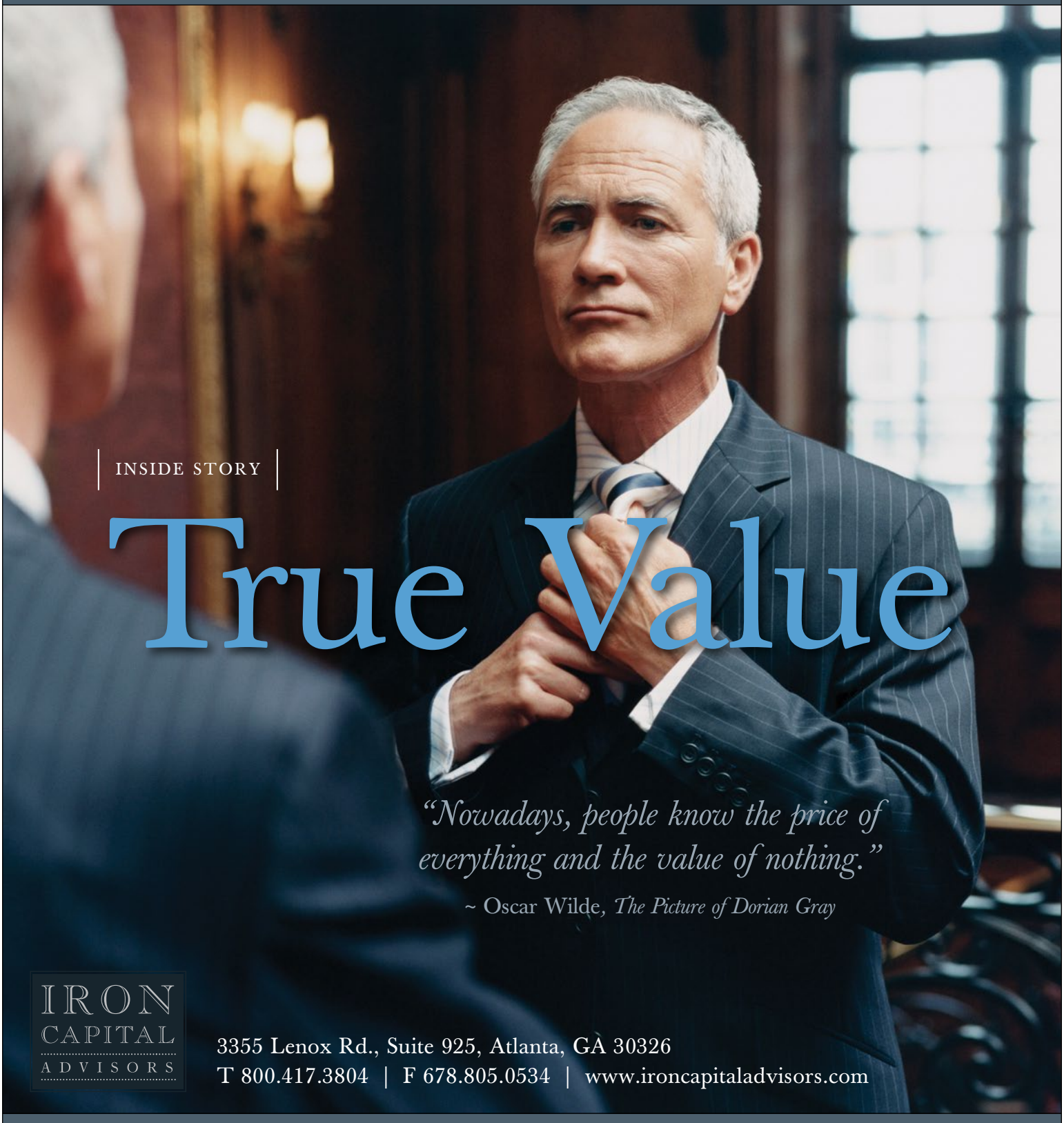

INSIDE STORY

True Value

"Nowadays, people know the price of everything and the value of nothing."

~ Oscar Wilde, *The Picture of Dorian Gray*

IRON CAPITAL ADVISORS

3355 Lenox Rd., Suite 925, Atlanta, GA 30326
T 800.417.3804 | F 678.805.0534 | www.ironcapitaladvisors.com

True Value

Dorian Gray is a fascinating character. For those who can't quit place him, he is the guy who had a magical self-portrait. He stayed young while his portrait aged. As long as he did not look at his portrait he could do whatever he pleased without ever facing the consequences. It was his portrait that aged and carried the marks of hard living, until one day he saw his portrait and what he had really done to himself. Beneath his youthful façade he had turned to ash. The sight of his portrait, of facing the truth, destroyed him.

Popularity, momentum, the madness of crowds can drive the price of investments in the short-term, but eventually value matters.

From a line in this story we get the cliché, "the price of everything and the value of nothing." An old friend of mine was fond of saying that clichés exist for a reason. They are often true, and 2015 was certainly a year where we saw this particular cliché alive and well in the financial markets. The S&P 500, the most watched and quoted index, finished the year up 1.38 percent. However, if one were to take away the four top gainers, the index would have finished the year down 4 percent. Beneath the positive façade was really nothing but ash.

The top two stocks for the year were Netflix and Amazon. Both are good companies, and I am personally customers of both. My wife and I don't know how we could pull off Christmas without the convenience of Amazon Prime. Just about every day in December we came home to find a brown box with a smile on the side (never mind how many we sent), then after Christmas one of those familiar boxes arrived with the book I asked for that Santa forgot (and no, it wasn't available on the Kindle).

Meanwhile, my eight-year-old son is into Pokémon. Pokémon is a trading card game based on a cartoon and video game that came out about twenty years ago. My son has discovered that he can watch all of the original cartoons on Netflix; in fact, he can watch just about any cartoon he wants whenever he wants on Netflix. If he is being nice, he can even start Barbie cartoons for his little sister.

These are great companies with excellent products. However, there is more to being a good investment than just being a great company; investors usually want a business to be profitable and sustainable. This is one thing the anti-capitalist crowd never seems to understand: any organization must be profitable if they wish to be sustainable. A few years ago I was on the board of a not-for-profit organization that actually understood this fact. They presented the board with their five-year plan and the budget portion was entitled, "Not-for-profit is a tax status, not a business plan."

I think this is an important point, because profit has become a dirty word ever since the financial crisis. A company's profit is the difference between revenue (money in) and expenses (money out). To be profitable simply means that an organization, or a person for that matter, spent less money than they had. That is really not such an evil thing, and in fact it really doesn't matter what kind of organization one runs; spending less than you have is essential for long-term survival.

While I was glad to know that this small local organization understood the importance of spending less money than they had, the large boards at places like Amazon and Netflix don't seem to think

such laws apply to them. Netflix does show some profit, but not much, while Amazon has not been profitable for most of its history and doesn't seem to care. As a result, an investor who wishes to purchase a share of stock in Netflix must pay $284.25 for $1 of earnings. If you think that sounds expensive, Amazon's stock cost $929.35 for $1 of earnings. Both stocks more than doubled in value last year.

That is great if one took a gamble on these two one year ago, but is it real? Is it sustainable? No, it is not. Benjamin Graham, the father of security analysis, used to say that, "In the short-term the market is a voting machine; in the long-term it is a weighing machine."

Popularity, momentum, and the madness of crowds can drive the price of investments in the short term, but eventually value matters. Those who invested in Netflix and Amazon last year will say otherwise. They will brag that they made money while just about everyone else lost it. They will say this time it is different. How do I know? Because that is what they said in the late 1990s when the tech bubble was still building. That is what they said in the 1960s with the "nifty fifty." That is always what they say when, in the midst of an otherwise down market, a few companies whose stocks make absolutely no sense seem to standout. Let us not forget that most of the wisdom of Benjamin Graham came from the fact that he witnessed, and survived, the bubble of the 1920s and the subsequent Great Depression.

They were saying it back then too – "This time it is different." The Amazons and Netflixs of the world are too cool to worry about old-fashioned ideas like value. At least they are today, but what is cool today often looks, well…I'm trying to think of a word nicer than stupid…several years later. If you don't believe me, just try to explain to your children how cool that outfit you were wearing in high school was when the picture was taken.

Part of the issue today is that many of the decisions being made about investing in the market are being made by machines and not humans. This is a key distinction. The machines I am referring to are computer programs run to trade into and out of stocks very rapidly, often based on breaking news. So if the news for a company is positive the computer buys, and if the news is negative the computer sells.

This makes perfect sense on the surface, however, the one thing that is not accounted for is that news is often priced into the stock already. What does that mean? If one invests in Amazon at $929.35 for every $1 in earnings, that implies that he has a very optimistic view of Amazon's business. One willing to pay such a price is assuming that the earnings will grow at a substantial rate. Thus most investors would say that a lot of good news has been priced into the stock. When news breaks and it is positive a human being would say, of course we are expecting positive news, but a computer program isn't that clever. Expectations don't seem to matter to the computerized traders, and as a result the winners keep on winning.

This works for losers as well. For example, that investor who paid $929.35 for Amazon's $1 in earnings could have paid $1.56 for $1 in earnings at Atwood Oceanics. Atwood is

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REVIEW *of* ECONOMY

Same old 2 percent. Third quarter GDP was up 2.0 percent. We expect the fourth quarter number to be a little lower but still positive. Is anyone else getting bored with this? We have been stuck at this low rate of growth for almost eight years now and there is no sign of it ending anytime soon.

The official unemployment rate dropped to 5.0 percent in November. The labor force participation rate ticked up just a bit to 62.5 percent. Employment has improved slowly but surely.

Inflation is non-existent with CPI coming in at 0.0 percent in November. The Fed finally moved, let's just hope that was not too late. Our economy needs more votes of confidence and less easy money. +

REVIEW *of* MARKET

The markets bounced back. The S&P 500 was up 7 percent for the fourth quarter rebounding from the hard selloff in the third quarter. The gains however were not equally shared. Stocks of smaller companies, represented by the Russell 2000 index were only up 3.6 percent and ended the year in negative territory.

Bonds ended the year roughly flat with the Barclays Capital US Aggregate Index up 0.5 percent for the year. High yield bonds ended the year down 4.5 percent. Most of the issues in the high-yield market are due to the bonds of energy companies being hurt by low oil prices.

International stocks as represented by the MSCI EAFE Index were actually up for the year 5.8 percent in local currency, but the rise in the value of the dollar hurt US investors. In dollar terms the EAFE ended down 0.4 percent. +

MARKET *forecast*

We were correct about the bounce back, but still frustrated that we have not gotten more of a rotation into stocks whose prices actually make sense. We remain confident in the longer term. Valuations on equities are average on the whole, but if you take out the top ten returners from 2015 whose average PE is over 160 then stocks are downright cheap.

Developed world large companies look the best. Emerging markets have real economic issues and small company stocks remain overvalued.

Bonds remain our biggest concern over the long term, but they are still a shelter in the storm when the market does go down. +

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an off-shore oil drilling company. Most of the news in the oil business has been negative. Of course, when an investor is paying less than $2 for every $1 in earnings, it would seem that a lot of negative news has been priced into the stock already. The price of oil has been dropping over the last year. At some point it would seem that this ceases to be a surprise, which is true for humans but computers…not so much. (By the way, Atwood's earnings are not only still positive, they are still growing.)

This is textbook market overreaction in both directions. What is unusual is that it is happening at the same time, and it just keeps going. Of course it will stop. The only way it doesn't stop is if Amazon literally takes over the world and we are not allowed to purchase anything that does not get delivered in a brown box with a smile on the side, and simultaneously we stop using oil forever. Understanding that these are ludicrous assumptions is what separates prudent humans from simple computer models.

Prudent investing is not always as easy as it sounds. Paying attention to what one owns and understanding why she owns it sounds simple, but it is work. Focusing on hitting an absolute rate of return over time can be tough when it seems that nothing which would provide that return is popular at the moment. The hardest thing to do, though, is to understand the risk. What could be risky about owning the stock of two of the most popular companies in America today?

If everyone was prudent then there would be no investing opportunities to be had.

What could risky about buying a house? How could one go wrong investing in this internet thing? What does Chuck mean when he's talking about value, doesn't he know this is a brave new world?

One of my favorite quotes from Mark Twain is, "History doesn't repeat itself, but it does rhyme." The last time Amazon was this popular it was 1999. 2015 was no exact repeat of 1999, but there may be a little rhyme. Amazon lost more than 80 percent of its value back then and it took a decade to recover. That time was a brave new world as well. Joel Greenblatt, Columbia University professor, hedge fund manager and author of "The Little Blue Book That Beats the Market," said it best; what we call prudent investing always works over time precisely because it doesn't work all the time. If everyone was prudent, then there would be no investing opportunities to be had.

But there are opportunities. Cheap prices mean low risk of losing money, but the stocks that are cheap are always the ones that are not popular. It is hard to conceive of a world where investing in a profitable company for $1.56 per $1 earned isn't a long-term winner. It is also hard to like the oil business. What seems risky is often safe and what feels safe is often risky. That dynamic is one of the toughest things to overcome when trying to invest prudently.

Substance and value didn't seem to matter in 2015. That does not mean that the world has changed. We have seen this before and we know how it ends; eventually what one pays for an investment is what determines its long-term success. If being prudent is out of style, then so be it. Fashion has a way of drifting back toward the classic faster than most believe. Patience is in order for the prudent investor.

CHUCK OSBORNE, CFA,
Managing Director