RGA INVESTMENT ADVISORS, LLC

September 13, 2012

August 2012 Commentary
Politics Are Short-Term, Focus Long-Term

August

August closed with equity markets spending 18 days in a tight consolidation—the S&P 500 spent most of those days with prices holding in a 1.5% range. For the month, the S&P added 2.5%, the Dow Jones Industrial Average tacked on 0.92% and the Russell 2000 climbed 3.5%. Notably, August saw substantially less volatility across global equity markets compared to the May through July period.

In both February and April of this year, we focused on the need for "digestion" after making large, volatile market moves. Once again, we believe this to be the prevailing near-term theme. What should now become immediately clear is after volatile periods, we tend to have periods of minimal volatility. We in the investment management business like to anthropomorphize markets, and this is true because markets often do have human-like characteristics.

People work exceptionally hard throughout the year, yet come August, we see many individuals take much-needed vacation time. It is during these down times that we set the stage for our next period of activity. Equity markets began this August with a continuation of the action that began in June—mainly a bounce-back rally from May's decline—and ended with one of the longest streaks of apathy we have seen since the dawn of the Great Recession.

Along with digestion, there is one tangential and new theme we would like to highlight: lumpiness. Markets expend considerable energy in bursts around these periods of digestion. Not only do markets do this, but so too do stocks. Returns tend to occur in a very non-linear fashion over the short-to-mid-term time period. This sits in contrast to the many planners who draw hypothetical return scenarios which move neatly from the bottom left of a chart to the top right. The typical path moves in fits and starts, often for long stretches without any visible trend, before a powerful spurt moves the needle. The same came be said for the actual fundamental growth (or contraction) in the underlying earnings of equities.

This is a fact lost on many participants in, and observers of the financial industry. And it's ever more true at the shorter time-frames. One of the foremost reasons we prefer long-term investment to short-term is that we can smooth out this lumpiness and mitigate what is referred to as "noise." Operating over the long-term affords us the opportunity to focus on what we perceive to be only the most consequential of signals. It also allows us to focus more specifically on the trend of earnings in our core holdings, rather than monthly economic data, which correlates to intraday returns, but not long-term growth.

This highlights a key failing in the financial presses today. The pundits focus far more on heat maps and headlines than they do long-term trends, and strengths and weaknesses of actual businesses. In fact, there is very little focus on real businesses themselves, and even less a focus on the longer-term time-frames. This is one of the many reasons we prefer to focus on company-specific factors rather than broader economic ones. Note that this does not mean we forsake broader economic factors that drive our companies' bottom lines. Instead it means we don't make portfolio decisions based on guessing the direction of the economy, if/when there will be Federal Reserve Action, and we certainly do not hold positions solely on the basis of their placement in the broader economy.

Beware of the Macro Tourist and the Veiled Political Pundit:

There is a new phrase being slung around, and we couldn't be happier to see it called out for what it is: macro tourism. Macro tourism is a term geared towards those investors who built long-term track records on the backs of prudent company-specific financial analysis, or arbitrage strategies, who now focus much attention (and risk capital) on broader economy-based trades. This macro tourism is both a cause and an effect of heightened market volatility and it poses significant dangers to investors. Economics is far more complex than the financial presses highlight and involve considerably deeper levels of understanding beyond purely the numerical analysis.

There are behavioral and social forces, and political processes which cannot be factorized by models like company-specific drivers are. Perhaps one of the largest causes of macro tourism today is the presence of a hotly contested political environment. Intense partisanship drives the desire to impose political beliefs on market facts. Which brings us to another point about both the state of the financial presses and investments today: beware of those with strong political opinions cited as the basis for an investment approach today. There are many examples of people attempting to pass political opinion for investment advice, and in this context it's often hard to distinguish opinion from fact. We see this from those urging the indiscriminate selling of equities in order to avoid "imminently rising capital gains taxes" to those constantly harping about the "fiscal cliff." It is no surprise that the rise of the political cooing happens as campaign season heats up, but it is frightening how little these harsh-sounding gripes truly dig into the economic realities of the situation.

Pursuing Long-term Value:

In times like these, with a heightened focus on the macro, we look for something specific and important in our portfolio companies. Our ideal company is one that we can buy today for its present earnings power value, with all the growth as a "free" option on top. There are a few terms here that require further definition. A company's earnings power is the valuation of that business' sustainable level of income. While sustainable income is typically a subjective metric, we have a great objective quantity to use in order to ascertain a worst-case-scenario income target—that objective numbers comes in the form of the Great Recession. As we all know, during this time period, company earnings were suppressed as the global economy went into tailspin-mode. The trough in earnings was the most severe since the Great Depression. We can use these numbers, with a look at five-year average earnings in order to confidently surmise a sustainable earnings power number.

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Once we can comfortably quantify our sustainable earnings power value, we want to target the company's stock at or near that price level, but preferably at a discount. When we buy a company at its earnings power value, we want to make sure that the company not only has been growing through the past, but has a reasonably high likelihood of continued growth. This insures that we will own at worst, a fairly valued company whose cash flow yield will justify its present valuation in order to generate a decent return for shareholders. Plus it leaves open the growth element to add incrementally on top of the bottom-line return.

A simpler way of stating this is we like to buy growing companies who are fairly valued based on today's earnings and zero future growth. The reason we took the time to elaborate is that it's an opportunity to provide a little more insight into how we think about investment situations, and to demonstrate that we approach this analysis as conservatively as possible in order to protect our downside, and put ourselves in position considerable upside. When things are bad, companies tend to be valued on their worst case scenario—typically the earnings power value sans growth for a "growth" company. Companies that are fairly valued based on their sustained earnings tend to have rapid revaluations when growth opportunities are reincorporated into a stock's price.

And that takes us back our point about lumpiness from earlier in this letter. We aim to expose ourselves to one particular kind of lumpiness and that is the fairly valued business, priced for no growth, which gets "repriced" to once again reflect its growth prospects. When we see such companies, the change in price happens exceptionally fast and need not require a commensurate market move. It takes much patience waiting for the fairly valued business to work out the issues of perception that lead to an attractive valuation, but over long stretches of time it is an effective investment strategy through which to mitigate risk and gain exposure to superior returns.

Warm personal regards,

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