Capital Drain

Rick's investment opinion newsletter April, 2014 v.10 no.2

Before printing, think about the environment

Hi Readers,

All is well here, and I hope all is well for you, too.

All is pretty much OK in the economy, too, or as Paul Simon wrote, “Alright in a kind of a limited way for an off night.” There's plenty of room for improvement.

Still, it's not bad, for which we should be grateful.

In my opinion:

Executive Summary:

- GDP reading is weak but not terrible.
- Sell in May and go away? Not us.
- Ukraine fallout: Companies with Russian investments.
- Pfarewell to Pfizer.
- Criminal indictments for banks.
- Chinese web IPOs: unclear accounting.
- How does one pick attractive investments?

The recovery continues, many US companies are doing well, and the prices reflect continued growth expectations. I remain leery of the conspicuous high-fliers, especially the “hot” new tech IPOs. Maybe I'm just too stodgy to go for what I think is glamor with insufficient substance. If so, lately the rest of the market has started getting stodgy, too, both here and in China.

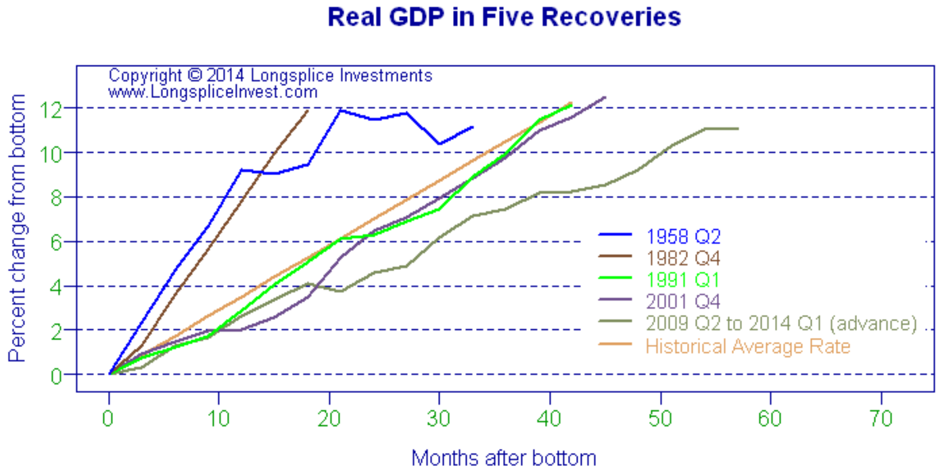
As confidence in the economy spreads, investing in all-market index funds becomes a bit more attractive. We are likely reaching the phase where a rising tide will lift (almost) all boats.

If you're inclined to pick among individual securities, be careful: stick to value, to safety, and call me to chat if you’re concerned about anything you’re holding. At the moment I wouldn't want to be holding bonds. The risk is high and the reward is extremely low.

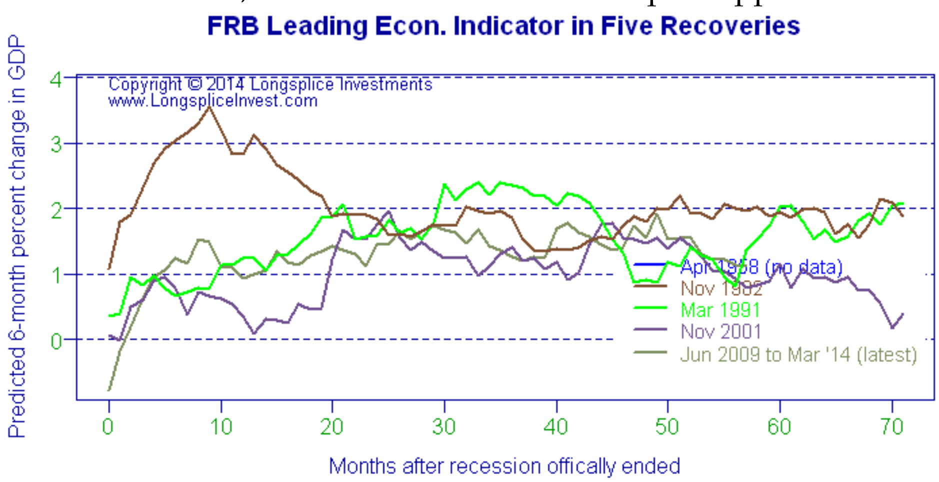
Above all, avoid the investments that are at all-time extreme valuations: junk bonds, developing-country bonds, and headline-grabbing stocks with high P/E ratios.

The Details:

No news is good news. On the economy at least, there really is not any earth-shaking (or mind-changing) news: just the continued slow improvement.

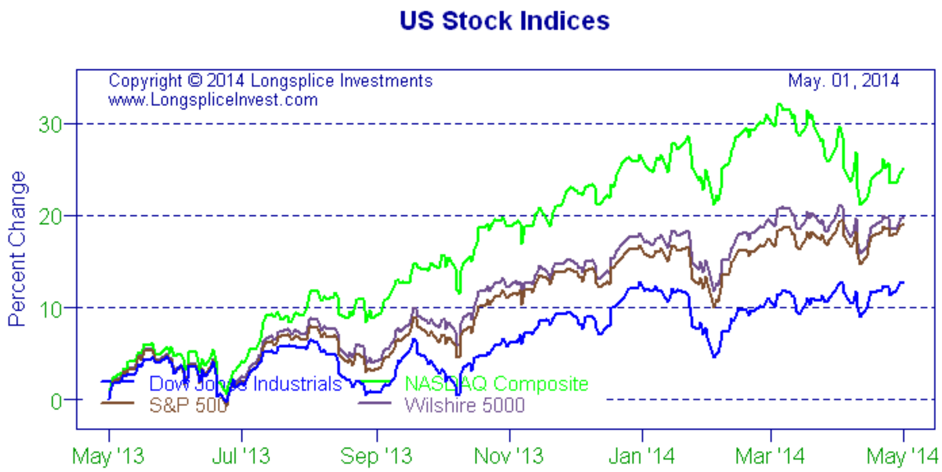


The latest reading of **GDP**, the 'advance' first estimate of growth in the first three months of the year, was a disappointment but not a surprise. Growth was near zero, for some technical reasons (like inventory decrease) and some obvious reasons, like terrible weather that kept shoppers home and builders idle.



The Leading Economic Indicators, which are measures of the economy that tend to predict the next few months of growth, are looking positive, according to both the Federal Reserve Banks' researchers, and the private Conference Board. That's nicely reassuring. Slow is better than stopped.

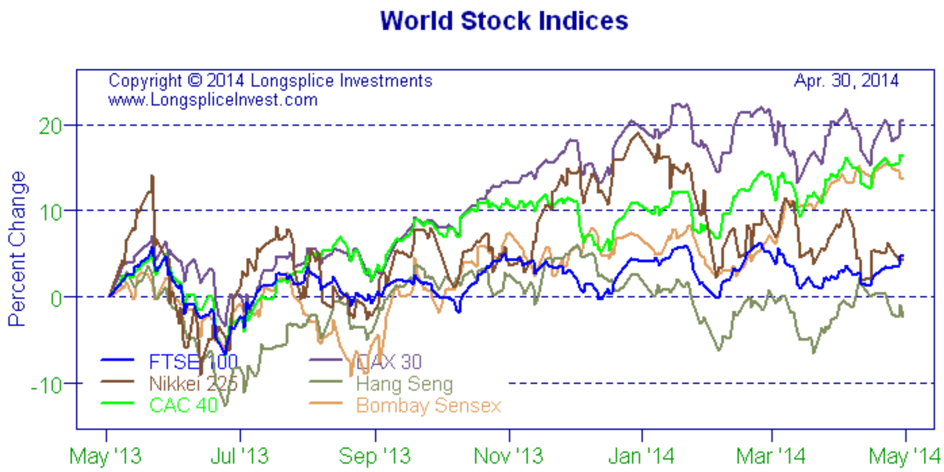
That's good news for the US economy, but what we really want is good news for our investments. The link isn't perfect, but good GDP news helps.



Our selection of dividend-paying stocks have played the tortoise to the high-tech hare lately, including a comeuppance for the hare in the last few weeks. Tech stocks had raced ahead since the end of the January correction, and were showing a little of that good ole' irrational exuberance. They, in particular the highly speculative profitless social media stocks, have since fallen back to more nearly reasonable levels while other stocks have continued to climb.

I've written before about how Quantitative Easing and other forces have been driving safe government bond yields down, and dragging even risky junk bond yields downward with them. Investors have begun to wake up to the fact that some of these junk bonds are real stinkers, and they're reappraising their market choices. Super-low bond yields favor dividend stocks. Conventional wisdom has it that stocks are riskier than bonds, but common sense says that junk bonds are riskier than good-yielding blue-chip stocks.

The dividend stocks are also, for now, better protection against a general stock market downturn. The yield is appealing. One bit of Wall Street traders' lore is "**Sell in May and go away**." Statistically, most of the stock markets' rise has come in the months from November to April. The summer months tend to be sleepy, low-gain months at best, with a few famous stock plunges in early autumn. It's different with dividends, though. While followers of the conventional wisdom are getting next-to-no yield parked in Treasury notes, dividend stock holders get half a year of continued portfolio gains, even if the stocks don't rise. So, we stay put.



These conservative stocks are also a comfortable place to be when the world gets scary, as **Russia** is now making it in their bid for **Ukraine**.

As it happens, even the stock markets nearest to the action do not appear very concerned. The FTSE 100, CAC 40, and DAX 30 are London, Paris, and Frankfurt, respectively. If they're not acting scared, nor will I.

I took some time, though, to scan the companies I hold for any significant exposure to the Ukrainian or Russian economy. No problem. The most at risk of the bunch appears to be DuPont, but they're everywhere (offices in 69 countries) and their Russian and Ukrainian offices are only a tiny part of their total.

It is with something of a heavy heart that I tell you that I'm selling another of the stocks I've been holding. In general, I have a lot of respect for **Pfizer** as a company.[1] I've held their stock off and on for decades, quite happily. I'm about to go back to 'off'.

Pfizer has launched a bid to buy another big drug company, AstraZeneca, based in the UK. The specific problems in my opinion are:

- Big mergers on average destroy value. They're simply harder than they look.
- This merger proposes to create the largest drug company in the world. Approval by the UK, EU, and US anti-trust regulators is far from assured.
- The rationale for the merger is too centered on the external factor of optimizing taxes, rather than performance.
- The operating efficiency they hope for comes largely from laying off staff from overlapping functions. That's an important part of a merger, but is disruptive at best.
- They also talk about improving competitiveness by merging their complementary product lines. As far as I can see, though, they don't talk a lot about synergies of combining their research programs. I would be much more impressed if they put more focus on improving research. That, not Pac-Man acquisitions, should be the real strength of a pharma company.

So, I wish them luck, but I'm selling their stock. If they do well, I may buy it again someday. In the meantime, for me, all the uncertainties of the merger make the risk too high for the reward, compared to other options.

1 Full disclosure: one of my siblings is a Pfizer employee.

To their credit, by the way, the stock price has nearly doubled since I bought it, and the dividends have been rising regularly and by large percentages. The price has jumped on the initial merger announcement. Take advantage of that.

In other news, the US government is finally talking about bringing **criminal charges against badly-behaving banks**.

NOT, though, against the huge US banks that scammed a generation of home-buyers, almost blew up the world, costing millions of working people their jobs, and had to be rescued with taxpayer money, and have since shown scorn rather than gratitude or even humility. No, not them.

Two Swiss banks may be charged for criminally aiding US tax evaders. Mind you, that is serious. But it's not the worst thing bankers have done these past ten years.

I'm reminded of the joke:

> Why is Bernie Madoff the only
> banker who went to prison?
>
> Only he robbed the 1%.

Funny, hunh? In a crying-while-ruefully-laughing kind of way.

You've probably read enough of my railing against overpriced internet IPOs, but I will do it again now for the **Chinese web IPOs** that are currently coming to US stock exchanges.

All the great (dreadful) investing rationalizations are present: Yes, (sincerely, not sarcasm) China is a great country, their markets are enormous, their entrepreneurs are very capable, the internet is an epoch-making technology, social networking is hugely popular, he who dares triumphs,... have I left any out?

However. These particular stocks have (even by internet standards) very low income and no profits. China's history of corporate accounting, and oversight of public companies is short and not encouraging. Legal structures are not mature nor stable. Barriers to entry for new competitors or new waves of products are low.

In short, there are far too many unknowns, and the prices they've been proposing are far too high. It's just a bad bet. At least at a casino you know the rules and by how much the odds are against you.

There are better ways to invest your money.

That leads nicely to a fundamental question: **How does one pick attractive investments?**

Buy low, sell high. Everyone agrees so far.

In my opinion:

Ignore recent market behavior, except possibly as a contrarian warning. Don't chase recent high performance. Don't ignore recent bad performers. (Where by 'recent' I mean up to the past few years, much longer than the last few days or weeks)

Financial orthodoxy is that you can't outsmart the markets. The markets are the distilled wisdom of a lot of smart, educated, experienced, well-funded investors.

My heresy is that sometimes you can be less dumb than the markets. We're a social animal and we can easily be swayed by what others in our pack are doing or saying. We're not perfect thinkers. We sometimes get over-focused, and sometimes get forgetful. When we see something new, we sometimes don't understand it.

I'm not proposing that I'm above any of those failings, and certainly not saying that the market is always wrong.

What I do to try to get an investing advantage is to explicitly think about those (and other) possible mistakes: what is just too much of a fad? What is being ignored? And so on.

That reflection leads to the real questions: what is too expensive compared to its risk, and what is cheap because it's out of fashion? If nothings seems to be mis-valued as far as I can tell, then the market may be right for a while, and I can feel comfortable investing right in the middle of the main stream, while I keep my eyes open for exceptions.

I hope you've enjoyed reading this.

If you have any questions, please write or phone. If you want to read more, the company web site has archived editions of this letter, lots of charts, and links to other interesting sites. There's also a web log where I discuss the process and progress of starting the mutual fund, along with occasional economic or investing thoughts..

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"Our doubts are traitors,
And make us lose the good that we oft might win,
By fearing to attempt."
--W. Shakespeare

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