Market Commentary

By Stephen C. Browne, CFA, CIO

After the PIIGS-induced selloff in May and June, global equity markets were kind in the third quarter, recovering to post year-to-date returns in the 4%-5% range. Emerging markets continued to lead, returning 18.2% for the quarter and 11.0% year-to-date. While believers in the long-term growth prospects of these economies, we are becoming concerned with the full valuations and high expectations for many companies in these markets. Several of our managers in the sector have modestly increased cash positions or reduced net exposure. We are less concerned about MLPs even though the 24% return of the Alerian MLP Index trounced the emerging markets. MLPs have reached fair value and any further price appreciation beyond the tracking of distribution growth may become cause for concern. However, given the difficulty of replacing the 6%+ tax-favored distribution yields of MLPs, it would require an extreme level of overvaluation to justify liquidating an MLP portfolio. Bond yields continued to fall with the Barclays Aggregate Index ending the quarter with a 2.4% yield to maturity. These low levels pose significant downside risks if and when rates begin to rise; however, cash currently yields nothing so opportunity cost of going to cash and waiting for rates to rise is a negative real return.

At the recent Grant's Interest Rate Observer Fall Conference, I was struck by one of the presentation subtitles which was *Inflation or Deflation? Fortunes will be Made or Lost on the Answer*. Given host Jim Grant's fondness for the gold standard and his keynote speech entitled *Bonfire of the Paper Currencies*, it was obvious which side of the debate most of the presenters were on. The arguments presented for an inflationary future were cogent and thoughtful. However, if inflation is so certain then why are long-dated US Treasury bonds trading at all-time low yields? Economist David Rosenberg at Gluskin Sheff, one of the few economists to foresee the financial crisis, thinks a decade of Japan-style stagnation and deflation are in order and presents equally compelling arguments. This brings up a serious question. If being on the right side of the inflation / deflation question will make or break a portfolio over the next decade, how does one choose? Does Comstock, on behalf of its clients, decide which economist is most credible, and if so by what metrics can this be decided? Is this reasonable given that historically the only things more unreliable than short term economic forecasts are long term economic forecasts? Economists, like everyone else not supernaturally endowed, have a lousy track record of predicting the future. Leaving aside the importance of completely unpredictable future actions of individuals or governments and acts of nature, economic data is crude and the dynamics of how different forces interact is very complex and nonlinear.

The problem is that assets that do well in an inflationary environment: gold, commodities and real estate, are generally toxic in a deflation. Long-dated government bonds, the only real deflation hedge, likewise will perform abysmally in a repeat of 70s style inflation. Fortunately there is a better way. Winning in this environment means protecting the real value of assets, not being proven right on a macroeconomic forecast. The goal should be to construct robust portfolios that can survive either inflation or deflation. Diversification then takes on a new light. Rather than a means to smooth returns and to protect against company-specific risks, it is now a defense-in-depth involving multiple asset classes and investment strategies. The bulk of this diversification can be achieved by owning high quality real assets which have stable income streams that can pass through inflation.

MLPs provide perhaps the clearest illustration of these dynamics. An interstate oil or gas pipeline operates like a toll road, with revenues based upon capacity utilization. Petroleum pipelines have federally mandated rates while natural gas pipelines enter into long term contracts with local utilities. Volume will vary with the state of the broad economy, but only by a small percentage. Inflation adjustments are built into rate agreements providing a revenue stream that is constant over time in real dollars. MLP capital structures are typically split evenly between equity and debt. In an inflationary environ-

ment, the MLP obtains rate increases proportional to the rate of inflation, and the value of their outstanding debt is reduced as it can be repaid in cheaper dollars. In a deflationary environment, the inelastic nature of demand for transportation fuel and natural gas for heating and electricity generation provides a stable revenue stream and the moderate leverage does not pose a financial risk to the company. It is important to remember, however, that not all MLPs are created equal in their financial strength and sensitivity to commodity prices. Other examples of assets with similar characteristics include high quality, low leverage commercial real estate, private timberland and properly structured natural resource investments. Around this core, value can be added by exposure to opportunistic and distressed credit, non-directional arbitrage, managed futures and other opportunistic strategies.

A less intuitive example of a quality real asset would be the common stock of a company that has stable revenues derived from providing an essential good or service, little or no debt, and assets that are intellectual property with no material ownership of "hard assets" such as factories or distribution facilities. Examples would be branded consumer staples such as Coca Cola or Philip Morris, software companies with a large recurring revenue base such as Oracle or QUALCOMM and pharmaceutical / biotech companies such as Johnson and Johnson or Abbott Labs. During the late 70s and early 80s when inflation was high, most stocks on the S&P 500 traded below 10 times earnings. The caveat here is that at the time, the S&P 500 was dominated by manufacturing companies, with nearly 70% of the index in asset-intensive industries such as Energy, Manufacturing, Utilities and Telecom with only 17% in Technology and Healthcare. This is important because inflation distorts the financial statements and increases the tax burden of business that have carry inventory and depreciate and replace hard assets. Profits and depreciation are both measured relative to historical cost, not replacement cost which can be significantly different in an inflationary environment. Companies are taxed on the difference between sales price and historical cost so inflation results in a higher tax burden for an asset-intensive business.

Other interesting presentations included a debunking of the notion that high frequency trading represents some insidious threat to the average investor. The advent of decimalization (stocks trading in one cent or less price increments rather than the 1/8th tick) and the spread of computing power has allowed firms to set up computers with quantitative trading rules that can be implemented multiple times within a fraction of a second. These trades are typically based on statistical relationships between securities. For example, a trader may observe that two oil companies generally move in tandem when oil prices change; they may program their trading algorithm to buy one and sell the other if the two securities react differently the next time the oil price changes. Our discussions with institutional brokerage firms and reviews of other research reveal that transaction costs, measured not only by commission, but also including bid-ask spreads and implementation shortfalls (the opportunity cost of not getting the trade done instantly), have continued to decline in recent years despite the growth of high frequency trading.

The aftermath of the financial crisis, burgeoning government debt and aging populations likely mean decades of subpar economic growth for most of the developed world. Most financial assets are fairly priced with many higher risk assets significantly overvalued. In this environment, investors should refocus on constructing portfolios that focus on meeting their financial goals, not around beating benchmarks, looking like peers or minimizing short term price volatility. A real rate of return of 5-7% on risky assets, which is in line with world historical rates of return on stocks, should be the goal for investors. High quality real assets should play a primary role in providing the growth and income necessary to meet these goals. The concept incorporates a broad range of assets that have the common characteristics of little or no financial leverage, stable revenue streams and the ability to grow income with inflation. Many investments with these characteristics exist today, including most importantly the common stock of quality American companies.

Please feel free to give us a call at (713) 977 2694 with any questions or to discuss further.

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