



## DISASTER PLANNING

The investment business is never easy but it's particularly challenging to know exactly what to do when faced with the sorts of tragedies of enormous consequence such as we have seen and are seeing in Japan. Through my nearly two decades of practicing this craft, I have come to realize that I am not particularly skilled at out-predicting the market regarding the economic consequences of these extreme events on-the-fly. News is difficult to come by and frequently contradictory and market movements are rapid, generally in both directions.

While I don't believe in fully efficient markets, I do accept that the markets are pricing in whatever news is available more rapidly than I can incorporate them into my stodgy investment process. As a result, I tend not to be event-reactive in situations like this and the reason is that it tends not to be value-additive to my portfolios when I do react to the events. I've developed an aversion to actions which are not value-additive over the years.

What I am is price-reactive. The future is unknowable at all times and one should always make decisions knowing that these sorts of events are possible and will most likely happen in the future, just at unpredictable times and locations. It would have been nice to have been all cash prior to the earthquake, but if fear of that scenario had led to

that positioning, one would have been all cash throughout all of history. Not only is that not a great investment stance, it's a hard one to build a thriving business around.

What I will do in situations like this is ask myself if prices seem to have reacted in an excessive fashion relative to a reasonable estimation of how the future may unfold. If panic seems to be in the air and prices plunge in a free-fall fashion, then often securities become priced where positive returns will be enjoyed under the vast majority of potential future outcomes as the recent dire times are assumed to be more likely to occur in the future than will generally be the case. The immediacy of the recent event colors the assessment of its future likelihood. That doesn't guarantee positive returns, as the future could unfold more horribly than likely for many reasons but it tilts the odds in one's favour, which is about all you can hope for in this business.

I have tended to have success applying that approach and the benefit of experience in the business is that it helps one to do more of what works for them and less of what does not.

I remain optimistic on valuations over an investment cycle, but the modest price break to-date from the Japanese crisis is not the sort to make me want to buy aggressively on its own.

### Mused Upon in This Issue:

The Federal Reserve is presently in the midst of its second large purchase of government securities, referred to as Quantitative Easing II. From reading the writings of Ben Bernanke, the goal appears to be to cure all economic ills without creating inflation and while possibly restoring hair growth in men. From the article:

*"The obvious questions that are begged are that if economic growth can be created merely by loose money and pumped-up stock markets, why doesn't everyone do this and why have we ever had market corrections or economic recessions in the past?"*

### S&P 500 Since Jan 1, 2008



Stocks remain roughly in the range they inhabited after the early 2008 weakness. The subsequent panic/rally has returned us to those levels, but no further.

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## A BREAKOUT DOESN'T COUNT IF YOU MAKE IT

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**A** long with “it’s raining on LaSalle Street” as an explanation for falling crop prices, I find the observation that ‘a breakout doesn’t count if you make it’ one of the funniest, most insightful insights into how markets truly function. Technical breakouts, where prices surge through prior levels of resistance on high volume, generally do signal something and can be considered bullish signals. However, if you’re the one doing all the buying, not so much.

I bring this up after pondering Ben Bernanke’s rationale for what is referred to as Quantitative Easing II, otherwise known as the electronic version of dropping dollar bills from helicopters.

The esteemed Chairman of the Federal Reserve Board of Governors laid out his thesis in an infamous op-ed piece for the *Washington Post* on November 4, 2010. Bernanke asserted that the Fed’s easier financial conditions *will* promote economic growth and that higher stock prices *will* boost consumer wealth and help increase confidence. He added that the increased confidence can spur spending and that higher spending leads to higher incomes and profits that, in a virtuous circle, supports further economic expansion.

It’s such a lovely little theory that I almost hate to take issue with it, but I must. Bernanke is basically saying that if the Fed gets easy, it can engender higher stock prices which will make people feel good, leading to spending, economic growth, even higher stock prices and a Sheenian Utopia where everyone’s a winner.

The obvious questions that are begged are that if economic growth can be created merely by loose money and pumped-up stock markets, why doesn’t everyone do this and why have we ever had market corrections or economic recessions in the past?

I think the answer lies in the headline—artificially inflating asset prices does not lead to the kind of confidence that creates actions that lead to sustainable wealth creation. The “breakout” from higher prices doesn’t count if Ben Bernanke made it. When higher stock prices come about as a result of improving underlying economic fundamentals and true wealth creation, they are coincident indicators of a number of positive activities and they are reflecting the true value that is being created. The higher prices may be happening around the same time as the improved and increased economic activity, but that does not mean that they are causing that activity. I would argue that they are

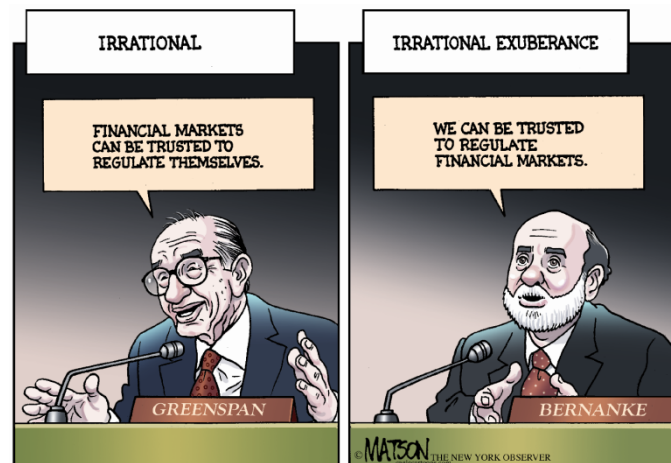
reflecting it, confirming it and being driven by it as opposed to actually creating it.

Bernanke is making, in my opinion, a classic cause-effect error. He must see that in the past, high stock prices have come about in a manner correlated with better economic times. Perhaps, they have even come in advance of the better times being properly recorded by the flawed set of government statistics that we have to rely on for assessing the economy. But that still doesn’t necessarily imply that they are causing the improved activity. Basing a massive expansion of the Federal Reserve’s balance sheet (undertaken only because they’d emptied their interest rate chamber already) on this dubious theory is an act of extreme arrogance. But arrogance is abundant in the land of bureaucrats.

I remain bullish on equity prices, but I believe the economy is recovering not because of the money-printing activities of the Federal Reserve but in spite of them. Just like with the stimulus bill, a shortage of pork was not what was holding back the economy. (In fact, more evidence of traction has been seen since the end of the stimulus era and the election of the tea-party-laden Republicans in the House last fall. They may not have achieved much in the way of material cuts yet, but at least they’re not coming up with new pork bills on a daily basis.)

Bernanke’s op-ed is chock full of certainty. He is confident the Fed’s help worked in the past and of the existence of a virtuous circle. His Fed has made “all necessary preparations”, in his mind, to unwind the policies at the appropriate time.

Humility about one’s ability to foresee the future is an extremely useful attribute in the world of economics. Certainty is not. We could use more of the former in Washington.



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## RETURNING ZERO CASH TO SHAREHOLDERS

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*“We remain committed to our stock repurchase program, and we believe that this is an efficient way to return cash to shareholders.”*

So stated John Chambers in his 2008 letter to Cisco shareholders, among other occasions. This bold assertion seems worthy of follow-up.

Cisco started buying stock in earnest after its fiscal year ended July, 2001. If buybacks were the permanent, price-agnostic elixir that managements seem to think they are, this massive buyback should have delivered outstanding results to investors. I can't find them.

In July of 2001, Cisco's shares traded between \$16 and \$19.75. Given that they were recently traded in the \$17 range, it would be fair to say that the stock has gone nowhere in the past decade and has also paid absolutely nothing in dividends. The share buyback has not delivered any noticeable return in the stock market to date.

Not too impressive, but perhaps not the full story. The company has paid no dividend, true, but it has “returned cash to shareholders” via stock buybacks and that is supposed to increase the intrinsic value of the company by reducing shares outstanding, increasing the proportionate share of ownership in the company. The market may not have recognized this, but perhaps it is misguided. If so, we should see some evidence of improved per-share attributes attributable to the shareholder.

In July of 2001, Cisco had 7.324 billion shares outstanding, a Mike Ratio (cash+ receivables + inventory minus all liabilities, kind of a liquidation bonus, so-named not because I created it but since I use it frequently) of \$0.26 per share and book value (net of goodwill and intangibles) of \$3.06 per share.

Over the course of the next nine years, Cisco reported \$263 billion in revenues, \$50 billion in net income and \$54.5 billion in simple cash flow (income plus depreciation minus maintenance cap-ex), all in round figures. Pretty impressive stuff.

That extraordinary cash flow was augmented by \$20.5 billion from stock sales (including the tax benefit) and used for \$17.5 billion in major cap-ex (acquisitions and such) and \$65 billion in stock buybacks. \$65 billion! Dr. Evil would be impressed.

To recap, Cisco spent more than it generated in cash buying back stock, and almost as much as it generated from operations and sales of stock to employees on buybacks. That's an enormous commitment to “returning cash to shareholders.” How much intrinsic value did it create?

By July, 2010 (9 fiscal years later), the Mike Ratio had increased by a whopping \$1.38 per share to \$1.64. Book value excluding goodwill and intangibles had grown by \$1.24 to \$4.30 per share.

The patient buy-and-hold investor, after 9 years, has seen his company report \$50 billion in income and \$54.5 billion in cash flow (roughly \$7 per original share) but, through the stock-option issuance/stock buyback scheme operated by management, these balance sheet metrics had only grown by from between \$1.24 - \$1.38 on a per share basis. The benefits of the buyback program cannot be seen on the balance sheet.

But, buybacks are about reducing the number of shares outstanding, increasing proportionate ownership, right? Surely this will be where the benefits are seen. The share count over this period did manage to decline from the opening 7.324 billion to 5.655 billion at July 31, 2010. 166 million shares were issued for acquisitions along the way, so the float reduction was effectively 1.835 billion shares, or 25% of the opening value. Assuming the same market cap, today's share price would be \$4.25 lower without the buyback (25% of \$17).

Had the company instead adopted a policy of not issuing stock to employees, not buying back stock but rather paying dividends equal to cash flow less major cap-ex, shareholders could have received \$5.05 per share in dividends (\$54.5 bb less 17.5 bb on 7.324 bb opening shares).

So, one could argue that the impact of Cisco's extraordinary stock-buyback and option-issuance scheme has been to trade a bird-in-the-bush \$4.25 of share appreciation for a foregone bird-in-the-hand \$5.05 in dividends. Not only is that an underwhelming trade, but given the epic scope of the buyback, one would have expected that it would have been massively additive to returns were it truly *“an efficient way to return cash to shareholders.”*

It is hard to describe this program as having been anything better than a mildly-negative wash as it has been practiced. As I search for reasons, I once again conclude that the most offensive aspect of the program has been the options-issuance to senior management and the buybacks serve as a useful smokescreen to the damage to shareholder value that options granting does.

**Postscript:** After much anticipation, Cisco has declared an initial quarterly dividend of 6 cents per share. Along with greatly reduced options issuance in recent years, governance trends are now positive.

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## BACK OF TOWN

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- I've never had much time for the argument that "we're spending our children's inheritance" so frequently heard during budget debates and when discussing the impact of running a deficit. To me, a deficit is merely one of three financing options available to pay for government services – taxation (direct payment by the those taxed), money printing (payment through the debasement of the currency, paid by those who hold paper assets) or deficits (payment through borrowing against future promises, which will end up being some mix of taxation and debasement). At a gut level, I have felt that you couldn't today spend the production of people in the future.

What I have come to believe, though, is that while you can't spend your children's future production today, you can promise a large share of it to someone else via the entitlement process. Social security, union pensions and medical benefits are largely promises made by governments today to people today that they will be entitled to 'x' share of the future production of all the people tomorrow. The problem with this situation is that 'x' is large and growing and the people whose production is being allocated away do not have a full voice in the negotiations.

That is immoral, unfair and a source of potential future class warfare. One positive of the requirement of states to run balanced budgets is that the issue is forced to be addressed before it gets out of hand. If the solutions found at the state level flow up to the federal level, that will be very good news.

- I really enjoyed President Obama's response to the question of whether the Republican electoral victories meant that his health care law was in danger. The President stated that it would be misreading the results to conclude that the American people wanted to see Washington re-litigate the arguments of the past two years. He couldn't be more right. But, of course, the American people thought that the election *was* the litigation of those arguments and that his point of view had lost!

- Back to budget issues for a moment, while I am everywhere and always averse to government spending because it is inefficient, I am not a proponent of balanced-budget amendments at the sovereign level. First of all, far too much time is wasted in the budgeting process in politics. The future is completely unpredictable. Budget projections are routinely off by hundreds of billions


of dollars, especially in the out years and yet people still waste time debating competing 10-year projections. CBO scoring diverts attention from relevant issues and is all based on objective models that rely on the garbage-in, garbage-out philosophy.

I *would* be willing to cap next year's spending at a fixed, say 98-102%, range based on last year's revenues. Then, we'd be dealing with hard, knowable data (or at least massively more so than when dealing with future projections) and we could spend our time debating relevant matters.

- One thing that has struck me about our modern world, having grown up in Canada and lived in Bermuda, two very civilized locales, is the persistence of the hard-to-believe regimes in certain parts of the world. "Leaders" like Gaddafi, Assad, Kim Jong-il and the Ayatollahs in Iran seem to me more like villains from the Saturday morning cartoons I used to watch as a kid than real live threats. And having never directly experienced them makes accepting that they are real all the more difficult. But real they are, and I am fortunate to not have lived under their tyranny.

- This bull market seems long in the tooth given its relentless nature and would appear to have discounted too much improvement in economic fortunes after having more than doubled from the market lows. Fear that the move has run its course abounds and keeps many out of the market. In my opinion, all data is skewed by the final plunge down to the 666 intra-day low on the S&P 500. Pessimism of that extent is rarely seen in financial markets and created an artificially depressed base price from which to measure percentage gains. This is one reason why the size and extent of the gains seen in this rally do not scare me and a further reinforcement of why focus should always be on the price being paid today relative to the investment merits of the matter in question, rather than on whether the market has rallied too much or fallen not enough in the recent past from some arbitrary starting point.

History is moving quickly these days. I extend my best wishes to all affected, and hopes for better times in the future. Until next issue,



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