July 2013

"Investors should always keep in mind that the most important metric is not the returns achieved but the returns weighed against the risks incurred. Ultimately, nothing should be more important to investors than the ability to sleep soundly at night." –Seth Klarman

Tapering Expectations

Dear Client,

As we write this letter, the International Monetary Fund has just cut its global growth forecast for this year and next. Amongst the reasons cited were slower growth in emerging markets, tighter credit conditions and expectations that the Fed will start its "Great Unwinding" (i.e. the tapering of its monetary stimulus program).

The word "tapering" usually refers to work done by a tailor, but it has recently taken on a meaning in a whole new context. Like a skilled tailor, the Fed will take out their pins, tacks and chalk, and start "tapering" its bond purchases as early as September.

What does this "tapering" mean for markets?

We may have received an indication of the impact of tapering on June 19, when Ben Bernanke merely suggested the obvious: that the U.S. economy is improving and as the recovery gets stronger, we approach the day that the Fed starts tightening its monetary policy.

Markets reacted with a swift sell-off.

The bond market was hit especially hard and has not yet recovered. The 10-year U.S. Treasury yield has risen from a low of 1.4% (July, 2012) to over 2.6% today. The 30-year U.S. fixed-rate mortgage rate quickly spiked by about 1% to 4.50%, an increase that will undoubtedly impact home affordability. Classic dividend stocks such as TransCanada Pipelines and Enbridge fell about 10% as fixed income at these higher rates make such stocks less attractive.

Bernanke and Co. will do their best not to shock investors when the time comes, but we have already seen warning signs that the end of quantitative easing may cause severe economic and market disruption.

Reversal of fortune

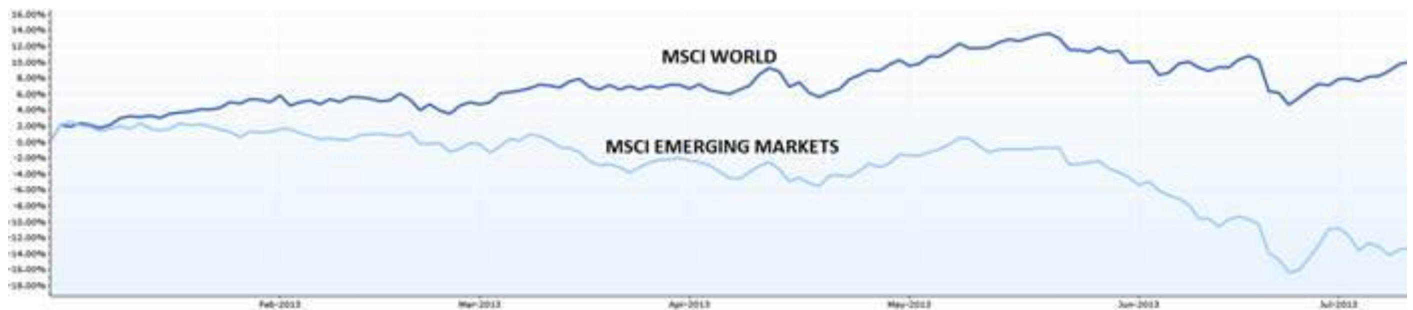
A number of long-term trends have been reversing this year, contributing to market volatility. Japan of course, is now in favour. Gold and other commodities have seemingly ended a decade-long bull market, while emerging markets are experiencing growing pains.

Emerging investment opportunities?

Emerging markets (EM) have been in vogue over the last several years, with countries like China becoming a major force in the global economy. In some cases, valuations often seemed rather steep. Given the recent poor performance of most of these markets, we are taking a closer look.

Emerging markets have been one of the worst performing asset classes in 2013, with the MSCI Emerging Markets Index down more than 12.0% (in USD) since the start of the year. In fact, 2013 has been the worst first-half return for these markets, relative to developed markets, since 1998 (source: Bank of America Merrill Lynch).

MSCI World vs. MSCI Emerging Market (2013 Performance)



Source: S&P CapIQ

There are several reasons behind this poor performance. These include: a stronger U.S. dollar (relative to most EM currencies), weaker commodity prices (which are the major exports of countries such as Brazil, Russia and South Africa) and higher U.S. Treasury yields. All this has been exacerbated by the recent U.S. Fed comments, as emerging markets equities were hit particularly hard by the prospect of higher interest rates. Social unrest in markets such as Brazil, Turkey and Egypt has also not been helping matters.

As value investors, the steep decline in emerging markets has not gone unnoticed by us. The drop in developing-nation equity prices has left the MSCI Emerging Markets Index trading at 9.6 times forecasted earnings, compared to 13.3 times for the MSCI World Index (source: Bloomberg).

Despite the recent hiccups, global growth is shifting from west to east, and capital will increasingly flow to these markets. That said, it is important to be mindful that corporate governance standards in emerging markets often do not reach the same levels as those in developed markets. These vary not only from country to country, but also among companies within the same country. As always, we seek to invest in companies with satisfactory reporting standards, sufficient transparency and where the objectives of management are aligned with the interests of minority shareholders.

For these reasons, investing in emerging markets can be challenging, but it is on our radar.

Recent purchases

Joy Global

Joy Global manufactures specialty mining equipment used to extract coal, copper and other minerals. It operates in a duopolistic industry, with Caterpillar being the only other major competitor. As its name implies, it is a global company, with over half of its sales outside of the U.S. Its shares have weakened recently, as the U.S. coal industry is suffering from new regulatory measures and competition from lower priced natural gas, though this latter trend is reversing as of late. Despite these issues, China and India are expanding coal-fuelled electricity generation, which offers good growth prospects going forward. About 50% of Joy Global's revenues are from servicing and parts, which is highly profitable and more stable. The company commands high margins, generates positive free cash flow and has delivered healthy revenue and income growth over the past decade. At the current valuation of less than 10 times earnings, we see opportunity.

Aegon N.V.

Aegon is a Dutch-based life insurance and asset management company with operations in Europe and North America. The Company also offers property and casualty insurance in the Netherlands and other European countries. Although based in the Netherlands, Aegon derives more than 40% of its revenue from the United States, where it owns Transamerica. It suffered like many during the financial crisis and required a government loan, which was subsequently repaid in 2011.

Aegon is well capitalized and has reinstated dividend payments. However, despite the improvement, Aegon still trades at a steep discount to tangible book value, as even healthy European financial companies are being penalized by investors.

Camellia PLC

Camellia PLC is primarily a worldwide diversified agricultural company that takes a very long-term approach to both its people and its assets. It is a leading producer of tea in India, Bangladesh, Kenya and Malawi, a grower of citrus, almonds and pistachio nuts in California, macadamia nuts in East and South Africa, as well as a developer of major, long-standing agricultural projects in Kenya and Brazil. The company also owns cold storage and engineering businesses, a highly regarded private bank in the U.K. and a wine estate in South Africa.

These are all outstanding assets that Camellia has patiently acquired and developed over the years. It has generated value for its shareholders by matching world class assets with a long-term focused management team. The company boasts one of the longest records of increasing annual dividends on the London Stock Exchange.

The corporate philosophy at Camelia stands in stark contrast to the short-term nature of too many companies today. This has had the effect of building intense loyalty amongst the management teams and has resulted in an excellent track record of value creation. The stock price declined recently, as the company's shares were removed from one of the indices due to low trading volume. This provided us with an excellent entry point.

High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: High Yield Quarterly Commentary

Final thoughts

Interest rates have been in decline for the past thirty years, providing strong support for home prices, equities and bonds. Today we find ourselves in a world with slowing growth, elevated levels of government debt, infrastructure deficits in the west and an ever widening gap between rich and poor.

U.S Treasury 10-year interest rate

Source: S&P CapIQ

This would normally be the time when governments would increase spending to stimulate growth, while central bankers would be reducing interest rates for the same reason. However, with the aforementioned high public debt levels and artificially low interest rates already in place, public policy is heading in the opposite direction. Whether the Fed will be able to “taper” without upsetting the markets or the economy remains to be seen, but if recent reaction is any indication, volatility will persist and we expect that we will have ample opportunity to deploy our cash.

As always, we welcome the opportunity to discuss our outlook and investments with you.

Sincerely yours,

Lorne Steinberg
President

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