

## Rallying the TruPS

The email came last Sunday afternoon from a colleague in New York, ominously titled “Hindenburg Omen”. A rare but historically predictive technical indicator had been tripped the prior week, indicating a potential stock market crash.

The Hindenburg Omen happens when both the number of 52-week highs and the number of 52-week lows on the New York Stock exchange reach certain levels. In a bull or bear market, either the highs or the lows are elevated, respectively. But when both are high, it shows a sort of market schizophrenia, indicating uncertainty. Historically it has resulted in calamity 25% of the time. At least that’s what the email attachment claimed.

Intrigued, we sought other sources. The Wall Street Journal had a blurb about it. The paper had also covered the dreaded “death cross” after it was triggered in late June, which created such a panic that stocks rose 8.35% the following month.

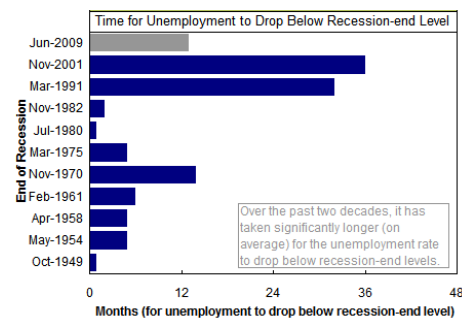
A quick look at the 52-week high/low list brought insight. While the Hindenburg was supposed to be an indication of dissonance within the stock market, roughly 90% of the 52-week highs were bonds, or their equivalents: bank-issued trust-preferreds, or TruPS, preferred stocks, and municipal bond funds. As interest rates had been plummeting in recent weeks, this didn’t exactly come as a shock. Lower rates equal higher bonds.

Times have changed, and if it trades on a stock exchange, there’s a decent chance it’s not a stock. Of the 92 names on the 52 week high list, only 7 were common stocks.

In reality, the Hindenburg head fake was simply an indication of the rising odds markets are placing on deflation. More on that later...

The most significant development since our last letter is the slowing of the economic rebound, largely indicated by persistently high unemployment. While the unemployment rate remains high, it is important to examine the current situation within the context of the past.

Historically employment began bouncing back relatively quickly following recessions, typically within months of the recession end. In the past two decades, however, it has taken years to just get back to recession end levels. Recall the “jobless recovery” following the 2001 recession? The job recovery ultimately came (much in real estate and construction, but never mind that), but took the longest to materialize of any job recovery since WWII.



Private sector employment growth has actually been better in this recovery than in the past two, with 620,000 jobs created in the last seven months. The aggregate data has largely been obscured by the ramping up and then decline of census-related employment, a once-a-decade event.

Employment and general economic uncertainty continue to lead to high

volatility and scattered equity valuations. While macro concerns dominate the minds of many market participants, patient investors can take advantage of a myriad of attractively priced stocks.

### Equities

Stocks eased in the 2<sup>nd</sup> quarter as the pace of the economic recovery slowed. Through July the market is roughly flat for the year.

Much of what we discussed in May remains relevant. Macro-related issues are driving the short-term movement of the market. Valuation and price, the daily legwork of what we do, much less so. We continue to find quality, well-capitalized equities trading at 40% or better discounts to intrinsic value, which is our price requirement on purchase.

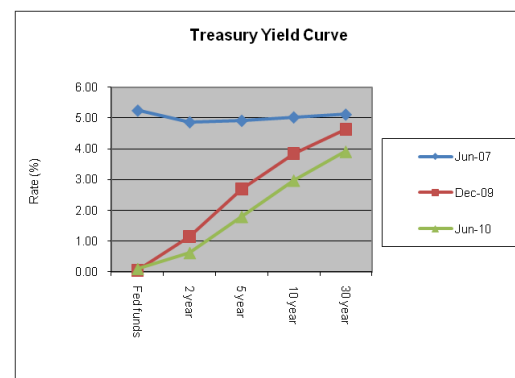
The S&P 500 is selling at 14 times expected 2010 earnings, a yield of more than 7%, while 10-year treasuries yield 2.7%. Such a spread is exceedingly rare: the only time since 1955 that it was wider was in early 2009. Stocks have been cheaper at times in the past, but only when interest rates were much higher. Interest rates act like gravity on stock valuations. While there are causes of concern, stock valuations are clearly discounting an adverse scenario.

Historically, future stock returns have been inversely proportional to the cheeriness of economic data. Specifically, stock returns have historically averaged about 5.4% better annually over the following two years when unemployment is above 5% rather than below. As Warren Buffett has noted

previously, “you pay a high price in the stock market for a cheery consensus.”

### Bonds

Bonds have rallied significantly since late April as stock market volatility has risen and some concern has grown over the possibility of deflation, or falling prices. As shown below, the yield curve has shifted downward since late 2009, with prices of all maturities rising.



The Japanese experience is on investors’ minds. Since the massive Japanese real estate bubble of the late 1980s popped, Japan has endured many years of near 0% interest rates, deflation and economic stagnation. There are major differences between Japan and the U.S. Japan’s real estate bubble was orders of magnitude larger, and Japanese restructuring has moved at a glacial pace. At this point, the Japanese scenario is considered a “tail” risk, unlikely to happen but possible.

We continue to favor 2-7 year maturities of the bonds of well capitalized, low leverage corporations. Several of our holdings are “below investment grade” as deemed by the rating agencies, despite financial strength which exceeds that of some companies that were rated

AA prior to the financial crisis. Many large institutional investors are constrained by the rating agencies due to rigid constraints, we are not. The Chairman of Sears Holding Group, one of the bonds of which we own due to the company's low leverage and vast real estate holdings, summed up the situation in his 2009 chairman's letter:

"When we inquire why our ratings are not higher than some competitors with credit metrics that are weaker than ours, one factor cited is that some analysts prefer their business models. Meanwhile, we have a higher market capitalization and less debt than many of these competitors. We increased our earnings, while many others have seen their earnings decline. We have a diversified business portfolio and a significant revenue base and scale. Obviously, we don't agree with all of the critical qualitative conclusions and the quantitative metrics speak for themselves."

Rating agencies have been tarnished due to overrating many of the packaged sub-prime and other mortgage bonds during the real estate boom. Less attention has been paid to their highly subjective judgments on corporate credits, but we view the status quo as an advantage for investors focused on the fundamentals over those with rigid mandates. Nassim Nicholas Taleb, in *The Black Swan*, noted that "a simple test of liquid assets to debt outperforms the majority of credit analysts."

## Stock Updates

**American Express** aggressively closed delinquent and at-risk card accounts during the downturn, and thus 2<sup>nd</sup> quarter credit losses and profits were back to pre-crisis levels. It's a striking contrast with banks, in which home loans will take years to resolve.

**Microsoft** shares are at the same level they were a decade ago, while earnings have grown at 11% annually in the last 10 years. Stripping out the \$4 a share in net cash held by Microsoft, shares are trading hands at less than nine times estimated forward earnings. We added the stock in August.

**Intel** announced the acquisition of McAfee, the security software business, for about \$7 billion net of cash. The price appears fair but higher than Intel's current multiple.

**First American Financial (FAF)** is the second largest title insurer in the U.S. We sold Fidelity Nat'l, the largest industry player, in the 2<sup>nd</sup> quarter to buy FAF, which is a newly independent company after splitting from Corelogix, a data services business. FAF is better capitalized and statistically cheaper than FNF, and we expect comparable profit margins.

**Mirant** announced a merger with RRI Energy, like Mirant an unregulated utility. The terms appear fair as the companies are trading at comparable valuations, and there will be room for overlapping cost cuts. Mirant remains dramatically discounted relative to net asset value and expected cash earnings.

**Blockbuster** is working on a financial restructuring which will leave no value for shareholders. BBI's business decline has accelerated in the face of heightened competition primarily from Redbox, and BBI remains highly leveraged. The initial investment thesis behind Blockbuster was that the company was cutting debt and continued to generate significant cash flow despite growing competitive alternatives. But the high operating leverage inherent in the business made the bet a risky one. We disposed of BBI shares in August. In the future we will be much more wary of businesses facing significant technological threats. For this reason we have avoided buying any newspaper stocks.

**Frontier Communications** was spun-off from Verizon in July and provides telecom services in rural areas. Financially the business appeared unattractive to us in terms of both price and potential, so we promptly sold. In light of the fact that the last two Verizon spin-offs (Idearc and Fairpoint) ended up in bankruptcy, we also figured that if Verizon doesn't want it, we don't either.

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