

Triumph of the Nerds

It's fair to say that Atlanta Falcons fans were disappointed following the team's "one and done" playoff loss to Green Bay this past weekend. Their 13-3 regular season record was the Falcons best since they went 14-2 in 1998 and made it to their only Super Bowl. Expectations were high.

A Falcons fan can perhaps find some explanation in Berkeley economist David Romer's 2003 paper, "It's Fourth Down and What Does the Bellman Equation say?" In it Romer analyzes NFL statistics, concluding that NFL coaches are far too conservative on fourth down. Falcons coach Mike Smith exploited the inefficiency during 2010, aggressively "going for it" 72% of the time versus 39% for the league as a whole*. In three games, the decision likely resulted in a win for the Falcons. Had the Falcons lost those three games, they would have missed the playoffs.

The story of *Moneyball* is one of inefficiencies in the game of baseball. Prospective talent has historically been picked by scouts, most of whom were mediocre ex-players. Most scouts had numerous biases which were not always predictive of future player success. They particularly overemphasized size and speed, as might be expected by men who chew tobacco in clubhouses all day.

Billy Beane, the general manager of the Oakland A's, shook up the game by utilizing a trove of statistics on what predicted player success. He managed to put together winning teams with a payroll one-third the size of the New York Yankees. Unfortunately for Beane,

over time baseball has caught on. In 2003 the Red Sox hired statistical godfather Bill James and won their first World Series in 86 years the following year. Finance professors would say that the game has become more efficient.

In investing, Ben Graham found that businesses that were selling at low prices relative to their earnings and net assets had a tendency to be good investments. He wrote a book about it in the late 1940s. A decade after his book was written, one of his disciples, Warren Buffett, took his principles and hit the ball out of the park, notching 30% annual returns over 11 years. Academia caught on and quantified the data decades later. And over time, the use of computers has made markets more efficient. But emotions and biases are likely to keep up a steady stream of exploitable inefficiencies, in both business and sports.

Equities in 2010

Stocks rode large waves of expectation and emotion in 2010. The early part of the year brought with it a heavy dose of skepticism as to the progress of the economic recovery. By April, spirits had been lifted on a rising tide of expectation. Stocks hit highs in early May, but receded sharply throughout the summer as economic data indicated a slowing in the recovery. Calls for a "double-dip" recession became more frequent and heated. Equities bottomed in early July, then rallied on better economic data to finish with an S&P 500 gain of 15.6% for the full year.

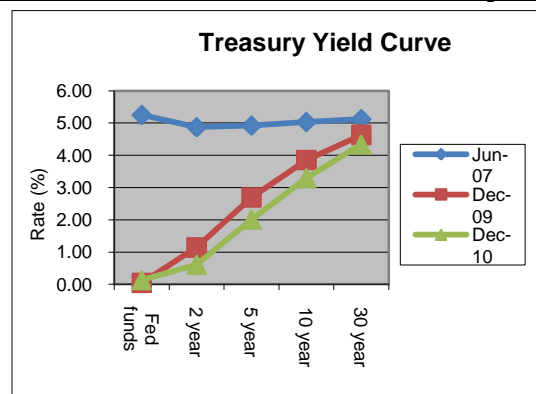
The overall market level appears reasonable. As of mid-January, stocks

are trading for around 14 times expected current year earnings, a modest discount to the historical average. We view inflation as the primary risk going forward. Inflation pushes up interest rates and acts as gravity on stock valuations, compressing multiples. In the inflationary late 1970s and early 80s, earnings multiples were uniformly in the single digits, as investors could alternatively get double-digit yields on government bonds.

Bonds

Due to the depth and severity of the *Great Recession*, the Fed has erred on the side of possibly creating too much money, in an attempt to invigorate the economy. So far the results have been favorable as GDP is growing again. But the side effect could be much higher inflation down the road. The recent higher prices at the gas pump are just one sign that markets are discounting higher inflation. Commodity prices overall rose significantly in 2010, with corn jumping 47% and wheat 38%.

Yields jumped on longer dated bonds in the 4th quarter as economic growth and inflation expectations rose. For the year as a whole, yields across maturities dropped. Bond yields remain paltry given the potential for higher inflation, and it has become difficult to find attractive reinvestment opportunities in the current interest rate environment. As such, we continue to stick mostly to shorter maturities.



Concern is rising over the potential for defaults in state issued, or municipal, debt. Many states suffer from deeply underfunded pensions and steep budget deficits. During the bull market of the 1990s, states were generous when it came time to renegotiate municipal compensation contracts. Pension return assumptions were in the high single digits during a time when earnings yields on stocks were in the low single digits. Since then earnings yields have increased and states have cut their return assumptions, truly a rear view mirror management style.

As concern has risen, yields on the highest rated 30-year municipal credits hit 5% this past week, compared to 4.53% for 10-year treasuries. Historically the situation has been reversed, as treasuries are federally taxable whereas municipals are tax-free. We are monitoring the situation but remain wary of lending for 30 years, where the highest stated yields are currently available. In the case of spiking inflation, a 30-year credit could drop 30-40% in value, inconsistent with that of a low-risk asset class.

Stock Updates

H&R Block prepares one out of every seven tax returns in the country. Block has a strong balance sheet and shares are on sale due to pessimism about contingent liability over their former mortgage division. We believe it is highly unlikely that any liability is material. Block recently acquired one of the largest preparer of digital returns in an attempt to broaden their competitive offering.

Motorola completed their long anticipated split into two companies in early January. Motorola Solutions received their handheld radio/scanner and networking businesses. Their “mobility” (cell phones, tablets) and set top box businesses ended up in Motorola Mobility, along with about \$11 per share in cash. We sold the Solutions business on valuation and are holding Mobility.

Chesapeake Energy possesses the largest reserves of natural gas in the U.S., with properties located in the mid-Atlantic and south. Chesapeake was a pioneer in horizontal drilling, a technique that allows drillers to tap into previously unreachable reserves of gas. Natural gas prices have lagged behind other commodities due to near-term oversupply, but gas is dramatically cheaper than oil and should benefit from substitution over the longer term.

Genco is a shipping company, operating a fleet of 60 vessels which transport dry goods around the world. Shipping rates remain depressed despite the economic

recovery, due to a near-term oversupply of ships and nascent recovery in shipping volumes. Genco has a young fleet, experienced management team, and ample liquidity. And, of course, the stock is cheap.

Mirant merged with RRI Energy in December, becoming **Genon Energy**. The transaction was a merger of equals with comparable value on both sides and strong cost cutting potential. Genon is statistically one of the cheapest names we own, selling at 40% of book value, and they have a strong balance sheet. The unregulated utility business draws fickle investor attention as fluctuating commodity prices result in erratic earnings. But cash flows are stable and well insulated by Mirant’s active hedging program.

*Wall Street Journal, 1/15/2011

Harper Asset Management specializes in managing capital for private clients according to a long-term, value-oriented process. We also assist clients with financial and life planning. Please contact us if you would like a review of your financial situation.

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