

Top-Down, Upside Down

Are stocks cheap? It's an important question, particularly to index funds buyers, as future results have a lot to do with the current price. Picture this:



That's a chart of the S&P 500 between mid-2000, when it was selling at about 30 times trailing earnings, and mid-2006. Price matters!

With the index recently around 1200, current estimates put the multiple at close to 12 times expected 2011 results. That's a whopping 60% discount to the 2000 price. And it's historically cheap.

Not so fast, some say. Yale University guru Robert Shiller uses a 10-year average of earnings, comparing the past to the present multiple. Doing this prevents one from placing too much emphasis on earnings inflated by a favorable economy. Ben Graham also warned about this:

“The purchasers view the current good earnings as equivalent to ‘earning power’ and assume that prosperity is synonymous with safety.”

According to Shiller, the current valuation is a little above the 50-year average, calculated on a “top-down” basis. By that method, one uses broad

economic assumptions to arrive at estimates. Shiller and others also believe that corporate profit margins are inflated and due to revert back down.

Our method is the inverse. We look at individual businesses and estimate what their value is. We find comfort in a long track record: businesses which have been around a long time have a lot more operating history and are thus more reliable than, say, Groupon. Like Shiller, we prefer ten years or more of data. We take a long run average (typically of profit margins), apply them to a current, sensible revenue level, and derive a *normal* level of earnings.

Where we would diverge from Shiller's methods can be illustrated by the following. Based on our estimates on what Microsoft should earn in the average year, the stock is cheap. Ergo, we own Microsoft. Do Shiller and S&P's top down analysis factor in Microsoft's individual results? They do not.

We haven't analyzed all 500 stocks in the index and thus can't opine on top down estimates. Instead we stick to assessing two dozen or so names and ensuring that we're getting more value than we're paying for.

Equities

The broad market treaded water in the 2nd quarter, with the S&P 500 up 0.1%, but sold off sharply in July and early August. “Sell in May and Go Away” has indeed paid the past two years. But the volatility has generated new bargains.

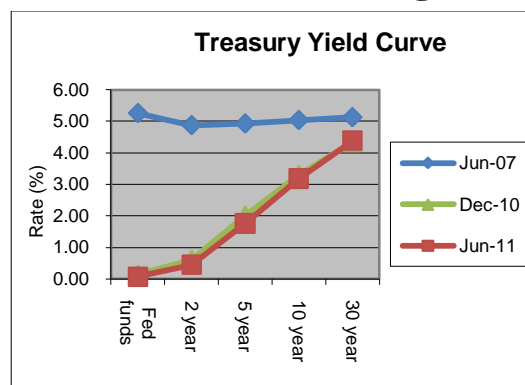
Within the market, momentum type stocks have lately outperformed at the expense of value. The excitement surrounding social media businesses has led to unusually high valuations among fast-growing but mostly unprofitable internet-related names. A slew of loosely related companies have rushed to the public markets, including recent IPOs of Zillow, Homeaway and LinkedIn. Groupon and Zynga are on deck, and chatter around the valuation of Facebook is a daily occurrence (recent estimate: \$70 billion).

	Value	Earnings	P/E
Facebook	\$70 billion	\$400 mil	175
Groupon	\$30 billion	-\$400 mil	N/A
LinkedIn	\$9 billion	\$15.4 mil	558
Zynga	\$10 billion	\$28 mil	357
Homeaway	\$3.2 billion	\$7 mil	457

The usual pattern is likely to apply to this mini bubble. A widening supply of shares will eventually weigh on these inflated valuations, and while this may be a bubble of relatively small proportions, it's likely to end in tears for some.

Bonds

Treasury prices were volatile as Congress battled over the budget and debt limit. Following resolution and S&P's downgrade of U.S. government debt, treasury bonds soared, but due to weaker economic data.



Treasuries at present are paying next to nothing. As of Aug. 12, the going rate for lending money to the U.S. government for 10 years is 2.23%. Inflation has averaged close to 3% in the past 10 years and was 3.6% in the year ending in June 2011, according to U.S. government statistics*. Assuming 3% inflation, the real yield on 10-year treasuries is -0.77%.

The government is happy that this is the case, for two reasons. First, low rates hold down the deficit as less interest is paid on the \$10 trillion in public debt. The government's cost of debt in 2010 was around 2%. Were this to simply double to 4%, below the historical average, the budget deficit would rise by an extra \$200 billion.

The second reason is that *in theory* low borrowing rates lower the cost of money, making borrowing cheaper and stimulating the economy.

But as Yogi Berra once said, "In theory there is no difference between theory and practice. In practice there is."

Following the debt agreement in Washington, markets defied the latter. Interest rates on "junk" bonds soared as economic worries grew due to weaker

data. Spreads jumped to more than 7% over treasuries from 5% in late July. On Aug. 11, junk yields were at the highest levels in a year, while treasury rates were close to one-year lows.

We have not held treasuries for the past few years, but have held on to the TIPS (treasury inflation protected securities) we owned because we felt they represented a unique asset class and offered a hedge against potentially high inflation. But we just sold all of our TIPS as the prices are now so high that we feel any inflation protection is probably priced in. Certain issues of secured, high-yield debt are presently available at attractive prices, and the opportunity cost is frankly too high. We took advantage of the recent rout in high-yield to buy secured debt of Sears and CIT, yielding 8% and 7.7% respectively and due in 6-7 years.

Stock Updates

Officemax was our worst performer in the quarter, declining 39%. The stock remains misunderstood due to accounting rules which require OMX to carry non-recourse debt on their balance sheet. As a result the balance sheet appears highly levered when in reality OMX has the best balance sheet among peers. OMX's current earnings are depressed due to economic sluggishness. The name remains our cheapest holding.

We added more **Berkshire Hathaway**, Warren Buffett's conglomerate. Berkshire is second to none in safety and quality, and shares are surprisingly undervalued. Berkshire holds both

securities and whole businesses, and we think the sum of the parts is over 50% above the current market price, and growing at 10% a year.

We sold **Boston Scientific** after a relatively short 15 month holding period, at a small profit. Boston's end markets are stagnant and earnings are less than we originally expected as their turnaround is mostly complete.

Bunge was sold in late May as shares approached our estimate of intrinsic value.

Google announced on August 15th the acquisition of **Motorola Mobility** for \$40 per share in cash.

*Some feel that the U.S. government significantly understates true inflation. One prime area of criticism is "hedonic" adjustments such as lowering stated inflation because the prices of computers and other high tech goods decline over time while their quality and capabilities improve. Such adjustments began in the mid-1990s.

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.

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