TIME TO BUY QUALITY?

"Many shall be restored that now are fallen and many shall fall that are now in honour" – Horace

BIG PICTURE – Mean reversion is one of the greatest truisms of capitalism and 'this time is different' are the four most expensive words in the English language.

There can be no doubt that over the past decade, investors have favoured highly leveraged, cyclical and low quality securities. Ironically, during the first decade of this millennium, Mr. Market has shunned high quality large capitalisation stocks characterised by growing revenues, stable earnings and solid balance sheets.

It is noteworthy that usually, it is the high quality franchises which sell at a premium to the speculative issues. However, thanks to the Federal Reserve induced speculative fervour, the high risk/poor quality companies are currently trading at a valuation premium! It seems as though the speculators chasing today's 'hot stories' are once again ignoring history and blindly relying on the Federal Reserve as their saviour. Never mind the two burst bubbles of the past decade (technology and housing), investors are once again queuing up for another round of culling.

Today, the small capitalisation, highly leveraged companies have become the market darlings and speculators are bidding up the prices of extremely cyclical stocks. In comparison, the high quality, conservatively financed multi-nationals are being given away. In fact, if you review the valuations of some of the largest companies on the planet, you will note that they have not been this cheap in decades.

We do not know about you, but we do *not* like to pay up for our merchandise and given the ridiculously cheap valuations available today, we have been buying into world-class companies. It is our firm belief that stocks are claims on the long-term cash flows of operating businesses and as value investors, we always try and buy into attractive companies at favourable prices. So, in the spirit of buying a dollar for sixty cents, we have recently accumulated positions in various "out of favour" companies.

First and foremost, we have recently acquired a stake in Bank of America, which is still despised by most retail investors. As you know, the credit crisis brought this financial institution to its knees and the company had to be bailed out by the US government. The past three years were probably the toughest in the company's history, but the important thing is that it managed to survive.

Whether you like it or not, Bank of America is a world-class franchise and one of the biggest players in investment banking and American consumer and commercial banking. Furthermore, after its highly controversial acquisition of Merrill Lynch, Bank of America has become a dominant player in the wealth/investment management business. Last but not least, Bank of America has a business relationship with 50% of American households and 98% of the world's 1,000 largest companies! The truth is that the US government has decided that Bank of America is 'too big to fail' and the stock is currently trading below its book value. In simple terms, given its long term earnings power and strong global footprint, we believe Bank of America is an attractive investment.

Elsewhere, in the land of distressed securities, we have recently initiated a position in oil giant - BP. As you will recall, BP was the operator of the ill-fated Macando well and in the aftermath of the disaster, it faced intense pressure from American policymakers. During the height of the crisis, it was unclear as to whether BP would succeed in stopping the leak, therefore investors sold its stock in earnest. As investors fled for the hills, BP's stock price fell by an incredible 55% and even today, it is trading approximately 30% below its pre-Macando level (Figure 1)!

Figure 1: BP is on the bargain table

Source: www.bigcharts.com

Now, we are aware that BP's spill related costs will run into the tens of billions and the potential liability will probably hang above the stock for a while. Nonetheless, according to our calculation, BP has sufficient assets and earnings power, therefore a bankruptcy is extremely unlikely. More importantly, from an investment standpoint, its current valuation is simply too good to pass.

If our assessment is correct, the Macando accident will go down as a poor chapter in BP's history, but the oil giant will survive and prosper over the following years. When other investors come to the same conclusion, they will bid up its valuation, thereby rewarding the existing shareholders.

In addition to Bank of America and BP, we have also invested in some other high quality companies, which are currently out of favour with investors. For instance, we have acquired stakes in a leading telecom hardware manufacturer, a biopharmaceutical firm and one of the top For-Profits schools in the US.

It is noteworthy that the For-Profits education sector in the US is currently under federal investigation and unsurprisingly, investors have been dumping the related holdings. Short-term uncertainty notwithstanding, it is our belief that this selling is overdone and Mr. Market is (once again) offering some genuine bargains for patient investors.

Look. We cannot predict the short-term direction of the stock market with any degree of confidence, but we do know that intelligent investing amounts to buying securities for less than their intrinsic values. In this department, we have allocated our investors' capital to reasonably priced companies which are home to rock solid balance-sheets.

Figure 2 highlights the fundamental characteristics of our portfolio. As you can see, our portfolio is currently trading at only 11 times prospective earnings and Wall Street analysts expect our businesses to grow their earnings by 14.8% per annum over the following 5 years. It is notable that the projected earnings growth rate of the companies in our portfolio is far superior to the companies in the S&P500 index.

Figure 2: Characteristics of our portfolio

	Your Portfolio	Relative to S&P 500		Your Portfolio	Relative to S&P 500
Price/Prospective Earnings	**11.05**	0.79	Projected EPS Growth - 5 yr %	**14.80**	1.53
Price/Book Ratio	**1.83**	0.90	Yield %	**0.70**	0.41
Return on Assets (ROA)	**10.24**	1.22	Average Market Cap $mil	**21,562.41**	0.49
Return on Equity (ROE)	**17.34**	0.82			

Source: Morningstar

In summary, our portfolio is trading at a lower valuation than the S&P500 index, yet its earnings are likely to grow at a faster pace than the broad market. Last but not least, the vast majority of the companies in our portfolio are conservatively financed and we are confident that we will outperform our benchmark (MSCI World Index) over the full business cycle.

As far as specific markets are concerned, we continue to like China, India and Vietnam and currently, approximately 40% of our portfolio is invested in these nations. Finally, in terms of sectors, we remain optimistic about energy (upstream firms, oil services stocks, uranium miners and renewable energy), precious metals, financials and Asian domestic consumption plays. In our view, as long as the monetary conditions remain favourable (low interest rates and a steep yield curve), the ongoing rally in global equities will continue. Accordingly, we are maintaining our exposure to our preferred investment themes for now.

ENERGY – The day of reckoning is approaching and the world does not have a contingency plan.

The truth is that the world's output of conventional crude oil peaked in 2005 and global oil exports are also past their prime. Furthermore, the unconventional sources (tar sands, heavy sour crude, ethanol, natural gas liquids, bio-fuels and shale) are struggling to keep up with the ongoing depletion in the world's largest oil fields. Therefore, it is *probable* that the world's current production of total liquids is at or near maximum capacity.

Veteran clients and subscribers will recall that we have been extremely concerned about 'Peak Oil'. However, for many years, ours was one of the lone voices in the dark. It is interesting to observe that up until 2007, various government sponsored energy agencies were extremely optimistic about their oil production forecasts. In fact, before it commissioned its first field by field analysis in 2008, the IEA used to claim that the world could easily produce over 110 million barrels of total liquids per day! Ironically, other agencies such as CERA and the EIA were even more liberal with their oil production projections and 'Peak Oil' was dismissed as a lunacy.

Thereafter, in November 2008, the IEA released its *World Energy Outlook 2010* report, which contained a thorough analysis of the world's 800 largest oil fields. In this study, the IEA admitted (for the first time) that most of the world's largest oil fields are depleting at a rapid clip and serious capital spending is essential to avoid an energy crunch in 2020. Although this report was a step in the right direction, in our view, the IEA was still painting an unrealistic picture.

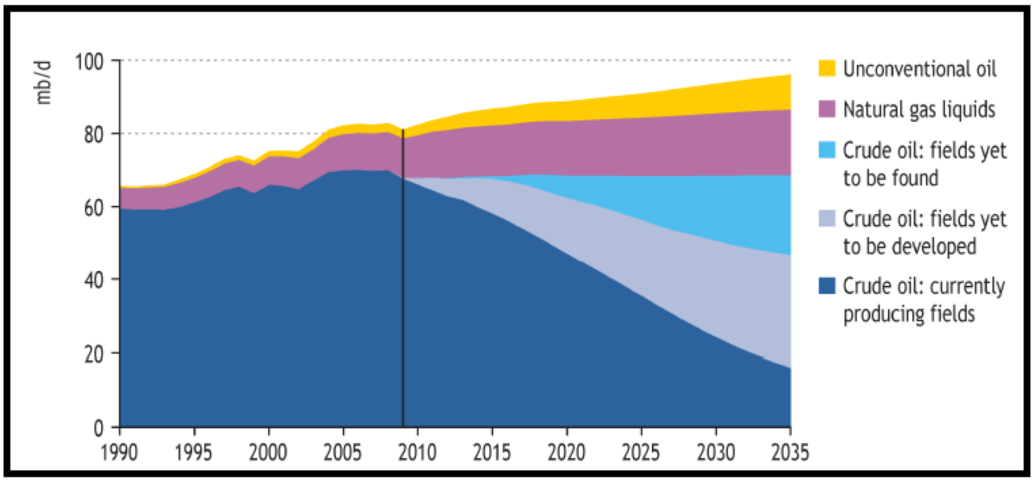
Fortunately, it has taken the IEA only two years to realise its mistake and its latest *World Energy Outlook 2010* report presents a far more realistic scenario. According to its latest study, the IEA now expects global total liquids production to increase to just 96 million barrels per day by 2035! Bearing in mind the fact that the world currently produces 88 million barrels of total liquids per day, the IEA is now essentially implying that output will only increase by 9% over the next 25 years!

It is notable that in 2009, the IEA stressed the importance of oil for economic growth and concluded that 106 million barrels per day will be required by 2030; representing an increase of approximately 18 million barrels per day above current output. Interestingly, in last year's report, the IEA predicted that global production will peak at only 96 million barrels per day in 2035! So, within the course of a single year, the energy watchdog for the developed world lowered its production estimate by 10 million barrels per day!

To complicate matters further, the IEA's latest forecast of 96 million barrels per day of peak production depends on the assumption of finding an extra 900 billion barrels of oil over the next 25 years! However, given the fact that over the recent past, we have managed to discover only 10 billion barrels of oil each year, we cannot help but take the IEA's rosy forecast with a pinch of salt. Call us skeptics, but at the current rate of discovery, it will take us 90 years to discover 900 billion barrels of oil. Yet, the IEA somehow believes that this task can be accomplished by 2035!

Figure 3 is taken from the IEA's *World Energy Outlook 2010* report and it does a good job of capturing the sorry state of affairs. As you can see, the IEA now expects the output from the currently producing fields (dark blue area on the chart) to drop from approximately 70 million barrels per day to only 16 million barrels per day by 2035. Furthermore, the IEA also believes that 60% of oil production in 2035 will come from oil fields not yet found (light blue area on the chart) or developed (grey area on the chart)! Once again, call us sceptics, but we do not believe that oil fields yet to be found or developed will somehow succeed in offsetting the ongoing depletion.

Figure 3: Admission of 'Peak Oil'?



Source: IEA, World Energy Outlook 2010

It is our contention that the world will struggle to produce more than 91-92 million barrels of total liquids per day and global demand will collide with available supply. Of course, we do not know the exact timing of this event but if global consumption continues to grow by 1.5% per annum, we will get there within the next 2-3 years.

Needless to say, when aggregate demand hits available supply, the price of oil will rise sharply. More importantly, if demand continues to increase in the developed world, there will be a permanent shortage of crude and governments will probably end up rationing petroleum. Furthermore, it is our firm belief that ultimately, oil will only be used for its highest uses (agriculture and aviation).

If history is any guide, the price of oil will not rise in a straight line and the secular uptrend will be punctuated by severe economic recessions. After all, the cure for a high oil price is a high oil price! At some point during the course of this business cycle, as the price of oil continues to rise, it will (once again) cause economic pain for the overstretched citizens of the developed world. When that happens, consumption will slow down and we will experience demand destruction in some parts of the world.

In our view, the next economic recession will be caused by yet another spike in the price of oil and during the next business slowdown, crude will get whacked again. This is the reason why we will liquidate all our energy related investments prior to the onset of the next economic recession.

Turning to the current situation, the price of oil is trading above US$90 per barrel (Figure 4) and during the course of this business cycle, we expect it to surpass its previous record of US$147 per barrel.

Figure 4: The price of oil has climbed to a new recovery high

Source: www.stockcharts.com

In addition to crude oil, we are also optimistic about the prospects of uranium. As you may know, various nations are scrambling to build new nuclear reactors and this is good news for uranium (raw material used for a nuclear reaction).

As the world approaches 'Peak Oil' and crude is conserved, demand for electricity will surge. Either that or the world will go back to horse drawn carriages which we seriously doubt! Furthermore, given the environmental damage associated with burning poor quality coal, the world will turn to nuclear energy to meets its energy needs. Therefore, worldwide consumption of uranium will appreciate over the following years and this will exert enormous pressure on mined supply.

At the time of writing, the price of uranium has climbed to US$61.5 per pound and it is probable that it will at least double from this level. In the previous cycle, the price of uranium peaked around US$140 per pound and we will not be surprised to see that level exceeded within the next 2-3 years. Such a bullish scenario for uranium is great news for the unhedged uranium mining companies and a modest exposure to these stocks seems like a reasonable bet.

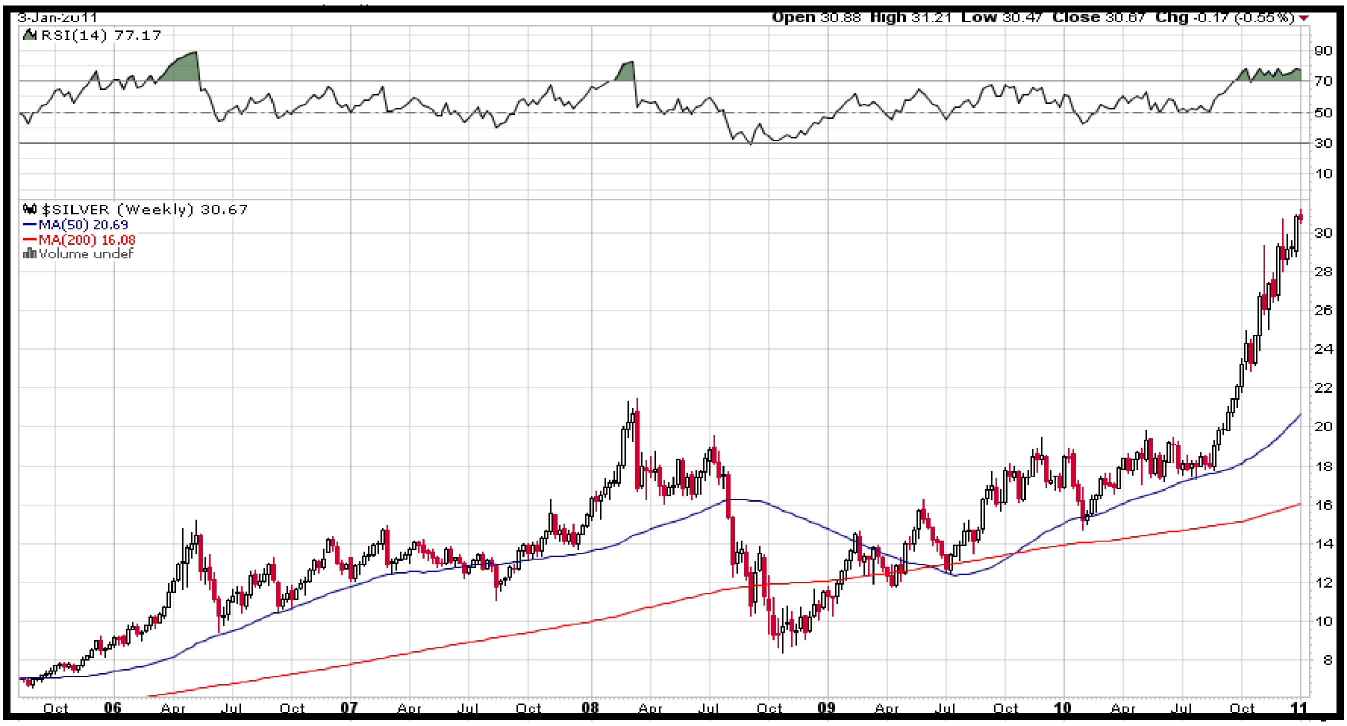
In summary, given the reality of 'Peak Oil' and our bullish bias, we have allocated approximately 30% of our clients' capital to those assets which will benefit from the looming energy crunch. At present, we have exposure to upstream oil companies, integrated energy giants, oil services firms, renewable energy stocks, uranium and electric car/rechargeable battery manufacturers. It is our contention that these businesses will prosper over the following years, thereby rewarding our investors.

PRECIOUS METALS – The ongoing secular bull market is gathering steam and precious metals are benefiting from the anti-currency play.

Over the past month, the prices of most precious metals have firmed, but silver has been the star performer. As you may recall, we were expecting a much deeper pullback in precious metals but as it turns out, the high consolidation resolved in an upward breakout. Fortunately, we stayed faithful to our gold mining stocks, so we have not missed out on the recent action.

Looking at the technical situation, both gold and silver are still overbought and trading above their respective means (as defined by their 200-day moving averages). Clearly, silver is far more overbought than gold, therefore more vulnerable to an abrupt sell off. Figure 5 shows silver's parabolic uptrend and as you will note, its price is currently 52% above its 50-week moving average!

Figure 5: Silver is overbought



Source: www.stockcharts.com

Look. The recent upward breakout in precious metals has certainly taken us by surprise but this does *not* mean that we will rush and chase this momentum. We already have a reasonable exposure to the precious metals mining stocks and are content to simply hold on to our positions.

During a powerful bull market, new buying should be done during periodic pullbacks, so the next meaningful correction will present a good opportunity for those who are looking to add to their holdings. Obviously, we cannot tell when the next correction will unfold but we do know that no market stays overbought forever. At some point, when most buyers have already bought, the pendulum will swing and the prices of precious metals will soften. That will be the ideal time to purchase physical bullion.

Near-term zigzags notwithstanding, as far as the bigger picture is concerned, the macro-economic environment is still favourable for precious metals. Wherever you care to look, central banks are creating new money and real interest rates are negative in most nations. In other words, savers are being penalised and the opportunity cost of owning precious metals is very low. Under these circumstances, it is hardly surprising that investors have been turning to gold and silver.

Although we are optimistic about precious metals, we want to make it absolutely clear that we are *not* gold bugs and do *not* expect a re-instatement of the gold standard. Furthermore, we are certain that precious metals are in an incipient bubble, which will ultimately end in tears. Make no mistake, no secular trend goes on forever and at some point in the future, the precious metals boom will also exhaust itself. In our view, significantly higher interest-rates will end up killing the precious metals bull and hopefully, we will be smart enough to exit before the boom turns into bust.

Turning over to the precious metals mining stocks, we are of the belief that they are grossly undervalued. It is notable that even though the price of gold has appreciated by approximately 35% since March 2008, over the same period, the AMEX Gold Bugs Index has risen by only 10% (Figure 6). Given the fact that the gold and silver miners' profitability is directly tied to increases in the prices of the physical metals, it is absurd that investors have not bid up the mining stocks.

Figure 6: AMEX Gold Bugs Index

Source: www.stockcharts.com

In any event, we believe this is a good buying opportunity and over the following months, the precious metals mining stocks should appreciate, perhaps significantly.

For our part, we are maintaining our exposure to dominant, unhedged producers and particularly like the South African mining companies. For sure, some of the more speculative exploration stocks have the potential to produce much larger returns but this is not an area which lies within our sphere of competence. Thus, we are content with our exposure to world-class mining outfits.

BONDS – Unless the global economy slips into a depression, the secular bull market in government bonds ended in December 2008. It is our contention that after a magnificent 27 year run, government bond prices topped out during the credit squeeze.

It is noteworthy that during December 2008, the yield on the 30-Year US Treasury Bond declined to approximately 2.5%. However, during the European debt crisis last summer, the yield on the long bond bottomed out at approximately 3.5%. In other words, despite all the concerns about European sovereign debt, the price of the long bond stayed below its record high. From a technical perspective, the 30-Year US Treasury Bond made a 'lower high' and this is a bearish development.

As far as the fundamentals are concerned, they are very bearish for US-Treasuries. First and foremost, America's central bank is creating new dollars and buying government debt (which is inflationary). It is interesting to observe that the Federal Reserve has now surpassed China to become the world's largest holder of US Treasuries! Secondly, America's debts and deficits are out of control and over the following years, money creation will only accelerate in the world's largest economy.

The facts that America's own central bank has now become the 'buyer of last resort' of US Treasuries and it is effectively creating new dollar bills to do the same, are telling us that genuine investment demand for US government debt is waning. This is another bearish omen and given the ongoing dollar debasement, it is only logical to conclude that when bondholders awaken from their slumber, they will demand a much higher return on their investment.

If our assessment is correct, government bonds of various nations are now in a secular bear market and over the following years, long term interest rates will rise. However, we are of the opinion that this new bear market will *not* be a one way bet.

For instance, as long as the global economy is in an expansionary mode, bond yields will tend to rise. However, during recessions and business slowdowns, interest rates will probably decline sharply. Therefore, a simple strategy of 'shorting' long term government debt over the entire course of the next decade is not likely to work out and one will need to be nimble at trading.

For our part, we will not engage in betting against US Treasuries due to the negative cost of carry associated with holding exchange traded funds designed to profit from falling bond prices. Moreover, we also suggest that investors refrain from buying leveraged 'double short' exchange traded funds which are meant to profit from a weakness in bond prices.

Those of you who are really itching to bet against US Treasuries should use futures as a way of participating in this secular bear market. Finally, it is worth keeping in mind that the best time to 'short' anything is after a rally, so now may not be the best time to initiate new 'short' positions in US Treasuries.

CURRENCIES – The counter trend rally in the world's reserve currency seems to be running out of steam and the US Dollar Index is struggling to break above an important area of resistance.

If the recent rally in the world's reserve currency is the 'real deal', the US Dollar Index will need to break above the 81.5 level. If it fails to do so, a renewed decline will be underway and our preferred currencies will appreciate even further.

Look. At this stage, we do not have a firm view on the currency markets and will let the market action guide us. As long as the US Dollar Index stays below the 81.5 level, we will continue to favour the Australian, Canadian and Singaporean Dollars.

As far as the currencies of the developing world are concerned, we continue to like the Chinese Yuan and Indian Rupee. It is noteworthy that the Chinese currency has recently climbed to a 17-year high against the US Dollar and we expect further strength over the following months. Fortunately, our large exposure to Chinese stocks is allowing us to benefit from the re-rating of China's currency.

Finally, turning to the European currencies, it looks as though the Euro and British Pound are on the verge of a rally. Fundamentally, we do not like these currencies, therefore we will not try and profit from this oversold condition. However, nimble traders can consider accumulating positions in both the Euro and British Pound.

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