

July 6, 2011

**Buffett, Gross and Siegel - Finding opportunities in today's market**

*"Money will always flow toward opportunity and there is an abundance of that in America .... Human potential is far from exhausted and the American system for unleashing that potential ... remains alive and effective."*

- Warren Buffett, Berkshire Hathaway Letter to Shareholders, February 2011

*"In terms of the stock market, there are amazing opportunities ... (compared to US government bonds) there's a huge gap and a huge differential."*

- Bill Gross, Morningstar Fixed Income Manager of the Decade, CNBC - June 7, 2011

*"We've almost never seen valuations (on the US stock market) this low when interest rates are as low as they are today .... relative to bonds today, I've almost never seen such compelling values."*

- Professor Jeremy Siegel, Wharton School, Author: Stocks for the Long Run, Business News Network - June 28, 2011

Given the recent concerns about European debt and uncertainty about economic growth, I thought it would be worthwhile to share perspectives from three of today's most respected stock market observers: Warren Buffett, Bill Gross (Morningstar Fixed Income Manager of the Decade) and Wharton researcher Jeremy Siegel (considered today's leading stock market historian).

Before getting into their views, here's a quick recap on the first quarter:

**Market performance in the first half**

From a volatility perspective, the first half of 2011 has been a repeat of 2010. Developed markets registered solid gains in the first quarter, despite the setback from March's earthquake and tsunami in Japan. The second quarter was a different story, though. Concerns have arisen from growing inflation threats in emerging markets, sovereign debt worries in Europe and a downgrading of growth forecasts for the global economy.

Below are first half results for key markets - note that these are in local currencies, so that the effect of swings in the dollar are not reflected here.

**% Change (all in local currencies)**

<b>2011</b>	<b>Canada</b>	<b>US</b>	<b>Europe</b>	<b>Emerging Markets</b>	<b>World Markets</b>
First quarter	+ 5.5%	+6.0%	+2.2%	+0.4%	+3.3%
Second quarter	-5.3%	-0.8%	+0.6%	-2.5%	-0.7%
First half	-0.1%	+5.2%	+2.9%	-2.1%	+2.5%

Source: Clientinsights

## **Warren Buffett - "Betting on America"**

In November of 2009, Berkshire Hathaway spent \$26 billion to buy the 77% of rail giant Burlington Northern that it didn't already own. In interviews, Warren Buffett referred to this as "betting on America." Buffett has been consistent in his positive outlook for the U.S. economy, looking past short term events to focus on American ingenuity and resolve, and its ability to attract the best and the brightest from around the world.

Buffett is consistently voted the greatest investor of all time. While Berkshire's investment performance has lagged in individual years, in his last letter to shareholders Buffett pointed out that there has never been a five year period where it has underperformed the S & P.

Here's an excerpt from this year's letter to investors, published in February:

*"Last year - in the face of widespread pessimism about our economy - we demonstrated our enthusiasm for capital investment at Berkshire by spending \$6 billion on property and equipment. Of this amount, \$5.4 billion - or 90% of the total - was spent in the United States. Certainly our businesses will expand abroad in the future, but an overwhelming part of their future investments will be at home. In 2011, we will set a new record for capital spending - \$8 billion - and spend all of the \$2 billion increase in the United States.*

*"Money will always flow toward opportunity and there is an abundance of that in America. Commentators often talk of "great uncertainty. Throughout my lifetime, politicians and pundits have constantly moaned about terrifying problems facing America.*

*"Yet our citizens now live an astonishing six times better than when I was born. The prophets of doom have overlooked the all-important factor that is certain: Human potential is far from exhausted, and the American system for unleashing that potential - a system that has worked wonders for over two centuries despite frequent interruptions for recessions and even a Civil War - remains alive and effective."*

Here's a link to Warren Buffett's February letter to shareholders:

<http://www.berkshirehathaway.com/letters/2010ltr.pdf>

## **Bill Gross - the case for owning great companies**

My second expert is someone who's not nearly as well known to the investing public - but is a household name among professional investors. Interview Bond Managers, and you will quickly find a "Chicken Little" theme. Bond Managers tend to see the problems ahead, rather than the opportunities.

As manager of PIMCO Total Return Fund, the world's largest bond fund, Bill Gross turned in a track record matched by few others and was named Morningstar Fixed Income Manager of the Decade. In part, this stems from his willingness to take contrarian views; in 2010, he went on record talking about the "new normal" of lower growth, higher inflation and increased risk in holding debt of governments around the world.

He has recently turned negative on US government bonds, recommending high quality corporate bonds and Canadian and Australian government bonds instead of US treasuries. In a June 7 interview on CNBC, he also discussed the appeal of brand name value oriented stocks:

*"In terms of the stock market, there are amazing opportunities in real interest space. I mean, a Procter, a Johnson & Johnson, a utility company, Southern, Duke, as a whole they yield 3 1/2 to 4 percent in terms of their dividend yield compared to a negative .5 percent in treasury space on that five-year. And so there's a huge gap and a huge differential if an investor is willing to take a minor downgrade in terms of credit.*

*"Corporations are in the catbird seat. They've got cheap financing, cheap leverage. They've got cheap labour and the ability to move from one country to another at their will. And so corporations basically have done very well, will probably continue to do very well."*

Gross did add a note of caution:

*"But to expect their margins to expand at the expense of labour here in the United States, at the expense of laying off additional workers, relative to their wages, real wages and their total nominal wage growth, I think is an unrealistic expectation. I think corporations basically are at the top in terms of profit margins. Doesn't mean that stocks are going to go down. It simply means that the catbird seat basically has been taken advantage of and that the heyday is probably in the past as opposed to the future."*

You'll find a transcript of his recent interview here:

[http://www.cnbc.com/id/43339656/CNBC\\_TRANSCRIPT\\_CNBC\\_S\\_LARRY\\_KUDLOW\\_SPEAKS\\_WITH\\_BILL](http://www.cnbc.com/id/43339656/CNBC_TRANSCRIPT_CNBC_S_LARRY_KUDLOW_SPEAKS_WITH_BILL)

And here's a link to the interview in June of 2010 on the new normal of slower growth globally:  
<http://video.cnbc.com/gallery/?video=1523466641>

### **Jeremy Siegel - why valuations are attractive**

My third expert is Wharton's Jeremy Siegel, considered today's leading stock market historian. His book "Stocks for the Long Run" examined 200 years of financial market performance and has been ranked as one of the most influential investment texts of all time. Among Siegel's claims to fame is an article in the Wall Street Journal in March of 2000, at the peak of the Internet bubble, warning about the excesses in tech stock valuations.

In a June 28 interview on Business News Network, he explained why he's bullish on US stocks:

*"We've almost never seen valuations (on the US stock market) this low when interest rates are as low as they are today .... relative to bonds today, I've almost never seen such compelling values."*

And here's why he, like Bill Gross, likes the idea of owning great companies:

*"History shows that dividend paying stocks beat inflation and are good investments for income, especially in the early stages of a financial recovery such as we see today ... The top one hundred dividend yielding stocks of the S & P 500 over the last half century beat the index by two and a half percent and did so with lower risk."*

Here's a link to the full interview: <http://watch.bnn.ca/business-day/june-2011/business-day-june-28-2011/ShowAllClips/#clip492118>

### **What this means to investors**

In today's low interest rate environment, it's hard to make a compelling case for cash except as needed for short term liquidity. As for bonds, Bill Gross represents the growing sentiment that generally the risk in bonds is greater than the reward, as economies recover and interest rates start to rise.

While not a reason to eschew bonds completely, especially for someone drawing down on their funds in the short term, this is reason to consider underweighting bonds while overweighting equities. Whether you adopt Bill Gross' "least of evils" view of stocks compared to bonds or join Warren Buffett and Jeremy Siegel in embracing stocks more enthusiastically, there are clear deals available in high quality value style stocks. Today, you can find quality companies with strong cash flows that provide a comfortable backing for their dividends and also have the potential for dividend growth in the period ahead.

For the past few years, the equity component of client portfolios that I've recommended have been tilted toward the larger value style companies. These "higher quality" companies haven't always outperformed firms with weaker balance sheets and low or no dividends. In 2008, all stocks dropped dramatically, regardless of quality. As for the past couple of years, since the spring of 2009 we've seen a "junk rally" in stocks in which low interest rates favoured more levered firms.

I don't believe that's likely to continue, as over time quality stocks will outperform. Meanwhile, dividends provide a floor for stock prices should we see continued volatile markets; like Bill Gross and Jeremy Siegel, I believe there are exceptional opportunities in the stocks of high quality, large, value oriented companies in Canada, the US and overseas.

As always, thank you for the opportunity to work together.

Best regards,

Arnold Machel