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Investment Strategy
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Investment Strategy

Be Conservative, Not Conventional

> "Here's the paradox: the odds are overwhelming I will end up richer by aiming for a good return rather than a brilliant return – and sleep better en route. Folks who seek a killing usually get killed. Gunslingers get shot, and often in the foot, with their own guns. While there is always some guy around on a red-hot streak, his main function is to tempt the rest of us into becoming fools and paupers. A return of 15% to 20% annually is a lot more than most folks realize, or need. If a 30-year old with $10,000 in an IRA gets 15% annually, he'll be a millionaire before normal retirement. That's the power of compound interest. If that same 30-year old were to sock away another $2,000 per year at 15%, he would end up as a 65-year old $3 million fat cat. At 20%, it's an incredible $13 million. That's a lot, but it's not too much to ask. The two most definitive studies ever on long-term returns, the Ibbotson/Sinquefield and Fisher/Lorie studies, both point to average annual returns for stocks of 9% plus per year going back to the mid-1920s. So 15% to 20% per year is really 66% to 100% better than the market as a whole. That's tough but doable. Consistency is the key. It is close to impossible to get a good, long-term, rate of return if you suffer serious negative numbers en route. It's the math. A single year that is down 30% means you have to get 30% per year positive returns for the next four years to get back on track for a 15% annual average. Or, if you score 20% annually for four years, and then suffer a 30% decline, your five-year average return is only 7%."
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> . . . Ken Fisher, *Forbes,* 1989

I have often republished Ken Fisher's sage quote ever since first reading it in 1989 because it speaks to the centerpiece of my investment philosophy. To wit, "Here's the paradox: the odds are overwhelming I will end up richer by aiming for a good return rather than a brilliant return – and sleep better en route." Or as Benjamin Graham wrote, "The essence of investment management is the management of RISKS, not the management of RETURNS. Well-managed portfolios start with this precept." Indeed, if you manage the downside the upside will take care of itself. Avoiding the big loss is the key to investment success. And, that's why when I think the odds are not decidedly tipped in my favor I tend to be more cautious in my investment approach.

The most recent example of this style was coming into 2011 when I became more cautious. That was a pretty good "call" on developing markets (emerging and frontier), but was not such a good "call" on developed markets; that is until February 18 when the S&P 500 (SPX/1313.80) peaked at 1344. From there the SPX slid into its March 16 intra-day low (1249), a 7% pullback. For the last few months I have commented that any decline would likely be contained in the 7% - 10% range. Quite frankly, however, I really didn't think the low recorded on March 16 was THE low, yet it increasingly looks like it was. Nevertheless, we did recommend buying select stocks the week of March 13 because a number of them had declined to levels where the risk/reward ratio was tipped in our favor.

Case in point, for months one of our favorite ideas has been Williams Company (WMB/$31.13/Outperform) based on the belief the new CEO (Alan Armstrong) would split the company into two parts. In mid-February he announced just that. Obviously Wall Street liked the idea given that day's leap in WMB's share price from $27.76 to $30.95. Subsequently, on March 16 WMB's share price had pulled back to $28.70 despite the fact the fundamentals had gotten better. Accordingly, we thought much of the price risk had been removed from the shares, and with the pending split acting as the carrot in front of the proverbial horse, we reiterated WMB as one of our favorite ideas.

Another one of our favorite ideas, following the management team's excellent presentation at Raymond James' 32nd Annual Institutional Conference (March 7), is 6.7%-yielding LINN Energy (LINE/$39.26/Strong Buy). As stated, LINN Energy is an independent oil and gas producer with outstanding prospects. It has a 20-year resource reserve, a 100% return on investment on its drilling program, should grow organically by 30% per year (plus acquisitions), is 95% hedged on its production, and has a cost of capital of ~7%. Similarly, we find EV Energy Partners (EVEP/$51.09/Outperform) attractive. Hereto, 5.9%-yielding EVEP is a master limited partnership focused on acquiring, developing, and producing oil and gas. What is intriguing about EVEP is its 280,000 acres in the Utica Shale reservoir, which is not being given much value. The reason is that there is little data on how prolific Utica will be. Recently, however, as our fundamental analyst Darren Horowitz writes:

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> "While the Barnett Shale is currently the company's growth engine, the Utica Shale has the potential to play a huge role in the company's future. EV Energy Partners is sitting on 150,000 net acres and an overriding royalty interest in an additional 80,000 net acres in this emerging shale play. No doubt it is very early in the play with very few public drilling results; however, the Point Pleasant portion of the Utica Shale, found primarily in Ohio, is attracting a lot of attention. As a reminder, the Utica Shale, perhaps the geographically largest shale formations in the U.S., sits below the Marcellus formation in the Appalachia. The Point Pleasant formation is the organically rich lower member of the Utica Shale, which is thought to have decent liquids content. Assuming EV Energy Partners' Utica acreage, from which the company currently has zero production, could achieve a market valuation of $2,000 per acre, in-line valuation with other undeveloped shale play acreage, then the company likely has roughly $460 million in value that is largely not reflected in its stock price."

From our perspective what EVEP represents is an attractive situation without the Utica Shale resource. Yet, if Utica turns out to be anything like the Barnett Shale, it would be a huge "win" for the company.

Turning to another name where we think much of the price risk has been removed, one of our fundamental bank analysts (Anthony Polini) had this to say last Friday:

> "We reiterate our Strong Buy rating on 4.9%-yielding Peoples United Financial (PBCT/$12.64). This out-of-favor stock could benefit from several factors over the next few months, including: an inexpensive valuation, a better-than-average net interest margin outlook, significant organic commercial loan growth opportunities, the closing of the Danvers acquisition in 2Q11, more aggressive share buybacks, and the market factoring in an eventual Fed tightening policy. The shares are inexpensive, having closed just above their 52-week low of $12.17 and are down 13% YTD compared to a 2% decline for the KBW Bank Index (BKX/51.82). The shares now trade at 16.9x 2012E EPS, 82% of book, and 131% of tangible book. (Moreover), People's is one of the best positioned banks for rising interest rates. A 100 bp increase in rates would increase PBCT's net interest income 6% compared to the peer median of 2%. A 200 bp increase in rates would increase PBCT's net interest income over 13% compared to 4% for peers. In other words, every 100 bp increase in rates adds $0.08 to EPS. Our $20.00 target price assumes PBCT shares trade at about 137% of 4Q11E book value ($14.65E), a discount to the 15-year industry average of 150%."

The call for this week: I am in Texas all week speaking at seminars/conferences and seeing institutional accounts, so these will be the only strategy comments for the week. That said, as stated last week, whether the March 16 "low" gets retested is now doubtful in my opinion. Still, a partial pullback to 1275 – 1300 on the S&P 500 cannot be ruled out because the recent rally has occurred due to more of a decline in Selling Pressure rather than enthusiastic buying. Indeed, the decline from February 18 into the March 16 "low" was accompanied by two 90% Downside Days, where 90% of the points and volume traded came on the downside. As well, there were two additional nearly 90% Downside Days (~89.5%) during the decline. Typically it takes at least one 90% Upside Day to conclude that a correction is over and so far we have not seen that. Still, I think a lot of the price risk has been removed from select stocks and therefore I am not afraid to gradually accumulate favored names.

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