CAPCO
ASSET MANAGEMENT

April 11, 2013

Dear Partners, Clients & Friends,

A common question we hear lately goes something like this: With the stock market up so dramatically, to levels that preceded crashes in 2000 and 2008, are we in a bubble? We tackle this question in three parts: the strength of the market's rebound; the potential for the Federal Reserve's monetary policy to cause excesses; and more specifically, the valuations and profit margins of our own companies. And we discuss recent activity in the "client only" section.

Is The Strength of the Market's Rebound a Concern?

Since its 2009 low, the market (by which we mean the S&P 500 index) has rebounded over 130%. And the index has reached the 1500 level for the third time. The first two times it reached 1500 preceded crashes (2000 and 2007), and the strong rebound in a weak economy has many people wondering if that means the market is in another bubble.

By themselves, neither the strong rebound nor the absolute price level are cause for alarm. Let's start with the rebound. In our 2008 fourth quarter letter, in the midst of the stunning 57% decline in the S&P 500, we argued that it was an excellent time to invest (and noted that Capco was, for the first time ever, fully invested). In support of that argument, we presented a table summarizing past crashes.

At the time, the outcome for the 2007-2009 crash was unknowable. We can now update the table to include it, and see that this strong rebound is historically unremarkable, even typical:

	Real GDP	Inflation (Deflation)	Nominal GDP	Peak Un-employment	Market Peak to Trough	Stock Market Performance, at Peak Unemp.	4-6 year Market Recovery
1930-1933	(29%)	(23%)	(45%)	25%	-86%	+54%	+200%
1973-1975	4%	31%	35%	9%	-48%	+37%	+164%
1980-1982	(1%)	27%	26%	11%	-27%	+21%	+148%
1990-1991	(0%)	9%	9%	7%	-20%	+31%	+115%
2000-2002	6%	8%	15%	6%	-49%	+29%	+83%
2007-2009	(2%)	7%	5%	10%	-57%	+27%	+133%*

*Through March 31, 2013

Nominal GDP was fairly flat during the recession, a result of slightly lower figures for both inflation and real GDP growth, and the subsequent recovery in GDP (not shown) has also been a little weaker than is typical. The stock market crash was the most severe since the 1930's, but began recovering strongly in 2009 as unemployment peaked (counter-intuitive, but typical). With the addition of the strong first quarter 2013 performance, the S&P 500 has risen 133% since its lows about four years ago, rivaling other market recoveries. In all, the results look remarkably similar to other recessions and crashes in recent decades and not remotely like the Great Depression with its contractionary central banking policies (a key distinction, as we also argued in that letter).

Note that this does not tell us whether stocks are overvalued or not. This simply says that a dramatic rebound after a crash is not, by itself, cause for alarm. This brings us to the second point: as the index reaches 1500 yet again, does it again presage a crash? We discussed this in our first quarter letter in 2012, but re-visit it here.

There is nothing about the absolute level of the stock market that tells one whether it is a bubble or not. The index price is just that, a price. Price is what you pay, but value is what you get. To evaluate a price, we have to look at what one gets for that price. When the index peaked in 2000, an investor was buying a huge weighting of very overvalued companies. The valuations were so extreme and widespread that unsatisfactory long term results were a near certainty (as Buffett argued in his famous 1999 Fortune article).

When the index reached 1500 for the second time, in 2007, an investor buying the index was then buying a huge weighting of financial companies. Their valuations were not obviously extreme, many even looked cheap, but the underlying profitability of many of those businesses was tied to a bubble in housing and finance. Such an investor may not have deliberately decided to make a bet on housing, but that is in effect what he or she did.

Ridiculous valuations in the 2000 technology bubble were easily observable and the subsequent poor market results understandable. The bubble in housing and its effect on financial institution profitability (in the years before 2007) was less directly observable, but long time readers know we wrote about this for years, were extremely cautious and were actually short some of the areas that ultimately imploded in the crash.

As the "price" of the index reaches 1500 again, what is the value (and risk) a buyer "gets." In our view, the market is not as cheap as it was a few years ago, but it is a much more reasonable combination of valuation and quality than it offered in either 2000 or 2007. Many weak businesses have been weeded out, and many of the survivors are stronger, better financed, better run and more profitable than they were.

As in 2000 and 2007, there are numerous "big picture" risks of course. Instead of technology valuations and real estate bubbles, today's problems are excessive government spending and debt, unfunded retirement and social promises, too big to fail banks, and the severe manipulation of interest rates (more below). For these risks (see numerous previous letters), we believe inflation is one of the most likely outcomes, and that ownership of good businesses is the most promising defense. Europe's troubles and the risk of renewed recession in the US present a risk to stock prices, but not a grave or long term one. This time, the big picture risks actually favor stocks.

<u>But Has The Federal Reserve Caused Speculative Excesses in Stocks?</u>

This recent quote from Federal Reserve Chairman Bernanke (February, 2013) caught our attention as we thought about this question:

"Although a long period of low rates <u>could</u> encourage excessive risk-taking, and continued close attention to such developments is certainly warranted, to this point we do not see the potential costs of the increased risk-taking in some financial markets as outweighing the benefits of promoting a stronger economic recovery and more-rapid job creation."

From our vantage point, the idea that the Fed's interest rates manipulations "*could*" cause speculation in "*some*" financial markets requires a certain amount of willful blindness, bordering on the Emperor's New Clothes. We won't debate whether it is sound economic policy. It is simply a fact that one of the costs has been to drive savers to pay speculative prices and to buy speculative, often unsound, yield investments. As we said in our last letter, "the excesses in bond overvaluation today are as obvious as the stock over-valuations were in the technology bubble more than a decade ago." We fully expect the bond story, when written in a decade or so, will be as disappointing for investors as the technology and real estate stories were earlier in the decade.

So in our opinion, the Federal Reserve has caused speculative excesses. But has it caused speculative excesses *in stocks*? That is a different question. As noted above, we do not believe the broad market is overvalued (individual stocks may be, but that is always the case). Another good litmus test is where investors are putting their money. By and large, big institutional investors have moved away from US stocks, and show few signs of coming back. And the money flows to mutual funds, reflecting the activity of individual investors and their advisers, has been consistently negative for US stocks. In the last few weeks, a trickle of money has started to flow back, and perhaps sentiment is turning. But it would be very hard to argue that the trillions of dollars the Fed has spent have found their way into the stock market, given the lack of institutional interest and outflows from US stock mutual funds in the hundreds of billions of dollars. This money could flow to stocks in the future, but that is hardly a reason to avoid stocks today.

<u>What About Our Portfolio Companies?</u>

If you are reading this letter, you probably find an overview of the market somewhat interesting, but what you really want to know about are the individual companies that we (and you) actually own. We believe our companies' prices reflect their greater value, not over-valuation.

The following table is for our 10 largest investments today, which currently make up 80% of our portfolio (a very high level of concentration that we are thrilled to have achieved). This table sets forth the changes in some of their key financial variables between 2007 and 2012 (with slight variations due to differences in fiscal years).

Company	Sales	Op Profit	Earnings	EPS	FCF
1	+53%	+54%	+58%	+64%	+128%
2	12%	11%	18%	39%	(12%)
3	44%	51%	21%	41%	89%
4	33%	12%	4%	19%	400%
5	38%	14%	12%	5%	56%
6	74%	89%	89%	88%	128%
7	39%	10%	5%	2%	N/M
8	66%	80%	89%	74%	99%
9	16%	(20%)	(24%)	(10%)	(5%)
10	37%	111%	108%	95%	N/M

In most cases, our company's sales, profits and cash flows are *dramatically higher* than they were at the 2007 peak before the financial crisis - often 30%, 40%, 50% or more. So a key underpinning to today's higher prices is that our companies are *significantly* larger and more profitable than they were five years ago, despite a massive recession and sluggish recovery. Their stock prices *should* be up.

This growth is what we've been observing month after month, quarter after quarter, for over four years now, as the headlines rolled by for one crisis after another. Strong companies in general, and ours in particular, didn't sit around and simply watch a recession happen to them. They invested in new products, people, and profit enhancing activities. They cut costs and improved processes. They acquired companies, bought back stock, paid down debt (or borrowed cheaply), rolled out new locations, and on and on. The fundamental work that has been done in our companies throughout this downturn is extremely impressive. For most of our companies, we believe the prospects looking forward are even better than the historical results cited above.

Naturally, most of their stock prices are up. But for 8 of the 10 companies, the ratio of the price to recent earnings has actually shrunk, even though the outlook is probably better today: by this measure, they are actually cheaper than they were then. We are very comfortable that the prices of our companies are not the product of frothy, speculative valuations; rather they are the result of greater profitability and excellent prospects.

There is another question about this progress we should address. A few investors we respect have argued that US corporate profits are up on unsustainably high profit margins (just as the high margins of financial institutions in 2007 proved unsustainable), and that they are due to revert (downwards) to the mean. This is exactly the kind of question that should be asked when things are going well, and we spent a fair amount of time on it last year.

In the case of our companies, the growth in profitability is not primarily a function of margin expansion. Five of our top ten companies actually have *lower* margins than they had five years ago. Four have modestly higher margins, but in each case these reflect real, fundamental improvements at the companies, and we believe they are sustainable. The remaining company does have a component of margins that we view as unsustainable, as it benefits from wide credit spreads (think "low interest rates"), but we factor this expectation into our thinking. Other than that one example, few of our companies employ significant leverage, so our companies' profits are not being propped up by today's low interest rates.

Ultimately, the question of profit margins is a question best answered by individual company analysis. One of the advantages of owning few companies and knowing them well is that we think deeply about what the economics of a business are, what they should be, and what could change. Durable profitability ultimately has to be justified by the value being added and the competitive position, and this is how we have always thought about it. The actual analysis can be complex, as margins can change for all kinds of reasons (product mix, geography, accounting, capital utilized, input costs, prices and so on), and higher margins are not inherently good or bad. We think about the profit margins of our companies A LOT, and we are not lying awake at night worrying about whether our company's margins are too high right now.

Conclusion

The market is up a lot, and it is natural for a value investor to think about taking something off the table. Clearly, where personal circumstances warrant (for instance, anticipated expenditures), one should do so. While we would never opine a specific forecast of the market or guess whether a crash is just around the corner, we do position ourselves by thinking about quality and valuation relative to an unknown future. In our opinion, valuation is not a reason to sell stocks. Our opinion here is heightened by the lack of alternatives: if one sells stocks, one must buy something, even if it is only cash. Our opinion of the alternatives that we have seen is that the risks and returns they offer are dismal – it's not even a close call.

We look forward to writing you next quarter.

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