CAPCO
ASSET MANAGEMENT

The following is an excerpt from our letter for the Third Quarter of 2010:

Investor Fatigue

A common refrain we hear these days is that investors are simply exhausted by the stock market: exhausted thinking about it, exhausted working with it, exhausted by its non-performance. Many diligent savers and investors have made literally no headway over a period of ten or twelve years or more. A deep fatigue has set in, and in the world outside Capco's walls, investors continue to pull hundreds of billions of dollars out of the stock market.

Misled into believing that stocks were always an inherently attractive investment if held long enough, many have now reached the opposite conclusions: the stock market "doesn't work," bonds are an inherently better investment, and stocks are too risky in light of our massive economic problems.

Investments succeed or fail because of valuation. Investors who focus on buying assets that are cheap tend to do well, those who overpay or who hold overvalued assets, do not. Superficially, price and value might seem to refer to the same thing, but they do not: price is what you pay, value is what you get.

At the simplest level, the value of anything is the present value of the cash it will produce to its owner in the future. With cash in a bank account, or a treasury bill, this is simply the interest rate on your principal; today, you might receive 0% to perhaps 2%, risking only the possibility of inflation. Valuing a stock can be thought of similarly. If you own shares in a company at $10 per share, and that company earns $1 per share, you have an "earnings yield" of 10%. Whether this is paid out as a dividend is immaterial: if it is, you receive an explicit 10% return; if not, your interest is worth $1 more, the amount retained on your behalf. There are obviously other factors that make valuation analysis more complicated than that, but this is the basic concept. And it's true whether you own one share or the whole company.

Now let's look at a specific company, and see how valuation explains both the poor returns of the past decade <u>and</u> the opportunity today.

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Earnings Yield Progression

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011E
Price	$27	$45	$40	$37	$27	$26	$29	$25	$23	$30	$28	$23	$25	$25
Earnings per share	$.42	$.71	$..85	$.69	$.70	$.92	$.75	$1.12	$1.20	$1.42	$1.87	$1.62	$2.10	$2.35
P/E Multiple	64x	64x	47x	53x	39x	28x	38x	22x	19x	21x	15x	14x	12x	11x
Earnings Yield	**2%**	**2%**	**2%**	**2%**	**3%**	**4%**	**3%**	**5%**	**5%**	**5%**	**7%**	**7%**	**8%**	**9%**

The table above highlights the "earnings yield" that was being earned by investors in this company each year. This is a real company, well known and widely owned; if you've owned mutual funds, you've almost certainly owned it indirectly. Its stock price is about the same today as it was 12 years ago. *Twelve years!* In those 12 years, earnings per share have climbed from $0.42 to $2.10, up 400%, and they are still growing. But the stock has fallen from $27 to $25 (ignoring modest dividends). This seems like an impossible result . . . until you look at the earnings yield. The problem was that the valuation in 1998, offering less than a 2% earnings yield, was so high that it should have raised serious questions about whether this could keep up with cash as an investment.

This story has been repeated in many companies. We could go through example after example from this period, including the S&P 500 stock market index as a whole. Ten years ago valuations were astronomically high. Prices fell, but not nearly enough. With each passing year, investors got more and more earnings. Earnings slowly "caught up". By the end of the decade, while the historical price trend looks terrible, the valuation is quite attractive (in fact, after some analytical adjustments, it's even better than it looks here). The length of time it took to "burn off" this overvaluation is staggering, but it has occurred.

The 2000's were not a "lost decade" for all stocks, only for <u>overvalued</u> stocks (and for the mutual funds that owned them). We each compounded our own capital at 14.3% (1998-2002) and 12.2% (1997-2003), respectively, in the years leading up to the formation of Capco. Since its formation in 2003, Capco Partners has compounded at 8.6% before fees. Cumulatively, that equates to returns of approximately 9%-11%, vs. the S&P 500 over comparable periods of 3%-5%. Even assuming annual fees of 1.5% in the years before and including Capco, these are very solid returns for a "lost decade." Each client's experience is different of course, depending on when they made their investment(s). But even clients who came in during 2007-2008 before the crash have outperformed, and are modestly positive after fees. Certainly, market indices and the average fund are not.

Conventional wisdom (and many a Nobel Prize winner) holds that the market is efficient, and that investors can't "beat the market." We believe that the market is frequently inefficient, can remain so for years on end, that a valuation discipline is critical to protect and grow capital. We also believe the market can be beaten, in part because we have, but also because this approach has demonstrably worked for decades for the few who embrace it.

The good news is that the "lost decade" has resulted in many very cheap, high quality companies, so it is easier for us to put money to work than it ever has been.

No Investors Fatigue in Bonds

What have investors collectively learned from the exhausting investment experience of the last decade? Not much, to judge by mutual fund flows. As money has fled equity funds over the last 18 months, more than half a trillion dollars has poured into bond funds. This has pushed up bond prices, depressing yields and future returns. If interest rates rise (if, for instance, bond investors begin to anticipate the possibility of inflation), the impact on the market value of a long-term bond is dramatic; probably more dramatic than many investors think is possible in something as "safe" as a bond. In our opinion, investors are collectively making exactly the wrong choice again for the coming decade.

Is it possible that bonds offer good value? We think not. The company we described above, as it happens, has recently issued some bonds. The 10 year bonds yield about 3%, 30 years yield about 4.5%. The equity, as noted, has a 9% and rising earnings yield (and we estimate a 12% free cash flow yield).

Consider some other examples (none of which we own). Johnson & Johnson similarly just issued 10 year debt at 3% and 30 year debt at 4.5%, barely above "risk free" treasury rates. Its stock (which Buffett considers safe enough to own) has an 8% earnings yield. Norfolk Southern just issued 100 year debt at 6%. The buyers of these bonds apparently believe there will be no significant inflation *for the next one hundred years*.

It is not particularly difficult to spot widespread episodes of significant over- and under-valuation (though it is impossible to say when they will end). So why don't the many investment management professionals do a better job of avoiding the problem? If there aren't opportunities, there aren't opportunities; why don't they just hold cash?

The answer lies in the very structure of the investment management industry. Almost all professionals operate under two mandates: to invest money only in a specific niche asset class (think "style boxes"), and to be fully invested at all times. This is a toxic combination: even if a manager is smart enough to know that his asset class is overvalued, he has no choice. As investors buy bond funds, their managers must buy bonds, regardless of price. This is not idle thinking. There are very powerful forces at work producing valuations that make no sense. They were at work in technology and index stocks in the late 1990s, and in real estate in the 2000s, and they are at work in bonds now.

We have written cautiously on bond overvaluations for several years now, just as we wrote cautiously about real estate years before the crash. We were particularly adamant about avoiding treasury bonds (and buying stocks) during the crash in the fourth quarter of 2008. Almost two years later, the 30 year treasury bond price has fallen -16%. The S&P 500 stock index, on the other hand, has jumped +31%.

So why are we still writing this? Because bonds are still overvalued, whereas many stocks are cheap. The only outcome that may justify these prices is deflation, in which event bondholders will earn their slender yields plus, in real terms, the rate of deflation. That is a possible outcome; if it is right, bondholders will make a little; if it is wrong, they may lose a lot.

Long time readers know that we believe inflation is much more likely than deflation. If the economy were left to itself, deflation would be likely. But Bernanke has bet his career on preventing deflation, he has the tools to do so, he has repeatedly said he will use them, he has already used them, he is using them right now and inflationary policies are far more popular than restraint. We believe deflation requires a major and unlikely reversal of policy.