KAVAR Canvas

The science of investing. The art of integration.

August 2014

Issue XVIII

Mulling it over the Midpoint

Written By: Douglas Ciocca

"Those that have knowledge, don't predict. Those who predict, don't have knowledge." –Lao Tzu

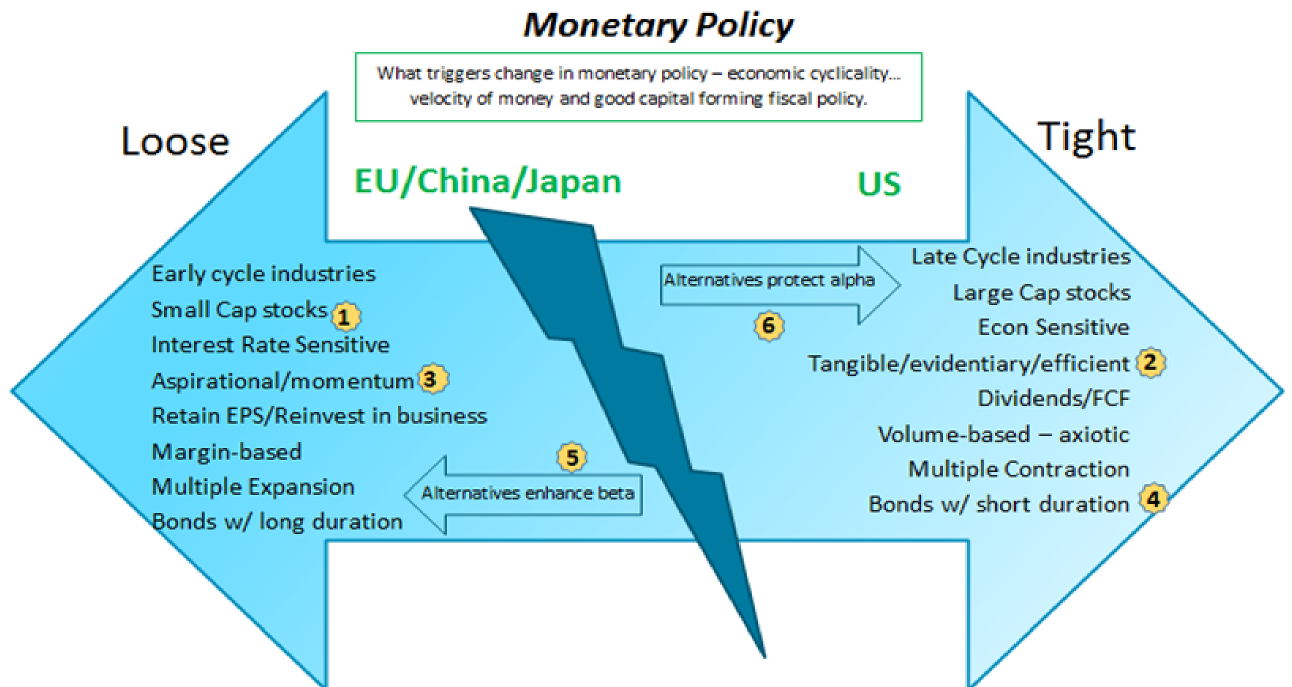
And so it is with this ominous warning, that our team at Kavar Capital presents its investment outlook for the balance of 2014. Less predictive than prescriptive, our advice is heavy on caveats and corollaries – a nod of respect to the intensity of the interwoven intricacies that make up our modern markets.

To date, 2014 has been a year defined by disquietude. Disquietude in geopolitics; in Federal Reserve Bank policy progression; and in economic data drivers. The Dow Jones Industrial Average is a reasonable proxy for the broader price action we've witnessed globally thus far: After falling 7.26% in the first 5 weeks of the year[1], the index more than fully recovered to elevate in excess of the much heralded 17,000 level in July. It has subsequently dropped nearly 3%, to a half percentage point below where it started in January[2].

Attributions of the Dow's erratic behavior involve the aforementioned drivers of disquietude and may prove prognosticative for how we envision the back half of the year unfolding.

While no single part of the financial markets exists in isolation, we do break down our outlook by asset class, but ultimately engage in overlap throughout the analysis.

The diagram below may assist in navigating the cross-currents that prevail at points of both market stasis and transition, and we have labeled certain areas on the continuum consistent with their references throughout. We consider this illustration to be indicative of, as my Italian ancestors were fond of saying, "how the sausage is made." Of course, they were referring to how they actually made sausage.



KAVAR Canvas

Mulling it over the Midpoint

Stocks.

US Equities. We favor US stocks with the following qualities: large in size and high in free cash flow distribution - particularly those with geographically diversified business models that can be scaled inexpensively.

We believe that much of the fuel for igniting global stock markets after 2008's Great Recession was supplied by the Federal Reserve Bank (a.k.a. the Fed). While all stock ships rose, its extraordinary monetary policy efforts disproportionally benefitted smaller companies – cheapening the cost of money enhanced their operating leverage and profit prospects. The Russell 2000, (an index of some of the smallest listed public companies), has actually outperformed the Dow Jones Industrial Average, (an index of 30 of the largest listed public companies), by nearly 1.5x since the market bottomed on March 9, 2009[3].

However, the Fed's policy was modified in January as it began down a path of liquidity extraction[4] – with steps befitting those of a baby as opposed to a bungee. Mixed metaphors notwithstanding, the Fed intends to tighten the flow of capital into the economy. And such tightening could trigger a reaction in small cap stocks opposite that of its opposite embarkation.

We think that larger US companies that have taken the opportunities to streamline their operations and their income statements are well positioned to attract investor interest. We believe that the best performing larger US companies will be evidentiary, not aspirational, in their business models and their profit generation will be uber-efficient – comprised of high and sustainable profit margins and healthy returns on invested capital.

These latter two properties form the foundation of strong free cash flow generation, which enables such entities to preserve or enhance their dividends, buy-back shares of their own stock or look for acquisition opportunities. Often characterized as "financial engineers," or "alchemists", we prefer to think of these companies as financial innovators that maintain attractive valuations in the absence of multiple expansion.

Multiples (a ratio of a stock's price to its earnings) tend to expand consistent with the expansion of monetary policy. Contraction would follow conversely. So, as the tide of easy money rolls out, it is always helpful to align with companies that are fully clothed. Therefore, internally funded, volume-based businesses in economically sensitive sectors provide us comfort in allocating domestic portfolio dollars. It is quite a different story internationally.

Foreign Equities. Almost in unison, European Central Bank President, Mario Draghi, Japanese Prime Minister, Shinzo Abe, and to a lesser degree, the People's Bank of China, have in recent months, elevated the intensity of their accommodative monetary policies. Yes, in direct contrast to the direction/intent of the US Fed, these foreign central banks are attempting to simulate their economies in an effort to break an emerging cycle of deflation.

While deflation may sound good to us – you mean things cost less?! I'm in! – it is anathema to a vibrant and well-functioning economy. Think of how it felt a few years back when your county of residence reassessed the price of your home lower than the prior year.

Early in an accommodative or, easing, cycle, a country's central bank will infuse units of currency in an economy - devaluing/ cheapening those units in the process. They accomplish this goal by encouraging banking institutions to lend money at small spreads over their cost of borrowing from the central bank. Known as transmission mechanisms, these banks can readily assess when loan demand begins to equivocate or surpass deposit supply, signaling a need for policy alteration in an effort to perpetually stabilize prices.

As you would imagine, certain industry sectors do well when monetary policy is easing and others when monetary policy is tightening.

And given the policy polarity that exists between the US and many other parts of the world, our outlook for our international portfolios favor: interest rate sensitive sectors like financials, industrials and materials companies. We are considering those that are not

KAVAR Canvas

Mulling it over the Midpoint

exclusively large companies, and those that possess viable export economies which positions them to take advantage of the higher cash flows that result form repatriating foreign sales into cheaper home currencies.

In addition, there are opportunities for multiples to expand overseas, meaning that the (3) "growth" orientation of some traditionally higher risk industry groups deserves careful consideration given the lower rates at which their risk is being underwritten.

Lastly, regarding international equities: we highly favor developed countries over developing countries for the rest of the year. The recent Argentinian debt default[5] and the near collapse of one of Portugal's largest financial institutions[6] are stark reminders of the systemic risk of certain areas of the world. Additionally, the competitive advantages that they once exclusively held– low labor costs and plentiful natural resources – have diminished as well.

An important point about the transitory nature of monetary policy and the timing of its impact: the transition can last beyond what would seem to be a sensible period of time, predicated on the following factors:

1. The resolve of the central bank to actually transition (talk is even cheaper than devalued currency);
2. The efficacy of the dose of the policy medicine applied before the transition;
3. Effective corroboration with the country's fiscal policy (wow, that could be its own entire newsletter!)

Bonds.

Much has been made of strength of the bond market thus far in 2014. It was close to a consensus call, among the talking heads of high finance, that interest rates would rise sharply throughout the first half of the year[7]……yet just the opposite took place. As of this writing, the yield on the 10-year bond stands at 2.47%[8]. It began the year at 3.02%[8].

We think that the strength in bonds can be accounted for by the following 5 prevailing conditions:

1. Strength in the dollar as foreign trade partners engage in monetary policy counter to our own;
2. Lack of substantive inflationary pressures;
3. Smaller (this is not a joke) deficits requiring less supply to come to market;
4. Competing investment alternatives that are not glaringly superior;
5. Geopolitical events (conflicts in Israel, Iraq & Ukraine to name a few) prompting fearful investors to seek safety.

And none of these items seems super-apt to unwind super-soon. So, we must balance the impact of the Fed's progression, (many types of bonds actually price off of the comparable maturity equivalent Treasury bond and the Treasury bonds are what the Fed impacts directly), with the complexion of the world's investment landscape to determine an appropriate risk/reward target for our fixed income allocation.

At this point, that target is to make loans to high-quality borrowers for periods of inside of 8-years (4) with a yield target of 150 basis points (1.5%) greater than the comparable maturity Treasury bond. Such a spread should provide protection from any unforeseen spike in inflation as well as earn a real return that is a premium to more defensive alternatives.

We are also favoring domestic bonds as opposed to foreign alternatives at this point given the previously mentioned systemic risk concerns as well as the alacrity with which our foreign counterparties must thread the proverbial policy needle - made most difficult with the ECB, as their constituency is comprised of 17 independent countries as opposed to a captive borrowing-base like that of the US.

Mulling it over the Midpoint

Alternative Investments.

Just a quick point of clarification on this sector, as its popularity has seemed to broaden its definition and obscure its impact, in our opinion. Sort of like it is difficult to determine which television programs are in fact, Reality TV shows these days! We value alternatives by the essence of the simplicity embedded in their name: they are “alternative” to plain-vanilla stocks and bonds.

We think that they can be particularly advantageous at points of inflection or transition in monetary policy in the following fashion:

- When the Fed is transitioning from a tight to an easy money monetary policy, we value alternative investments that enhance Beta. Beta can be thought of as the propensity of a portfolio’s returns to respond to gyrations in the financial markets[9]. If an easy monetary policy possesses some of the benefits described above and demonstrates disproportionately positive benefits, then an enhancement of such could pay off handsomely. 5

- When the Fed is transitioning from an easy to a tight monetary policy, we value alternatives that preserve Alpha. Alpha can be thought of as the excess return on a portfolio relative to that portfolios benchmark index[10]. 6 More simply stated, a portfolio’s propensity to preserve purchasing power. If a tight monetary policy elevates concerns as defined above, some shock absorbency could be critical as it relates to the long-term principal preserving objectives of our portfolios.

Given that the Fed has stated its intentions of turning away from its easy money ways, alpha preservation is on our radar. By incorporating funds that can prosper when volatility vaults, we feel that our risk-adjusted returns can be adequately addressed. Strategies for pulling this off include incorporating funds that short stocks/sectors that they feel are overvalued and those that peg performance objectives to benchmarks such as CPI (Consumer Price Index) by correlating positively with inflation.

It would not surprise us greatly if the last six months of 2014 look a lot like the first 6 months…..a positive equity bias comprised of fits and starts….a grind higher as some like to say. There are no shortages of anxious items on the global stage right now and most all have at least a short-term impact on investor psychology, which carries over immediately to impact the market’s meandering.

Our goal is discipline. Discipline in adhering to the guideposts displayed above. Discipline in allocating capital with a long-term focus – realizing that the identification of trends and their materialization can often possess elongated timing nuances. And discipline to test our theories with regularity. Our predictions are only as deep as our knowledge. And our knowledge must deepen each day to continue to reinforce the confidence that you have placed in us as your advisors.

[1] Source: Bloomberg Market Data

[2] Source: Bloomberg Market Data

[3] Source: Bloomberg Market Data

[4] http://www.npr.org/blogs/thetwo-way/2013/12/18/255253296/fed-says-it-will-begin-tapering-off-its-stimulus-in-january

[5] http://www.economist.com/news/americas/21610296-argentina-has-defaulted-again-deal-its- creditors-not-out-question-no

[6] http://www.forexfactory.com/news.php?do=news&id=497552

[7] http://online.barrons.com/public/page/roundtable.html

[8] Source: Bloomberg Market Data

[9] http://www.investopedia.com/terms/b/beta.asp

[10] http://www.investopedia.com/terms/a/alpha.asp

11460 Tomahawk Creek Parkway, Suite 420, Leawood, KS 66211 (913) 428-3300

IMPORTANT DISCLOSURES:
The views expressed herein are those of Douglas Ciocca on August 4, 2014 and are subject to change at any time based on market or other conditions, as are statements of financial market trends, which are based on current market conditions. This information is provided as a service to clients and friends of Kavar Capital Partners, LLC solely for their own use and information. The information provided is for general informational purposes only and should not be considered an individualized recommendation of any particular security, strategy or investment product, and should not be construed as, investment, legal or tax advice. Past performance does not ensure future results. Kavar Capital Partners, LLC makes no warranties with regard to the information or results obtained by its use and disclaims any liability arising out of your use of, or reliance on, the information. The information is subject to change and, although based on information that Kavar Capital Partners, LLC considers reliable, it is not guaranteed as to accuracy or completeness. This information may become outdated and we are not obligated to update any information or opinions contained herein. Articles may not necessarily reflect the investment position or the strategies of our firm.