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Second Quarter 2013

Intro

The market has continued its steady upward climb through 2013, as the economy is showing signs of continued if modest improvement. Key indicators such as unemployment, the housing market, and consumer confidence have shown steady gains, and this is reflected in the markets. These indicators are related to one another, since when people are secure in their jobs and their homes they feel free to spend more, and vice versa. During the crisis, all of these metrics suffered in tandem. Now during the recovery, they benefit each other in a virtuous circle.

A major factor at play in the economy currently is the Fed's "quantitative easing" programs. As George W. Bush famously summarized the financial crisis, "If money doesn't loosen up, this sucker could go down." The quantitive easing program is the Fed's response to this, and it has certainly loosened things up. The program is controversial in some ways, not least due to its size. Currently the Fed is buying $40-85 billion of bonds per month and has increased the monetary base by over $2 trillion so far. This is uncharted territory in terms of financial stimulus.

The policy is well-considered in the sense that it hits the economy in all the right places, including specific benefits for the housing market. The patient does seem to be responding to treatment so far, as the economy is showing improvement in all of these areas. After several years of this stimulus, the all-important question is when and how to stop it. Ben Bernanke merely mentioning that the Fed may "taper" this program was enough to send markets into a multi-day decline.

The market seems most worried that the Fed would take a ham-fisted approach to the stimulus and suddenly turn it off and let the chips fall where they may. Instead, Bernanke has indicated that the program will be decreased slowly, and only in response to improved economic fundamentals. There have been three "phases" so far, and at the end of each phase the stimulus was stopped to check the state of the economy. So far the economy is not able to run on its own, so the stimulus continues.

However it happens, the end of the stimulus program will probably prove disruptive to the markets for a short while. Yet over the long term the markets will recover, and in years to come, will be much higher. None of our investments are in such a precarious position that they could be harmed by a short disruption, and we are carrying enough cash to take advantage of irrational drops in stock prices if they do occur.

Net Asset Value vs. Earnings Valuation

A key question for any value investor is how to value businesses. Two common lenses through which businesses are valued are net asset values and recurring earnings.

Net asset value is the more conservative of the two. With this approach, we pretend that the business is shut down today and liquidated, and shareholders receive only the proceeds from the immediate sale of all assets, minus liabilities. This value is essentially the tangible book value, minus some margin to account for the difficulty in selling business assets in a hurry. In this way, an average but healthy business might be valued at 90% of book value.

Alternately, we could look at the business as a recurring stream of earnings. This requires us to assume that the company will stay in business for years to come, and that it will be able to maintain its competitive position during that time and not falter in any lasting way. This requires a more optimistic view, but also leads to higher valuations. An average but healthy business earning an average 11% on equity valued at 12x earnings would be valued at about 130% of book value, for example.

This 40% difference in value between 90% and 130% of book value, which is quite a difference in terms of investor returns, is really just a matter of two different perceptions of the same business. A nervous investor would be on the low end of this scale while an optimistic investor would be on the high end.

Some of the most dramatic changes in value in the stock market (both increases and decreases) occur when the market widely changes its perception of value from one view to the other. During normal economic times, most businesses are valued on a "going concern" basis. However, when the financial crisis first took hold of the markets, the market abruptly re-valued virtually all businesses at or below liquidation value. Some strong franchises can be worth 300-500% of book value or higher. Yet the market didn't care and bid many of these companies down to book value or below, thus at 20-30% of their true value, posting declines of 70-80%.

During the recent stock market recovery, the opposite has occurred. Because of the crisis, the norm for the past few years was to value businesses as if they were distressed. As evidence of the recovery is finally becoming clear, the market began to re-value businesses on a going-concern basis, moving the stock prices up by 25-50% or more. The new valuations are not particularly rich by historical standards, but just represent a more favorable but typical view of the business.

This trend is visible not only in the numbers but in the coverage of the markets. Take Bank of America for example, a couple of years ago, the analyst and news reports were all about the bank's liabilities, bad loans, legal settlements, etc. However in the earnings report last week, the focus was suddenly on revenues, earnings, and growth potential. This change in perception has helped move the stock price from $6 to over $14.

This phenomenon has been a factor in our outperformance over the past couple of years, and also helps to explain how the market could be reaching new records yet still remain reasonably valued. I will touch more on this while discussing individual investments, below.

Howard Hughes Corporation

This is a real estate holding company that was spun off from General Growth Properties during its restructuring. As the name implies, the company was originally created to hold and manage the real estate holdings of billionaire Howard Hughes. We first bought shares in this company in August 2011 at less than half the current market value.

The real estate assets held by this company are widely varied and also in various stages of development These include master planned communities in high growth markets such as Las Vegas and Houston; second-rate shopping malls such as Landmark Mall in Alexandria, VA; and unique properties such as the South Street Seaport in Manhattan. The unusual nature of these properties makes them difficult to value, and the fact that the company has gone through a restructuring recently means that hard numbers on these assets are hard to come by. For these reasons, the stock was trading very cheap relative to the potential value of the properties, it seems that since investors had difficulty measuring the value of the assets, they assumed they had no value.

The South Street Seaport for example was carried on the books at a value of $3.1 million, just $8.50 per square foot. Yet in 2010 this asset produced more than $5 million in net operating income. Using a cap rate of 6%, typical to retail assets in Manhattan, suggests the fair value is closer to $80 million. And this $5 million NOI is based on current rents of around $100 per square foot, which is very inexpensive considering this is waterfront property in lower Manhattan. Rents reach as high as $3000 per square foot elsewhere in Manhattan. Clearly, if the property can be upgraded to fetch rents more in line with what is typical in Manhattan, it could be worth multiples of $80 million.

It is amazing to think that such a prominent property has been carried on the books for less than 4% of its fair value. Looking at the company's other assets, there is probably not quite as much of a value discrepancy in all of them, but in every case I believe the market has not been recognizing their full value. As the company develops and promotes these assets, I think the value will surface.

Though the stock has more than doubled since we bought it, I intend to continue to hold it as it matures. As a primarily development-stage company, it does not pay a dividend. This may change in the future as the properties generate more cash flow. A particularly favorable outcome would be the company converting to a REIT, which usually carries a high dividend yield.

Bank of America

This company is a good example of the phenomenon I mentioned earlier regarding liquidation vs. going concern valuations. It was not that long ago that analysts were calling for the demise of the bank, asking if it was "too big to fail". I felt strongly that the liabilities the bank was facing could easily be absorbed by its enormous balance sheet and earnings potential, and bought shares of the company for bargain prices ranging from $6 to $9.

Under the leadership of Brian Moynihan, the company has dealt with most of its pressing issues and can now focus more on the business of being in business. Last week the company announced excellent earnings, increasing 70%. Suddenly, the focus is no longer on the bank's problems, but its earnings power. There were some positive surprises as well, including excellent results from the company's Merrill Lynch group. As a result, the company's share price is now around $14.50, and I feel that it can continue to go higher.

Access National

The regional commercial bank based in Reston, VA has continued to pound out steady profits and book value gains. The company has reported 51 consecutive quarterly profits (a period that includes the full extent of the recession), and over the past 3 years has increased its dividend tenfold from $0.01 to $0.10.

The company recently announced that it closed one of its smaller branch offices based on Boulder, Colorado. This was a small branch, responsible for about 6% of its residential loan volume and less than 3% of profits last year. However, the announcement sent the stock down more than 20%. I suspect that the announcement was misunderstood, due to a clause in the SEC filing requiring the company to note that the disposition affected 20% of the company's profits.

The reality is that the accounting charges that the company must make in connection with the disposition are more than 20% of last year's pretax profits. I think the market misinterpreted this as the branch being responsible for 20% of the company's profits. Based on this I took the opportunity to increase our position in this extremely well-run bank and look forward to being a shareholder for years to come.

Closing

I hope that this newsletter has provided you better insight into our investments. If you have any questions, please don't hesitate to contact me.

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