January 17, 2014

Client accounts finished 2013 near their highest levels to date. Accounts on average gained more than 30%, participating in most of the upside of the S&P 500, which returned 32% for the year. The performance was notable given that accounts were less than 70% invested in stock for most of the year. The remaining holdings were allocated to lower returning, but more predictable, fixed income investments.

The stocks we held outperformed the broader market, with a particularly large contribution from four small company stocks: Liberator Medical, Rite Aid, Entravision, and Motor Parts of America. Each more than doubled over the course of the year. Their gains were the product of substantial earnings growth, combined with higher multiples placed on those earnings, as investors became more optimistic about the companies' future prospects.

Comments on the economy and markets

The global economy appears likely to continue to grow at a low single digit rate next year. Europe's weaker economies have shown some improvement, although very high unemployment still threatens political stability. China continues to post respectable growth and thus far has avoided a real estate crisis despite what appear to be artificially inflated values. In the US, incremental employment gains, continued demand for autos and housing, and somewhat higher state and federal spending, should support another year of single digit domestic GDP gains.

On December 18 the Federal Reserve announced it would reduce its open market purchases of long term bonds in January. The bond purchase program, also called 'quantitative easing', has helped keep long term rates low and in consequence has supported higher prices for stocks, bonds, and real estate.

When the Fed first discussed reducing purchases earlier this year, the stock and bond markets fell precipitously. This time markets were better prepared. The bond market had already priced in reduced Fed buying, and bonds prices were largely unchanged following the Fed announcement. Stocks actually rallied on the news, with investors cheered by accompanying commentary from the Fed that it would hold short term rates low for an extended period.

While the Fed has absorbed much of the investment community's attention, the valuation of our holdings is likely to be the single most important determinant of our investment performance. The valuation of our stock holdings is a function of the prices of those holdings relative to their earnings, current and future. The valuation of our bond holdings is a function of the payments they will make to us over the life of the bond (including a lump sum payment at maturity), relative to the bond price today.

Stocks, taken as a group, are more expensive than they have been for several years. Stocks currently trade at roughly 16 times estimated 2014 S&P 500 operating earnings. While by no means 'bubble' territory, this level is towards the higher end of average historical valuations. Since the beginning of 2011, the S&P 500 has risen roughly 50%, while the underlying earnings of S&P components have risen only half that. So roughly half of the gain in stock prices over the last three years has come from earnings growth, while the balance comes from investors paying more for a dollar of earnings.

Despite the foregoing, some sectors of the S&P look attractive. Financials as a group are valued roughly where they were in 2011, at a fairly reasonable 13x estimated forward earnings. The stocks of Citigroup and Bank of America are actually cheaper than they were three years ago, relative to earnings, despite improving earnings outlooks. For these reasons I continue to like our bank holdings as longer term investments.

Fixed income securities (bonds and preferred stocks), taken as a group, look expensive, but there are still individual securities that look attractive. In particular, some junior bonds and preferred stocks currently pay mid to high single digit yields, which appear quite attractive relative to the broader bond market. I continue to opportunistically add to our holdings of these securities as components of our fixed income allocations.

Notes on Specific Holdings

I increased holdings in Agrium in recent months. Agrium is the largest owner of farm retail outlets in the world. Those outlets provide farmers with fertilizer, seed, crop protection chemicals, as well as soil sampling and chemical application services. Agrium has grown the business in recent years by persuading farmers to purchase Agrium branded seeds and crop chemicals rather than branded products manufactured by Monsanto, Dupont, Syngenta, FMC, and other large agricultural product manufacturers. Agrium earns more profits per sale on its private label product, and as those sales increase total company profitability should increase. Agrium is also growing its retail business by acquiring smaller, less efficiently run competitors, and by increasing the services it offers farmers, including soil analysis. These various initiatives should support earnings growth for the foreseeable future. Furthermore, the business is in what appears to be a long term secular growth trend in agricultural production.

Despite these positives, we can purchase Agrium today at attractive prices, due to investor concerns about its second business, the mining and manufacture of agricultural fertilizers. Within this area Agrium specializes in the chemical production of urea and ammonia, nitrogen based fertilizers. This business is unpopular with investors due to a long history of boom and bust profit cycles. In my view these concerns are exaggerated, because Agrium's low cost of production makes it difficult for foreign producers to compete in the US market, and will likely support more stable profits for the division going forward.

I also think investors are failing to give proper weight to Agrium's fast growing farm retail business. Within three years, farm retail should generate more than half of Agrium's earnings, up from a third today. As the retail business comes to represent more of Agrium's total earnings, I expect investors to place a higher multiple on the overall earnings of the company.

I sold all holdings of Liberator Medical, one of our best performing investments in 2013, because of its current high valuation. Liberator is a reseller of external catheters and other disposable medical devices. The company's primary assets are its large and growing customer list, its efficient procurement and delivery of devices, and its timely billing and collection, primarily from Medicare. Liberator's stock price has doubled since my original purchases early in the year, and has begun to look expensive relative to peers.

Liberator exemplifies an investment where our comparatively small investment base was an advantage. The company is well managed, highly profitable, and likely to be acquired. But the company is too small and obscure to interest most large investors. Because those investors were not bidding for its stock, we were able to purchase shares at what I viewed to be a wide discount to fair value. I am actively looking for other companies which, like Liberator a year ago, are attractively priced but have yet to be recognized by the market.

Last quarter I wrote about General Motors. I continue to believe the outlook here is positive. As I wrote last quarter, the company is benefitting from improved quality, improved customer perception, better management, more efficient manufacturing processes, a massive reduction in debt and pension liability, and a broadly favorable environment for new car sales. The US Government also sold the remainder of its shares late last year, removing one more concern for some investors. While GM's stock price has risen since last quarter, the shares remain quite inexpensive relative to earnings. I expect GM's shares to continue to perform well as the company grows earnings over the next several years and begins to return more of its free cash flow to investors.

My last quarterly note included positive comments on First United, a community bank operating in Maryland and West Virginia. However, First United's third quarter earnings revealed troubling declines in profit margins, and these appeared likely to persist. At the same time, the stock prices of our large bank holdings – Bank of America, JP Morgan, and Citibank – were attractive. In addition, these large banks have structural advantages over community banks, including more scalable technology and better branch networks. As a result, I decided to sell holdings of First United at a small loss while increasing exposure to the big three banks.

As always, let me know if you have any questions.

Best wishes for 2014,

Doug

Note: This information is intended as a general discussion of past account performance and investment strategy. It is not a recommendation to purchase any specific security or type of security. An investment in securities involves the risk of loss. Douglas S. Weiss is a registered investment advisor, member FINRA. Client performance is based on the arithmetic average return across all accounts managed for at least one year, net of management fees. Data is unaudited. S&P 500 index return is based on total index return, inclusive of dividends.