QV UPDATE
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What a RIOT!!!

How much would you pay for the letters RIOT stenciled in black blocks letters on an aluminum panel? If you were the one who recently purchased this piece of art from a Sotheby's auction, your answer would be $29.9 million. Strangely, this amount isn't entirely surprising given that the same artist sold a blank canvas stenciled with the letters FOOL for $7.8 million in 2012. As admitted art ignoramuses at QV, we defer to our readers to decipher who the fool may be in these transactions.

In the May 15th issue, Grant's Interest Rate Observer takes Blackrock's CEO Larry Fink to task for claiming that contemporary art and metropolitan apartments are two of the greatest stores of wealth in the world. In disputing Fink's assertion, Grant's juxtaposes the RIOT piece to 19th century artist Jean Louis-Ernest Meissonier's once renowned paintings which garnered as much as $60,000 in the 1870's, but today sell for as little as $1,100 because their initial pre-eminence had all but turned passé by the early 1900's.

The froth in the upscale condo market also incites some skepticism to its proposed store of wealth over time. The Wall Street Journal reports that a single 66 story tower in Manhattan currently has more than 60 apartments listed above $20 million compared to a total of just 29 condos in all of Manhattan in 2008. Meanwhile, a few blocks away, a luxury penthouse at 432 Park Avenue recently sold for an eye popping $95 million.

Beyond the argument of whether $7.5 million per letter art and opulent downtown condos are in fact good stores of value, the greater lesson may be that what appears reasonable today because it is both commonly accepted and popular may turn out to be neither popular nor reasonable in the future. For investors, understanding this distinction can prove the difference between superior and subpar long term results.

Unfortunately, in an environment of persistent asset price expansion, investors can get strange ideas about what constitutes good value. When asset prices are generally high, investing can start to feel a lot like crossing a desert; after going long enough without anything to drink, one can start to see water where it does not exist. Straying off course in search of illusory oases however, can often be a fatal temptation. Such mirages can take many forms in equity markets, even within areas that superficially appear the cheapest.

In a generally expensive market, seemingly cheap stocks are often so for a good reason. A low price to earnings ratio on a cyclical or commodity stock often exposes investors to companies at the peak of their earnings cycles. Alternatively, a low valuation may be representative of secular decline in a business' end markets, structural fault lines in its' business model or other risks such as high debt levels, which, in a weaker environment could lead investors to permanent capital losses. Even very successful investors can occasionally be misled by such mirages. For example, in the fall of 2006 a famous value investor made a very compelling argument to a classroom of Columbia MBA students for the purchase of auto parts maker Lear Corp on account of its apparent cheap valuation in relation to its earnings power in a normal environment. Although the stock almost doubled in the coming months due to a takeover bid which eventually failed, by 2009 Lear declared bankruptcy due to high debt levels that it couldn't support in a seriously weakened global economy. In this case, the investor's mistakes were not only projecting a normalized environment years into the future despite the oscillating nature of Lear's end markets, but more importantly, overlooking the threat of excessive leverage in a cyclical business when arriving at the conclusion that there was good value in owning the company.

For investors, so much of winning over the long term has to do with not losing through big mistakes. With asset prices having risen for six years, truly great deals are few and far between. Successfully navigating such an environment entails remaining resolute in your definition of value, remaining rigorous in the analysis of risk and being cognisant that even the best estimates are only estimates. The concept seems simple, but like crossing a desert, the path can be long and full of doubt when you're thirsty and you see what looks like water in the distance.