QV Update

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The Virtue of Not Doing

For many of us, a state of temporary inaction is often a foreign notion, or at least at odds with modern culture's hi tech assisted obsession with constantly doing and the instantaneous gratification it affords. In a recent report by Kleiner Perkins Caufield & Byers, a top venture capital firm in Silicon Valley, the company estimated that every day the average smart phone user checks their phone 150x (we wonder who these people are and how they get anything done?). Although this statistic would help us understand the source of an epidemic in carpal tunnel syndrome, the idea that a tool intended to enable us has become a perpetual preoccupation of our time reveals something striking about our incessant urge to constantly do.

Albeit this example is mostly a harmless affliction that won't likely cause anyone to abandon their cellphones anytime soon, unfortunately this obsession with doing also pervades our psyche as investors only with far greater consequences. Keeping with the cellphone theme, consider that the 12 month turnover in shares of Apple Inc is 4.7x. At this pace all the shares outstanding swap hands once every 53 days. It would appear that investors (speculators) in Apple are not behaving much differently than those of us addicted to constantly fiddling with our cellphones.

Unfortunately with all this doing over such a short time frame, it turns out that would be investors are essentially just trading their own emotions with others' expressed as short term trepidations in valuation multiples. A study by RBC Capital Markets shows just how true this is. Over timeframes less than 6 months, the study found that ~75% of price return can be explained by fluctuations in price multiples (Price to Earnings in this instance) and over 12 months, nearly two-thirds of returns. In fact, it takes nearly 72 months before the actual earnings potential of an investment really comes to dominate (>75%) its return potential. This not only underscores how hard it is to consistently make money in the short term given the need to accurately predict a myriad of factors such as market and interest rate directions, quarterly earnings results and investor sentiment while simultaneously avoiding countless other exogenous pitfalls, but also how owning (not temporarily renting) quality companies leads to investment success over time as competitive advantages, sound management execution and earnings' compounding power take charge in the long run. To paraphrase Warren Buffett who once said that his investment style is "lethargy bordering on sloth", only "Wall Street makes its money on activity. You make money on inactivity".

To investors chagrin, Corporate America is often no better at sitting on their hands when it is prudent to do so. In the past it was leveraged buyouts, and after that it was Merger and Acquisition fuelled empire building. Today share repurchases seem to be the saveur du mois. Although a much more subtle activity, repurchases can be no less malign when it comes to whittling away at shareholder value depending on the price that is paid. AT&T, a long term holding that was recently exited near multi year highs in the QV Global Equity Fund provides a decent example. With the stock rising to prices not seen since before 2008, the company has been using debt to voraciously repurchase shares as modus operandi for inflating EPS in order to compensate for dismal revenue growth and pressured margins. In Q1, AT&T repurchased $5.9 billion in shares at an average price of ~$35 while over the last 12 months it has repurchased a total of $12.7 billion. In this instance shares in Q1 were purchased at a price equivalent to 14x 2013 consensus earnings, or if you invert this number, at a 7.1% earnings yield. Meanwhile, Morgan Stanley estimates AT&T's cost of capital to be 6.4% – in other words AT&T's return on its buyback is 0.7% above its cost of capital – a pittance in our view. If management cannot reinvest in the business at more acceptable rates of return, any excess cash should be used to bolster the balance sheet rather than take on more debt to buy back shares (net debt to equity is at a 13 year high of ~80%) or simply return any excess earnings to shareholders so they can deploy it elsewhere at higher compounding rates. Management at AT&T however, have decided to engage in slight of hand with investors by producing short term gains at the expense of higher risk and in our opinion long term investor value creation. As Santayana said, "fanaticism consists in redoubling your efforts when you have forgotten your aim".

In Japan, much doing is also afoot as large scale financial alchemy is being employed to cure all ailments. Abenomics may successfully resurrect Japan from its 25 year malaise, it may not (we remain sceptical that further monetary wizardry can beget meaningful long term growth) but regardless, markets have reacted in spectacular form with equities ballooning up 80% at their peak since November before violently reverting 15% while the yen moved from 79 to 103 and bonds yields oscillated on a wild volatility roller coaster throughout. Many investors, aghast at missing out on the action, have piled into the trade in vigor. At QV, Japan has always been included in our ongoing global process of searching under rocks for ideas and it continues to be throughout the ongoing flux in Japanese risk assets. In 2013 however, our process has not uncovered Japanese ideas which fulfill the qualities we crave in good companies. As always our process and demands for quality and value are key. We will wear the shoe if it fits but we remain steadfastly reticent to jump on the bandwagon with the doing of others for the chance of being in the short term action at the risk of long term expense. As our parents cautioned us long ago, don't go jumping off a cliff just because everyone else is.

Back in the US, the Bernanke press remains alive and well this year, continuing to push investors out the risk spectrum en masse in their clamor for return. This has been going on so long it is more a banality than a revelation. At QV, we would very much like to believe that 50 is the new 40 and 40 is the new 30 but we only have to go so far as the mirror to see that it's not so. To wit, the assumption that a utility stock is the new bond and a consumer staple the new utility and that we should accept accordingly lower return prospects without a resultant decrease in risk is a fallacy of the highest order. With rates looking as though they may finally be in the infancy of their inevitable ascent, this manner of self-delusion will only end in tears and likely sooner rather than later. True some short term elation from all the action will likely be foregone, but not unlike a head rush before a hangover, it is one we are willing to forego. Rather we count ourselves lucky to know the virtue of not doing in the face of greater vice.