U.S. Stock Markets: 4Q08

The S&P 500 Index ended 2008 at 903.25, down 37% for the year, including a -21.7% drop in Q4. As you're well aware most stocks went down in unison. In laymen's terms, many of the major banks in the United States would technically be insolvent if not for us giving them money, and the global financing system as a whole is in-process of rebuilding itself from the ground-up.

The S&P 500 stock index is down 46% from its October 2007 high as of this writing. Below I talk about why stocks are cheap; government bonds are expensive; fear is widespread, yet understandable; and stock price volatility is much less important than being invested in companies with strong balance sheets and growth potential once we get out of this cycle.

Comments on Our Performance

For the 4Q08 accounts predominately invested in stocks under-performed the S&P 500's -21.7%, with most of our accounts down between 25% and 30%. For 2008 we out-performed the S&P 500 by about 13% on average, beating almost all actively traded mutual and stock-based hedge funds. This was due to the fact that through the first nine months of 2008 most accounts had made money vs. the S&P 500 Index being down almost 20%. While losing a lot less than the other guy is valuable, 2008's 4th quarter was not pleasant.

Big Picture – What do we do now?

Big stock market declines are valuable because they serve to test your current portfolio allocation (stock vs. bond vs. cash allocations), and, once the emotion clears, what is left are facts and rational analysis. Investing is pretty simple when you take out the emotion caused by volatility. The first fact I consider when investing is the rate of return on "low risk" investments. If rates in this category are sufficient for our needs, there is no reason for us to seek riskier investments…thus this is where we invest. In the "low risk" category, I include highly rated government debt, United States bank CD's, money market funds and highly rated business bonds like Wal-Mart, McDonald's, Coke, etc. Here are important facts to consider today.

- Low Risk Opportunities -

Most government debt yields almost nothing. For example, here are the yields on U.S. government debt -

1 month: 0.01%
3 month: 0.13%
6 month: 0.32%
1yr: 0.46%
2yr: 0.85%
5yr: 1.65%
10yr: 2.62%
30Yr: 3.33%

Likewise, money market funds today are yielding less than one half of one percent. You can get a little higher rate in U.S. bank CD's than you can U.S. bonds, but the rates are still a paltry 1.5% to 1.75% for one year. In the middle of last year I bought CD's issued by an Ohio bank yielding 4% through early 2010. I bought these for less than half of WSI's clients, and at the time I felt locking-in a 4% yield over two years was being too conservative – I imagined the clients I bought these for getting annoyed with me locking in a portion of their money at such a low rate. Of course, I had no idea the stock market crash would occur and taking a 4% return over 2008 would be a decent outcome. The key question is would you lend your money to the U.S. federal government for 10 years at 2.6% interest? Would you divvy out your cash into various bank CD's at 1.5% to 3.5% over a five year period?

- Common Stocks Offer High Free Cash Flow Yields –

Buffalo Wild Wings Example

Conversely, the free cash flow yields of businesses trading on the U.S. markets are astoundingly high, due to the Q4 market crash. For example, our top investment, Buffalo Wild Wings (BWLD), will generate about $35 million in adjusted free cash flow for 2008 (free cash flow is the left-over cash a business produces that can be used by its owners). If Buffalo Wild Wings were to stop growing new stores, it could pay us a dividend based on 2008 earnings of about 10%. When we compare this with getting 1.5% to 1.75% in one-year bank CD's, Buffalo Wild Wings stock looks appealing. If we further assume 2009 is going to be a horrible year for the economy, and Buffalo Wild Wings' free cash flow declines 20%, its free cash flow yield would still be 8% for 2009 (vs. 1% for short-term bonds or 5% for highly rated, 10 year bonds). This dire prediction is hopefully unrealistic; given BWLD will likely increase new restaurants by 12.5% to 15% per annum over the next three years, eventually growing its 560 restaurant base to 1,000. I believe the intrinsic value of BWLD to be well north of its current valuation, and an appreciation into the $30's is likely if it can continue to grow earnings. The stock is so cheap at the current $23 share price and $400 million market capitalization that if it drops 25% it shouldn't faze us. Assuming it continues to execute well inside the restaurants and continues to find promising new locations, the market will recognize the intrinsic value of the business in time. Interestingly, I've had seen some good things from the company lately. On the Monday after the Super Bowl I was at the Hillsboro, Oregon, Buffalo Wild Wings and the manager commented that sales on Super Bowl Sunday were the highest ever for their store, and their take-out business was a key driver of the new daily sales record. Also, I travel to Minnesota twice per year with my wife and kids to visit her family. They live about 30 minutes south of Minneapolis/St. Paul, in a suburb called Lakeville. About three minutes from their house a new Buffalo Wild Wings is going in. I can tell this is going to be an excellent location, and it gives me confidence this management team operationally is on its game (growth of surrounding area; disparity of restaurants; location in a stand-alone mall next to a Super Target and Best Buy; excellent visibility off the main road; next to a freeway entrance/exit).

As an aside, Buffalo Wild Wings has $45 million in cash vs. only $7 million of debt. Therefore it has no debt maturity issues, and its self-financed growth is a competitive advantage in today's environment.

Other Cheap Stocks

Free cash flow yields are extraordinarily high for other businesses we own – the health insurers United Health (UNH) and WellPoint (WLP) each should generate free cash flow yields of 10% in 2009. Pfizer's free cash flow yield should be in the low teens. Microsoft, a business we do not own, could conservatively pay shareholders a dividend yield of 7% to 8% per year assuming realistic assumptions. The list of safe and large free cash flow yields is endless, highlighting the values in today's stock markets.

In summary, stocks are on sale. I'm selectively bullish on stocks over investments in the "low-risk" group. History shows being bullish when the crowd is most pessimistic is the path to wealth creation. I believe by not following the crowd into zero-to-low returning bonds, and by selectively buying businesses with solid balance sheets and generating high levels of cash will prove profitable.

Opportunities in Corporate Bonds

You will notice in your portfolios we've recently made select investments in corporate bonds including Mohawk Industries, Interpublic Group and Sears Holdings. During the stock market crash many investment companies were forced to dump bonds at fire-sale prices, meaning those with liquid cash got some great deals.

- Mohawk Bonds -

In Mohawk's case, we had the opportunity to buy its bonds maturing January 2011 for a yield to us of over 10% per annum. If we purchased these bonds today we'd only earn 6% on our money because prices have since recovered. I found the 10% yield so attractive that I made the decision to sell our Mohawk stock and replace it with the bonds. The downside of this decision is if the economy begins to recover in late 2009 or 2010, the stock could return 25% per year, vs. our locked-in 10%. However, we've traded a lower potential return for reduced risk. Our risk owning Mohawk's bonds is the company declares bankruptcy, making it unable to pay its 2011 debt payment. I believe this risk is remote, but possible, if we have an absolutely terrible 2009 and 2010 economy.

- Interpublic Group Bonds -

For those of you with me in early-to-mid 2007, you might remember when we bought the bonds of KB Home, due December 2008, for a yield of 8.25% per year. The housing market was falling faster than a skydiver without a parachute, hurting all homebuilders such as KB Home, and homebuilder bond yields across the board were high for those who did their homework and took a calculated risk. I studied KB Home and came to the conclusion it had enough cash and liquidity to pay off its debt coming due in December 2008, but I was not comfortable owning the bonds due in later years (I actually studied the entire industry, including KB Homes, D.R. Horton, Lennar, Centex, Toll Brothers, Pulte Homes, etc., and liked KB the best). On December 15th, 2008 the bonds came due and we received our principal and final interest payment in full. It was a satisfying return. My regret is we didn't put 5% or more of our portfolios in the bonds, especially with the hindsight of the 2008 stock market crash.

Interpublic's story is strikingly similar to KB's of 2007. Interpublic is North America's largest conglomeration of advertising agencies subsiding under the corporate name of "Interpublic Group." The bonds we purchased mature on November 15th of this year, and yield over 11% on our purchase price. In my analysis it has the capacity to pay off the $250 million maturing this November due to the fact it has $300 million in cash on its balance sheet and should generate positive free cash flows in 2009. Like KB Home, I would not touch the bonds maturing in 2010 or 2011 because the risk of default is materially uncertain. The risk we face owning the 2009 bonds is Interpublic bills clients on payment terms extending for months. Should the economy absolutely fall off a cliff and multiple businesses / clients of Interpublic go bankrupt, Interpublic could face a cash shortfall when its clients say "sorry, we just went bankrupt and we can't pay our advertising bill." The good news here is no client makes up more than 2% or Interpublic's revenue, and, because it's the largest agency in North America, its client base appears diverse. I think bankruptcy risk is possible, but remote, and an 11% annualized return in this environment compensates us well.

- Sears Bonds -

We recently bought Sears bonds maturing May 1st of 2009, for annualized yields between 5% and 7%. Given money market rates are below 1%, and bank CD rates are equally low, I've been searching for some low-risk, higher-than-zero return alternatives to park our un-invested cash in. In early February I found some three sellers of Sears' bonds maturing May 1st, 2009 – the first seller wanted a price that returned 7% to us, the second seller wanted a price that returned 5% to us, and the third seller wanted a price that returned only 0.65% to us (all returns are annualized). So, we bought all the May 2009 Sears bonds offered by the first two sellers, and left the 0.65% return bonds to someone else. I can only speculate why the two sellers were desperate to dump their bonds. The third seller asking for the price that equals a 0.65% return on our money appears much more rational given money market rates and short-term U.S. government debt both yield near zero percent. I see very little risk of Sears defaulting on these bonds, and will continually search for more at fire-sale prices.

A Weaker U.S. Dollar Appears Inevitable

A recent addition to our investments is the "TBT." The TBT is an investment vehicle that appreciates in value when interest rates on U.S. government debt rise. I believe interest rates on U.S. government debt are too low because a herd mentality has caused investors to flee stocks and bonds and put massive amounts of money into U.S. government debt. Further, it's very difficult to see how the U.S. dollar doesn't eventually drop in value. To pull the U.S. economy out of a massive recession, we are printing Dollars and inserting them into the economy at a furious pace in an effort to recapitalize banks and spur lending. The TARP program initiated under Congressional Democratic leadership and signed by the Bush Administration is projected to cost us $750 billion (we've spent the first $350 billion). Next, the Obama Administration is expected to enact an "economic stimulus package" to the tune of $700 billion or more. This money just doesn't come from a "rainy day fund," or a Federal bank stuffed with cash reserves that we saved. We, the U.S. people, do not have the money to finance the TARP nor a stimulus plan, so we are issuing debt. Our debt is being purchased largely by foreign governments (China is the single largest holder of U.S. sovereign debt). We then print dollars and flood the economy with our replenished ammo (to be patriotic your author recently purchased a slightly used U.S. Dollar printing machine on eBay, but the seller wouldn't accept U.S. Dollar payments so I had to pay in Australian Dollars). I think once people world-wide recover from the enormous shock of the global stock market collapse, rationale thinkers will get out of U.S. debt based on the realization we're issuing too much debt and running unsustainable budget deficits. The consequence should include a rise in U.S. government interest rates, benefiting the TBT.

What I think is important to recognize is, even if this works and our economy begins to grow, the aggressive printing of U.S. Dollars has consequences. One is pretty simple – an increased supply of a currency should translate to a devaluation of the currency. Furthermore, the U.S. government is making the same mistake the U.S. consumer made in 2003-2006. Our government is taking on too much debt via an "adjustable rate mortgage" to finance the repair of the U.S. economy. Current U.S. Federal government debt composition is predominately financed with Treasury Bills maturing in one year or less at historically low rates. It appears the U.S. government is missing a fantastic opportunity to lock-in low rates for 10, 20 and 30 year bonds, instead opting for an even lower rate in short-term debt. Unfortunately, short-term government borrowing rates at zero and 10 year borrowing rates at 2.6% are reminiscent of Cinderella at the ball – the party has to end. In affect, I believe there is a price bubble in U.S. government debt, and the TBT is an ultimate winner of this bubble bursting.

Closing Comment

It's vital we not focus on stock prices to validate our well-being. Instead, we need to focus our attention on the free cash flow yields our businesses generate, and compare those yields to what we can get in the "low risk" camp. I encourage you to ignore stock price volatility, and instead focus on free cash flow yields in comparison to investing alternatives. When you begin viewing your investments with a realization your portfolio will return 7% to 10% in free cash in 2009, falling stock prices become a test of patience – not a measurement of success or failure. In the end, there should be a significant rally in equity prices, but it will likely take longer than I'd like.

Thank you very much for your trust, and especially for your level-headed support during the good and bad times.

Sincerely,

Bryce Peterson

President

Washington Street Investments, LLC

Quote of the Quarter: "The human brain is wired for momentum. It's what kept us alive in the caveman days. To get from getting eaten back then, if you saw 1,000 people running the other way, your brain told you it was a good idea to run with them."

– Bruce Berkowitz, Manager of the Fairholme Fund on a conference call he conducted during the stock market crash. That's a paraphrased line from memory, but I think it's particularly instructive about today's money climate when you see U.S. government rates at 2.6% for 10 years, vs. free cash flow yields of solid businesses returning 8% even considering the worst of my 2009 estimates. The crowd has run out of stocks and many corporate bonds, hiding in U.S. government debt.

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