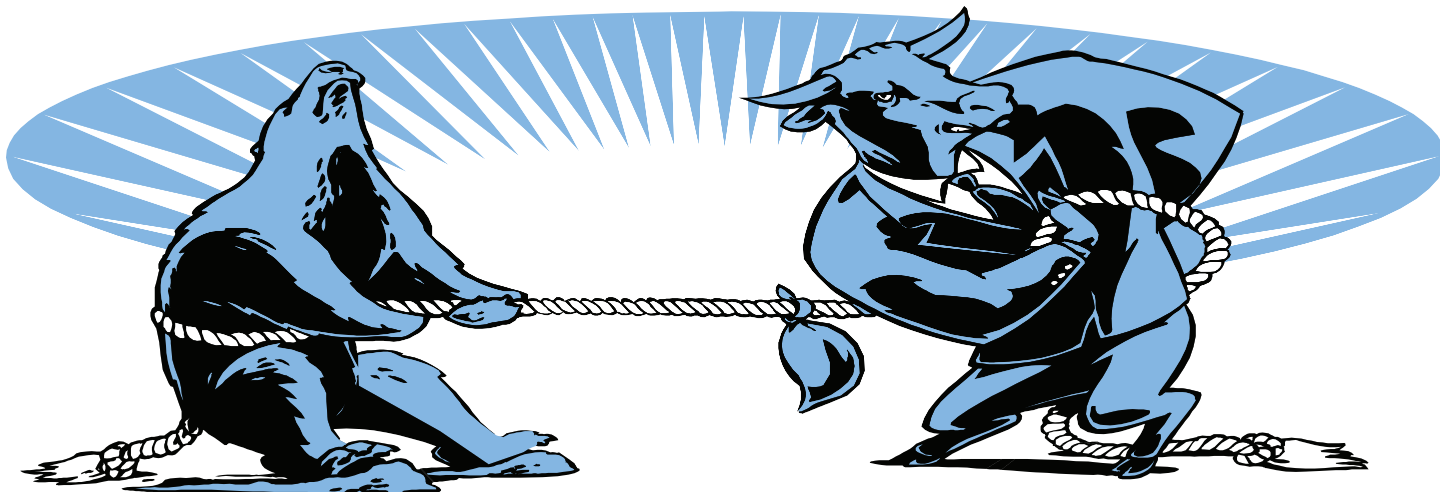
JACOBI INVESTOR DIGEST Fall 2008



## Inaugural Edition

At last year's Wesco Company annual meeting, Charlie Munger listed a series of qualities that have been critical to the extraordinary success of Warren Buffett. Among those were getting involved in something in which you have an intense interest, insisting on objectivity over ideology, being a constant learning machine and being in a field where you can get better with age. Regarding these last two points, Munger wrote in *Poor Charlie's Almanac*, "It's hard to believe that he's getting better with each passing year. It won't go on forever, but Warren is actually improving. It's remarkable. Most men in their seventies are not improving but Warren is."

The *Jacobi Investor Digest* is our attempt at being constant learning machines and sharing what we learn with our clients so that we can all get better with each passing year. Frankly, this is our mission over the next twenty years. Accordingly, much of what we write will concern mistakes we have made and something new that we have learned. This is a practice we have used in our office over the past fifteen years and with our new Registered Investment Advisor (RIA) structure, Jacobi Capital Management LLC, we are now able to communicate our thoughts more freely. In the past, heavy regulation and compliance rules prohibited us from such communications. This is one reason why we are so excited about our small, but significant change.

In this inaugural edition, we hope to accomplish two things; (1) explain the Jacobi investment philosophy and (2) assess how long-term investors should be looking at the market. What you will not find in this edition or future writings are any short-term predictions on markets, asset classes, or individual securities. Despite the proclamations of many in the print and television media, we have never found anyone with an ability to consistently make successful predictions.

For example, we recently finished reading a piece from the print media in which the top "Strategists" from twelve Wall Street firms were asked to predict the ending value of the S&P 500 on December 31, 2008. They were asked this question in December 2007, when the S&P 500 was valued at roughly 1484. The predictions ranged from 1450 to 1800. With the S&P 500 currently sitting more than 38% below the lowest prediction of 1450, you can see what a difficult job it is to predict the value of the market.

*Broad Market Index
**S&P 500 Value on December 21, 2007, 1484

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## The Jacobi Investment Philosophy

The simplest way to sum up our investment philosophy is expectations investing. In general, we want to avoid purchasing businesses* with high expectations and seek to own stocks with strong business models and relatively low expectations, selling at reasonable prices. We have found that more often than not, high expectations lead to declining share prices because there is a meaningful disconnect between the current market price of a stock and the real value of the business. Although in the short-term market prices can be all over the place, over the long-term the market is efficient and will close the gap between the current market price of a business and its real business value.

### *How do you determine the real value of a business?*

The real value of a business is the value today, of the cash flow that the business is expected to generate in the future. It can be likened to a rental property. One way to determine what you are willing to pay for a rental property is to estimate how much rent you will receive as the owner of that property. You may determine that you will own the building for 10 years and during that time you will be able to raise rents about 5% per year and that the building will be fully occupied for the duration of your ownership. These few calculations will give you a fairly good idea as to what the rental property is worth and if you are shrewd, you will offer the current owner that price or perhaps a little less as the owner will undoubtedly reject the first offer.

We assess the value of stocks in a similar manner. If we decide to purchase a stock we are primarily concerned with whether the current price of the stock reflects our estimate of future cash flows or whether the current price reflects much higher/lower expectations of future cash flows. Ultimately, we would prefer to own stocks where the expectations of the future prospects of the business turn out to be meaningfully lower than what the business can and actually will deliver. In these situations, stock prices are likely to increase to reflect the real value of the business.

### *How do you measure expectations?*

We try to measure expectations in several ways, including looking at the current share price, watching the flow of funds into and out of certain market sectors as well as observing sentiment models. The price of a stock will tell you a lot about investors' expectations. For example, we can look today at a stock like McDonalds (MCD) and determine that at a price of $56.62 (10/28/2008), the current price is reflecting expectations of roughly flat profit margins and a long-term earnings growth rate of approximately 9% per year. We would argue that given the long-term growth rate in the fast food industry (3%-7%), and MCD's relative dominance and strong brand, the current price does not reflect very rosy or significantly low expectations. Hence, we would not necessarily initiate a purchase of MCD at the current price or liquidate any existing position.

*We use business and stock interchangeably because as investors, we are owners of our fractional share of the business.



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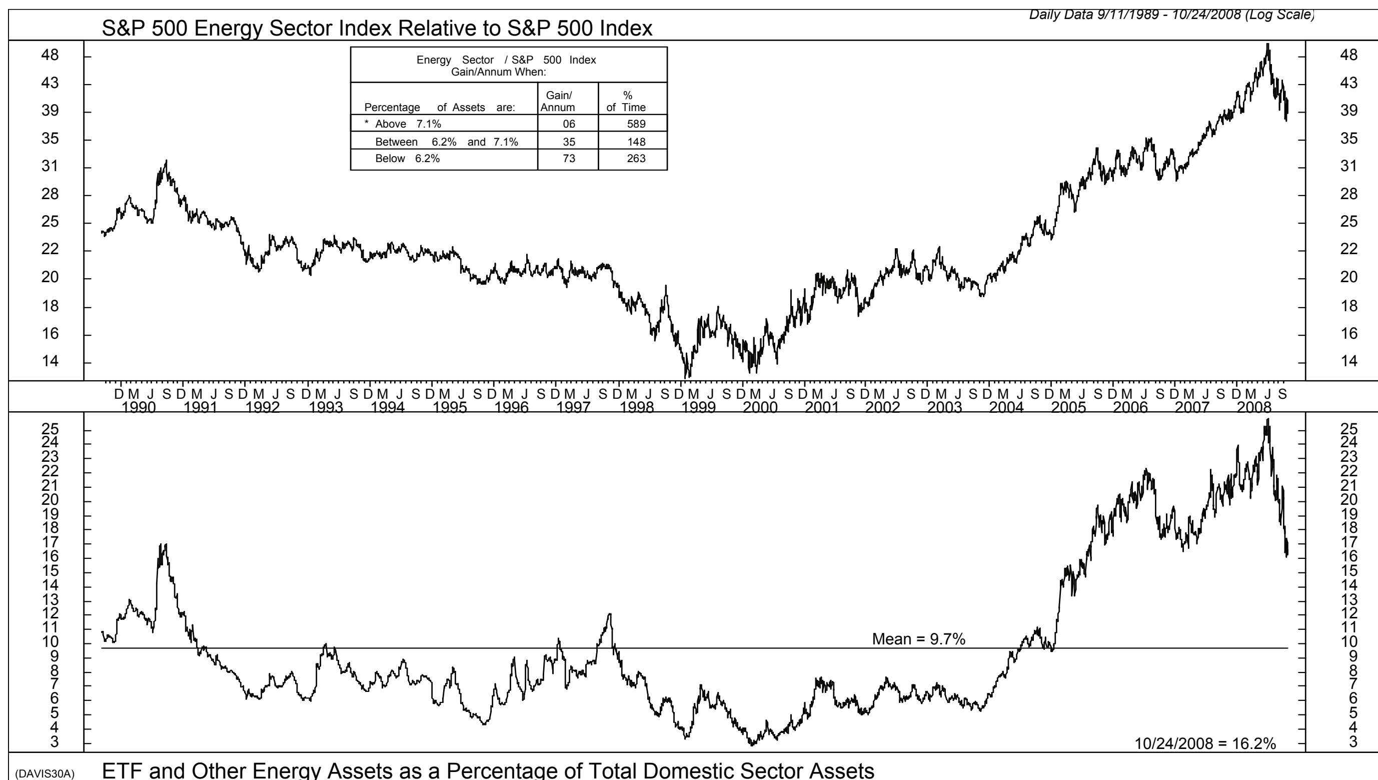
## How do you measure expectations?...cont'd.

As we noted above, we also look at fund flows into and out of the S&P industry sectors as an additional way to better understand investor expectations. The chart below details the fund flows into the energy sector of the S&P 500 over the last 19 years. Though this data does not capture every investor in the market, it serves as a reliable proxy of the general flow of funds into this sector. We think the lower half of the chart captures the essence of investors' expectations. Over a 19 year period, investors have allocated roughly $0.097 of every $1.00 invested, to the Energy sector. In 1999-2000, investors were only willing to allocate about $0.03 of every dollar to the sector, reflecting historically low expectations of future returns.

If you fast forward to 2006-2008, expectations of future returns in the Energy sector were so high that investors were willing to invest about $0.26 of every dollar into the sector despite a historical average investment of only $0.097. It is worth noting that this chart will not define for us whether or not we are in an Energy bubble nor when or if a bubble will burst. However, this chart along with other data points on investor expectations will help guide us to areas of the market that are likely to yield excess returns over the next 3-7 years.

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## Thoughts for the Long-Term Investor

Many of our clients are concerned these days. There is a good deal of panic in the air and there is a legitimate cause for concern. We want to assure our clients that we are also on edge about this market and concerned with the near-term uncertainties. However, we remain committed to our investment process, which we believe to be objective, and determined to allow that process to govern our behavior rather than our emotions.

Let us take a look at how the average investor in the United States has performed over the years. In a *DALBAR** study of individual investment returns from 1984 to 2002, it was found that the average investor earned +2.7% per year, while the market (S&P 500) earned +12.2% and the average stock mutual fund earned +9.3%. Stop and think about that for a second. During a secular (long term) bull market, with cyclical (short term) bear markets and recessions, the average investor only received 22% of what he/she would have achieved in a passive index fund. Buffett, always a simple man, refers to this as rear-view mirror investing. Since the economy and markets are made up of inevitable and necessary cycles, both secular and cyclical, investors constantly using the rear-view mirror approach consistently achieve sub-par results. The *DALBAR* study captures the rear view mirror approach, which drives investors to skip from mutual fund to mutual fund, chasing performance and effectively buying at the top and selling at the bottom.

By the way, when we refer to the average investor, we are not only talking about the small investor. After a major market advance in 1972-1973, professional pension fund managers in the United States placed more than 90% of their net cash flows into stocks, a record commitment at that time. After a horrific bear market in which stocks became 60% cheaper, those same managers only put 13% into U.S. stocks. That's right! They quit buying because stocks got cheaper!

The late John Templeton used to say that "Men buy stocks like perfume and jewelry for their wives. They ask what is most expensive and buy it. Unfortunately, they should buy stocks the way their wives purchase clothing and groceries, by asking what is on sale and buying what is cheap." We are seeing this same behavior today as professional pension consultants put record numbers of alternative investments (oil, gas, commodities, hedge funds and private equity) into pension plans during the first half of 2008, just before the 60%-70% collapse this past quarter in these assets.

The economic cycles of the past century proves that market irrationality of an extreme kind periodically erupts. Investors wishing to do well over the long term must have a plan to deal with extreme market cycles--both exuberance and despair. As Buffet said, "What's needed is an antidote, and in my opinion, that's quantification. If you quantify, you won't necessarily rise to brilliance, but neither will you sink into craziness."

As many of you know, we have and always will attempt to build all our models around quantifying. We take a weight of the evidence approach to investing, with the evidence being numbers, which works much better than an approach based solely on our opinions and biases. Our process of quantifying leads us to ask the following question, *What if..then what?* In other words, what if "X" happens, then what will we do? This process of inverting seems so simple yet is quite difficult in practice.

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**DALBAR,* Inc, Quantitative Analysis of Investor Behavior, 2003



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## Thoughts for the Long-Term Investor...cont'd.

For example, what if investors had looked at market valuations in 1999 and asked, what happens if market valuations revert back to their long-term mean, what will I do? Investors could have determined that with the market selling in excess of 36x* earnings, it was priced to return less than 3.0% per year. Investors could have taken it one step further and considered that a mere reversion back to the long-term average (15x-17x) meant that we could see the S&P in the 700 range or one half of its valuation at the time. Determining that the market had a decent chance of delivering lousy returns by just reverting to "normal" was not the most difficult part. The difficult part would have been sticking to a discipline of not buying as the market raged on throughout 1999 and 2000. Unfortunately, investors put a record $307 billion into equity mutual funds during the twelve months ending March 2000 (*Applied Finance Group*).

## *The key question today for the long-term investor is what if the U.S. gets through this downturn, then what?*

In the chart below, we take a random basket of 15 of the leading American companies to help tell this story. Here lies a cross section of American businesses chosen mainly because they have identifiable consumer brands. In 1999, these were good businesses and we would argue that they are good businesses today. At the end of fiscal year 1999, the basket reported $17.44 of combined earnings and $5.52 of combined dividends. Over a 9 year period, the basket grew earnings almost three-fold to $50.85 (+12.6% CAGR), and will report 2008 dividends of $16.59. Without knowing the price of this basket, we would have expected this basket to increase in value given the substantial growth in earnings and dividends. However, it is October 2008 and the basket is priced at $564, approximately 20% below its 1999 price of $707.

| Company** | Price 12/31/99 | EPS 1999 | P/E 1999 | Dividend 1999 | Dividend Yield 1999 | Price 10/24/2008 | EPS 2008E | P/E 2008 | Dividend 2008 | Dividend Yield 2008 |
|---|---|---|---|---|---|---|---|---|---|---|
| UPS | $69 | $2.04 | 33.8x | $0.58 | 0.84% | $46 | $3.60 | 12.8x | $1.76 | 3.83% |
| Tiffany | $44 | $0.98 | 44.9x | $0.12 | 0.27% | $23 | $2.80 | 8.2x | $0.66 | 2.87% |
| Coca Cola | $59 | $1.30 | 45.4x | $0.64 | 1.08% | $42 | $3.00 | 14.0x | $1.52 | 3.62% |
| Exxon | $40 | $1.19 | 33.6x | $0.84 | 2.10% | $69 | $8.75 | 7.9x | $1.55 | 2.25% |
| Microsoft | $58 | $0.70 | 82.8x | - | - | $22 | $1.87 | 11.8x | $0.44 | 2.00% |
| Cisco | $54 | $0.53 | 101.9x | - | - | $16 | $1.31 | 12.2x | - | - |
| Johnson & Johnson | $47 | $1.49 | 31.5x | $0.55 | 1.17% | $61 | $4.70 | 13.0x | $1.80 | 2.95% |
| McDonalds | $40 | $1.39 | 28.8x | $0.22 | 0.55% | $53 | $3.55 | 14.9x | $1.50 | 2.83% |
| Wal-Mart | $69 | $1.28 | 53.9x | $0.19 | 0.28% | $51 | $3.50 | 14.6x | $0.93 | 1.82% |
| Disney | $30 | $0.66 | 45.4x | $0.20 | 0.67% | $23 | $2.35 | 9.8x | $0.35 | 1.52% |
| Proctor & Gamble | $55 | $1.43 | 38.5x | $0.57 | 1.04% | $59 | $3.50 | 16.9x | $1.45 | 2.46% |
| Texas Instruments | $48 | $0.92 | 52.2x | $0.09 | 0.19% | $17 | $1.80 | 9.4x | $0.40 | 2.35% |
| General Electric | $52 | $1.07 | 48.6x | $0.49 | 0.94% | $18 | $1.96 | 9.2x | $1.25 | 6.94% |
| Caterpillar | $22 | $1.32 | 16.7x | $0.64 | 2.91% | $33 | $6.10 | 5.4x | $1.62 | 4.91% |
| Wells Fargo | $20 | $1.14 | 17.5x | $0.39 | 1.95% | $31 | $2.06 | 15.0x | $1.36 | 4.39% |
| **Total** | **$707** | **$17.44** | **40.5x** | **$5.52** | **0.78%** | **$564** | **$50.85** | **11.1x** | **$16.59** | **2.94%** |

***The example above and following are a representative sample of certain cases where securities mispricing may have occurred. The examples are intended to be illustrative only. Source: JCM Analysis*

*Using the S&P closing value on 12/31/1999 of 1469.25 and fiscal year 1999 reported GAAP earnings of ~$40 per share.



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## It Matters What you Pay for a Business

It matters what you pay for a business (stock). Overpaying for a good business can be equally as devastating to your investment as mistakenly purchasing a bad business. In 1999, investors were willing to pay $40.50 for every dollar of earnings generated by our random basket. The expectations of future returns were much too high for this basket in 1999. As result, a very acceptable +12.6% annual growth in earnings for this basket was not enough to justify the 1999 price of $707. In fact, the earnings yield (1/40.5) was just +2.5% when during the same period, the 10 year U.S. Treasury was yielding 6%.

As we look at the basket today, we see a big difference in expectations. For starters, the basket trades at 11x earnings with a dividend yield of almost +3.0%, roughly 3.8x the 1999 yield. The basket is priced to return +9.0% with an implied long-term earnings growth rate of less than 4.0%.

Let's assume that we purchase this basket, and we are unlucky and the price of this basket falls further or hangs around its current price for some time. In this case, we collect our dividend, which by the way is not terribly different from the yield on the 10 year Treasury*. Perhaps we are even lucky enough to have this basket revert to long-term market valuations of 15x-17x earnings which implies an earnings grow rate of 6.0%-8.0%. The 6.0%-8.0% is above the current implied growth rate of 4.0%. Therefore, any amount of growth in excess of 4.0% should represent potential upside in the value of this basket. There is something about a 4.0% growth rate for our random basket that strikes us as achievable!

This illustrative example is meant to display a situation in which a little inverting goes a long way. It aims to answer the following questions: What if the U.S. gets through this downturn, then what? Will these or any other businesses be able to grow again? At today's price, how much do they need to grow to justify the current price?**

Historically, the U.S. has always recovered because it is a fairly resilient economy. At $13.8 trillion, the U.S. economy accounts for a fifth of the world's total output. The GDP*** per capita in the U.S. equates to approximately $46,000, compared to the European Union at $32,900, Japan at $33,800 and China at $5,300. Not only is the United States the largest economy in the world, it is one of the most productive economies because each one of us accounts for $46,000 of goods and services produced!

Just as investors pouring capital into the market in 1999-2000 experienced some short-term success, which eventually led to long-term suffering, investors supplying capital today will most likely experience some short-term suffering while exposing themselves to probable long-term success. Hence, are long term investors better off owning a group of leading companies with an 8%-10% earnings yield and 2%-4% dividend yield or will long term investors earn a better return in the 10 year Treasury bond—a place that many investors are currently hiding out?

*3.8% is the 10 year Treasury yield as of 10/29/2008
**Based off JCM calculations, the current price of this basket implies a +4.0% long-term growth rate in earnings for the basket.
***Gross Domestic Product (GDP) is the amount of goods and services produced in the United States.



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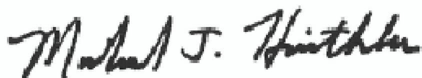
## Thank You

We want to thank our clients for their continued patience and belief in our investment philosophy. We are proud of the lasting relationships that we have built with our clients over the years. We may have a new name, Jacobi Capital Management LLC, and somewhat of a new structure (RIA model), but we still have our same team and remain committed to our same investment philosophy, one based upon sound principles of inverting, curiosity and patience.

## A Quarterly Publication

The *Jacobi Investor Digest* will be a quarterly publication that we intend to distribute via email. If you would like to continue to receive a hard copy of this publication please email Ed DeMichele at edemichele@jacobicapital.com. If you have any questions regarding this publication or otherwise, please feel free to contact us at 570.826.1801 or at info@jacobicapital.com.



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