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In Pursuit of Value

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Cash

How to invest that cash is the question that nags at investors and many companies too. For individuals planning their retirement, it can be quite sobering to see how much savings are required to achieve a desired level of retirement income. Miniature interest rates plus the steady grind of taxes on investment income combine to push out the target date farther than one might expect. Fed Chairman Bernanke's recent Congressional testimony assured that low interest rates will be with us for a good while longer yet. The Dove-in-Chief finds little evidence of dangers from increased risk taking in financial markets fuelled by Quantitative Easing 1,2,3 etc. By which he means that savers generally still retain substantial cash investments as the trauma of 2007-08 slowly recedes. Low or negative real interest rates on government debt (i.e. yields below inflation) remain good for the economy on balance, albeit not that good for savers in search of income. Cash isn't trash though – during the next bear market it'll provide welcome comfort to balance unpleasant swings in risky assets. However, you can have too much of a good thing.

Over the past 100 years or so real interest rates have moved around more than you might think, often driven by fluctuating inflation but not always. Investment managers don't always just indulge themselves by studying racy research reports on companies they follow; *A History of Interest Rates, 4th Edition*, by Sydney Homer and Richard Sylla, if casually left on your coffee table may limit the dinner invitations you receive from visitors who happen to notice it. I must confess that it's actually a fantastically interesting 2,000+ year economic history, but possibly not to everyone's taste.

Among the many statistics Homer and Sylla offer is that low or negative real interest rates have existed for far longer periods than you might think. Yields on government debt that returned dollars with lost purchasing power prevailed from World War II until the 1960s. It turned out to be an expedient way for the Federal government to pay down the enormous debts incurred defeating the Axis powers, and for almost two decades the tyranny of financial repression effected a slow but steady transfer of real wealth from savers to borrowers. America's fiscal disposition in 2013 has much in common with that of 60 years ago. We have enormous debts incurred in part through wars. The interests of the borrower are rather more important than the lender. Absent a grand compromise in Washington to find greater fiscal balance, the time-honored reliance on savers to passively transfer real wealth to borrowers represents part of the solution. There seems little reason to expect this to change anytime soon. In fact, such policies are broadly in America's interests if not in everyone's. Buyers of fixed income debt whose yields are tethered to where the government happily finances itself can at least console themselves with the patriotic satisfaction of knowing they're helping the country.

Corporations are sitting on growing piles of cash and are similarly wrestling with what to do with it – or at least, their investors hope they are. David Einhorn has made a creative proposal to Apple (AAPL) that they issue new securities, perpetual preferred (naturally named "iPrefs") to holders of their common equity. His suggestion highlights the segmentation of income seeking investors from equity investors. His presentation is too complex to fully describe here but can be found on Greenlight Capital's website. In summary though, companies like AAPL generate such enormous cashflow that a portion of it can be regarded as having the

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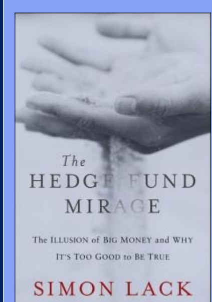

type of certainty bond investors crave. iPrefs combine the reliability of a fixed income stream easily supported by the underlying business without incurring any debt. By straddling the gap between equity and fixed income investors, there's a compelling case that AAPL could excite their investors with innovation almost as much as they do their consumers. So far the company will go no farther than say they're studying the issue, but questioning how much cash a company really needs to hold is well worth asking. In AAPL's case $137 billion seems a little excessive.

We don't own AAPL but we do own Microsoft (MSFT), a company similarly burdened with more cash than they really need and also apparently reluctant to return it. Consequently, we believe their equity is valued at a level that incorporates the expectation of some destruction of that cash pile through ill-considered acquisitions. Since 2007 MSFT has generated $132 BN in free cash flow but its use of that to fund dividends and buybacks has come up short in recent years. They have $68BN in cash, $56BN net of long term debt. It grows at $26BN a year before capital investments – which is the problem. The stock reflects the unfortunate possibility that they'll buy something they shouldn't, such as another aQuantive, almost totally written off with a $6.2BN charge in the second quarter of 2012. Reflecting on what went wrong at Xerox, Steve Jobs once theorized that companies with a monopoly are eventually run by salesmen because marketing becomes more important than product development. MSFT's Steve Ballmer shows no indication of retiring, although if he did it just might unleash the biggest gain in market capitalization of any CEO's departure. We must confess that we remain invested in MSFT in spite of their CEO, not because of him.

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Much of MSFT's cash is held offshore, and repatriating it for buybacks or dividends incurs a tax bill. Many U.S. companies are waiting for an altered U.S. corporate tax code or temporary amnesty, something whose timing is hard to predict. Meanwhile, investors in MSFT and AAPL carry the burden of assets earning 0%, far below each company's cost of capital. My colleague Henry suggested that a commitment to repatriate, say, 10% of offshore cash annually would at least begin the process of returning to shareholders what these companies don't need while avoiding the CFO's nightmare of bringing cash home at a 35% corporate tax rate just before a more benign regime. We have owned MSFT for over two years. Perhaps the focus on IT companies and their cash provoked by David Einhorn will lead to a little more value creation for the owners.

Natural Gas

It's been some time since we last wrote about this topic. The vast shale gas reserves in the U.S. have transformed the long-term energy outlook in recent years as their potential has become more apparent. Over the past years we've invested in several E&P names in the sector, focusing on those companies with low debt and low operating costs.

It's generally worked out well although not in every case. Two years ago Petrohawk, one of our holdings, was acquired by BHP Billiton in a strategic acquisition at a substantial premium. Subsequently the assets were substantially written down and BHP found a new CEO. That as well as an abundance of natural gas forcing down the price has tempered the appetite for M&A activity. Chesapeake recently accepted $1BN for 50% of some assets previously valued at three times that, illustrating the shift in values. Not everything Aubrey McClendon (former CEO) bought has turned out to be cheap.

For our part, we still own Range Resources (RRC) and Devon Energy (DVN) although reduced both positions on recent strength. E&P exposure has fallen to around 7% of our Deep Value Equity exposure. We continue to research investment opportunities that will benefit from persistently cheap natural gas, and recently made a small investment in Agrium (AGU), a global producer of agricultural products and services. In their wholesale business they manufacture large amounts of fertilizer, for which natural gas is an important input. The company has made a series of acquisitions which have so far failed to produce as much value as they should have, and the involvement of an activist investor (Barry Rosenstein of Jana Partners) additionally made this an intriguing story. There are many angles to the U.S. shale gas revolution.