

# Yellowstone VIEWPOINT

## ➤ MARKET PERSPECTIVE

This summer I'll celebrate 10 years of marriage with my beautiful wife. Early on in our life together we made a trip to the local supermarket. I was perplexed and perhaps even a bit offended when I saw her select a bag of chocolate chips without examining the price-per-ounce metric in fine print on the price label to ensure that she made the best value decision. Questioning her somewhat intensely, I asked "what are you doing?" and threw the name-brand bag back on the shelf, putting the lower price-per-ounce generic bag in the shopping cart. This story is also known by its other title, "Why I Ate Waxy Chocolate Chips for the First Five Years of My Marriage."

You see, I come from a family that values value... if there's a way to measure it; I'll use it. And as it turns out, the same way there's a way to measure the price-per-ounce on a bag of chocolate, there's a way to measure the "price per dollar of earnings" on the equity of individual companies or on stock market indices as a whole. You know this as the P/E or the price/earnings ratio. The lesser known figure that can be distilled by taking the inverse of the P/E ( $E/P$  or simply dividing the P/E ratio by 1), is the "earnings yield." Calculating the earnings yield on company stock will tell you how much the company earns as a percentage of each dollar invested.

Astute economic theorists have developed models over history that assign a hierarchy of yield expectations relative to the level of risk that accompanies the investment asset class. So, for example, investors should demand a higher yield premium on small company debt because the risk on short-term Treasury bond investments is very low relative to the risk on long-term corporate debt (the likelihood is much higher that a small company will default in the long term than the federal

government will default in the short-term). Because this hierarchy should technically remain the same over time, investors are able to judge the relative value in each asset class according to historical ratios of one to the other.

One metric, dubbed "The Fed Model," pairs the earnings yield on the S&P 500 against the yield on the 10 year Treasury, positing that they should be roughly equal over time. While no measure is without flaws and there are many other considerations, today's 10 year Treasury is yielding less than 3% while the earnings yield on the S&P 500 is approaching almost 7%... signaling that equities remain drastically undervalued relative to bonds.

In the first two and a half months of the second quarter of 2011, earnings expectations on the S&P 500 have actually risen from \$96.84 per share to approximately \$99.34 per share, while in the meantime, the value of the S&P has dropped from about 1325 to 1269 as of this writing. Essentially what this means is that relative to the end of Q1,

purchasing equity shares today, you get even more "earnings per dollar" or earnings yield.

It must also be said that just because equities are "cheap" relative to bonds and historical standards, it doesn't mean that they can't get cheaper. Nonetheless, we still find that continued expectations for earnings increases due to growth in overseas revenue and a slowing, but continuing domestic recovery give cause to feel enthusiastic

about the prospects for equity returns for year-end 2011 and going forward. It also bears mentioning that value must not be the only consideration when weighing investment decisions - a truth that is borne out in the chocolate chip analogy. A low-priced company with slowing growth prospects is the market-equivalent of the inexpensive, but taste-impaired waxy chocolate chips.



## ➤ ECONOMIC OUTLOOK

### Nonfarm Payrolls: Fewer Jobs Created Recently

A strong, thriving US economy creates upwards of 200k nonfarm payroll jobs per month. While analysts expected our job creation to keep those levels in early June of this year, the reports were woefully below expectations. As initial jobless claims surged and payrolls wobbled, the domestic unemployment rate ticked back up to 9.1%.

Nonfarm Payrolls



### ISM @53.5: Domestic manufacturing slowing

Perhaps this blip is a lagged result of the earthquake in Japan or storms and tornadoes in the South, but regardless of why, we're now approaching contraction in the domestic manufacturing sector. Preferred levels during expansion range from 55 to 65, an area we're dropping below only now after a solid year and a half of recovery from the 2008-09 recession.

Institute of Supply Manufacturing Index



### Rising US Exports: What A Weak Dollar Gets You

There aren't many economic charts that are back above their early 2008 levels, but the total US trade balance is not only well above those levels, but also at 20-year highs. Not surprisingly, it seems to have correlated with painfully evident weakness in the US Dollar relative to foreign currencies. If you haven't yet noticed, our US dollars will get us only .95 Canadian cents.

US Exports



## ➤ SOCIAL MEDIA IPOs: MAKING EVERYTHING ELSE CHEAP BY COMPARISON

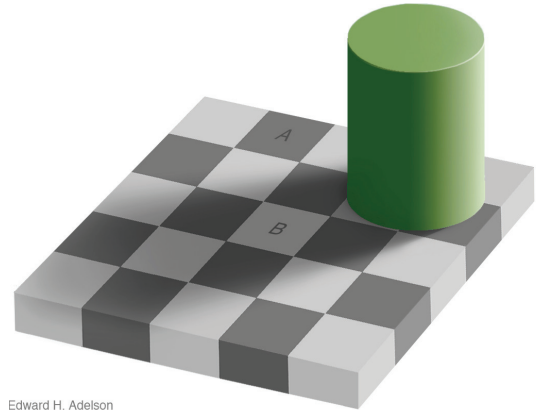
In the movie, *The Social Network*, a scene was recreated from the early days of Facebook in which Sean Parker, the more experienced internet guru, explained the possibilities for the social networking site to its young founders. He says, "How big can it get? How far can it go? This is no time to take your chips down. A million dollars isn't cool... you know what's cool - a billion dollars."

If a billion dollars is "cool," then what word defines 100 billion dollars? Is there even an adjective in the English language superlative enough to describe what has become the estimated IPO value of Zuckerberg's college creation? What is a reasonable valuation for a company that is a destination for more than 42% of web users (Alexa), is adding users at a rate of 10+ million per month (Inside Facebook), and will generate an estimated \$2 billion in 2011? If that's the case, a \$100 billion IPO might be an understatement, as the trend for new social media IPOs is hardly a paltry 50x p/e ratio.

Social media is clearly the theme for 2011 Initial Public Offerings (equity trading debuts in which private companies sell shares on the public market for the first time). In May, LinkedIn began trading at \$50 a share, quickly rising to almost \$95 per share before recently settling back to \$60. At \$60 per share, it's trading at roughly 335x next year's earnings. Assuming it can grow earnings at expected projections of more than 100% per year, its valuation is still in a radically different realm than other strong growth companies on the market.

At those valuations, even with growth metrics that hearken back to the year 2000, it's hard to justify making an aggressive case to buy despite the cost. After all, the first rule of growth investing is "Don't overpay."

What is exciting, though, about these new entrants to the public ownership market is that when LinkedIn, Facebook, Twitter, and others are fetching ridiculously high premiums for their growth, the valuation of existing strong-growth tech companies like Apple (at \$315 is trading at a forward p/e of 12.7) will seem outrageously cheap by comparison.



Edward H. Adelson

It's a simple truth of human nature that we see things in relative terms. Consider the image above. It seems the B checker box is much lighter than the A box, but go to the trouble of folding this page so that the boxes are touching, and you'll see that they are actually the same shade. In the tall shadow of the p/e ratios of new social media stocks, we'll perceive new value in other growth names that have stalled.

While this is far from a proven mathematical formula which will demonstrate and calculate inordinate value, it reveals a human tendency that can be exploited in a world where perception at the moment is the reality, and many very effectively argue that the stock market is exactly that kind of world.

## ➤ WELCOME RAINBOW CAPITAL

We are pleased to welcome Mr. Andy Goodman and the clients of Rainbow Capital, LLC. In the second quarter of 2011 we completed the merger of our firms and have been taking the opportunity to get to know our new clients. Yellowstone Partners President, Dave Hansen says he is "glad to be in the unique position of being able to grow our assets under management without impinging on the high-level quality service and attention our clients have come to expect."

"I made this decision based on a careful analysis of our respective firms and the benefits for my clients," said Rainbow Capital principal,

Andy Goodman. "I'm particularly pleased to be joined by Rick Baird, CFA, as co-manager of the large-cap value strategy that has been the cornerstone of Rainbow's investment management."

Over the course of his 25-year career, Mr. Baird has achieved an impressive record of managing value stocks and municipal bonds. After holding key positions at Zion's Bank and First Security Investment Management, Rick founded Wind River Advisors, which also merged with Yellowstone Partners in 2009.



## ➤ FIXED INCOME UPDATE

*Rick Baird, CFA*

Bonds were once the province of investors who valued stable principal with a steady income stream. However, recent years have seen increased volatility as investors swing between a flight to quality and anticipation of coming inflation. Throughout much of this period, some investors have stayed on the sidelines waiting for the Great Bond Selloff. This never seems to materialize except for brief spurts in yield which are quickly reversed. We think there are several factors to consider in today's bond market:

### Bonds Versus Money Funds

In reading many of the mass-market financial publications, such as Money magazine, we're struck by how often commentators say rates on bonds can only rise from here. Never mind that they've actually fallen. Investors need to differentiate between longer bonds and short-term fixed-income such as money market funds and treasury bills. Short rates are controlled primarily by the actions of the Federal Reserve, while intermediate and longer bonds (including mortgage rates) are primarily based on inflation expectations. We agree that since short rates are near zero, that over the long-run they will rise. However, 30-year treasury bonds are currently around 4.30% - toward the upper end of the 5-year range of 2.6% to 5.3%. In municipal bonds, the 30-year AAA bond is normally 2.25 percentage points over the 2-year municipal. Today, this spread is 3.86 points; and despite the recent decline in rates, the absolute level of 30-year municipal bonds is higher than it was throughout much of 2006. We believe investors are being rewarded to moderately stretch out along the yield curve. Even if we were to experience an end to near-zero short rates, a typical market response over the past 15-20 years has been a "twist", where short rates rise and longer rates actually decline or remain stable. The opportunity cost for investors of staying short is considerable.

### Inflation

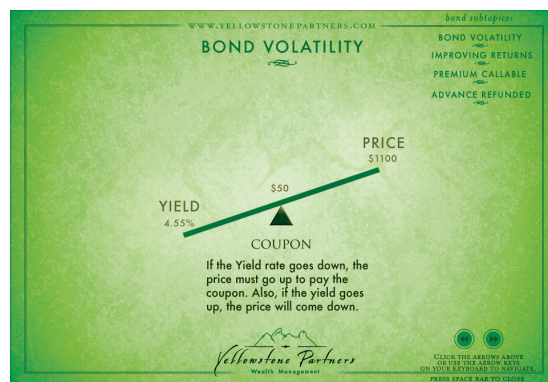
Since longer bonds trade off of inflation expectations it is important to note that structural inflation tends to be primarily due to capacity constraints and labor force pressures from a rapidly expanding labor force. Neither are a concern at this point. In fact, in January we saw the official beginning of a long wave of retirement for the baby boom generation. This demographic development will continue to moderate interest rates as retirees position portfolios

for greater income. A related concern has been the rise in commodity prices. This rise was mainly a 2010 response to government intervention in the markets. 2011 has seen many of these price rises reverse. We view a rise in basic commodities, such as oil or food, as similar to a tax on consumers. All things being equal, taxes are generally deflationary since consumers are less able to purchase discretionary items. It is interesting to note that from January 2002 to mid-2008, the Rogers International Commodity Index rose about 350% - 26% annualized, yet consumer prices rose only 3% annualized.

### Federal Reserve Actions

Investors have been concerned about the end to the latest quantitative easing program and what it will do for bond prices. We believe the Fed will monitor results closely to see if it impacts consumer spending as the higher commodity prices did. In any event, we don't see short-term interest rates rising until possibly after the elections of 2012. Rather than pressure interest rates on the upside, we have said for over a year now that the more logical outcome of an expansive Fed is to pressure the dollar, particularly against currencies of countries running current account surpluses. We also think that the Fed's balance sheet will shrink when the economy strengthens, and the Fed will reign in the extra cash to head off inflation. We think this provides a stable foundation for bond returns.

For more information on our bond strategy visit:  
[www.yellowstonepartners.com/bonds](http://www.yellowstonepartners.com/bonds)



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