Jack Adamo's Insiders Plus

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Dear Friend & Client,

Thanks for joining me.

The market went on a Christmas tear, reversing the year-end profit-taking the first week of the month that looked like it might take hold. I don't know what the final figures will be, but it will probably be one of the biggest yearly market gains since 1999, the year before the tech bubble peaked, then crashed.

There is little doubt the market is overvalued. What doubt there is comes from some "this time it's different" scenarios. The most popular of these are the recent pickup in GDP to 4.3%; the U.S.'s new found energy independence; the continued unprecedented Central Bank accommodation; the low cost of capital, and the low cost of labor. The last one seems to me to have the most validity, however, it also seems that all of these factors have been discounted by the market to some extent.

With all these moving parts, it may be that traditional valuation measures are not relevant, but, lest we forget, that has been the cry in all prior bubbles. That leaves me in a frame of mind to listen to the old-timers who have consistently gotten it right in the past, regardless of the new wrinkles floated to justify market prices. Tops on that list is Warren Buffett. He recently said in his typically low-key, understated manner, that he is finding it difficult to identify bargains in the market now. Of course, the size of his portfolio limits the market-cap size he may look at, so one could argue that there are perhaps still some cheap stocks among the small caps. However, we must also keep in mind that Buffett is very careful about what he says about the market and how he says it. He knows the pull he has. He deliberately tones down his comments.

Jeremy Grantham, Ben Inker and the other folks over at GMO Capital are the other extremely reliable source of accurate market evaluation over a long period of time (since 1977). In its recent letter, GMO said all stocks are currently over-valued, with the small caps more so, and emerging markets less so. That gives some justification for our in stocks like Banco De Chile, Philippine Long Distance Telephone and Sasol Limited. It also explains why we're only 43% invested in the Main Portfolio. In early November GMO was slightly more than 50% invested in stocks; about 20% in bonds and 30% in cash. With the run-up since then, we may safely assume its stock allocation is closer to that of our Main Portfolio. I'm heartened by that news.

I should point out that, like us, GMO has substantially underperformed the market this year, but lest you think the company's market view is sour grapes, note that its flagship fund (which has a minimum investment of $1 million) has beaten the market and outperformed 84% of all funds tracked by Morningstar over the last decade.

Despite this view, Grantham says it is possible the market could rise another 30% more over the next two years, given the actions of the Fed and other Central Banks, as well as the herd instincts of the market. He is resigned to underperforming over that period; GMO invests on value, not trends. There is too much guess-work involved in the latter. The record shows we too are good at gauging value and very bad at guessing crowd behavior, so I concur with this approach.

John Mauldin, who has for many years brought us the choicest nuggets of wisdom from many deep-thinkers, recently had this to say about the situation: "The majority of market players appear to believe that another crisis might materialize, but in the meantime you have to dance while the music is playing."

This ties in into something the folks at GMO said about money managers following the crowd to protect their jobs. If they lose money while everyone else is, their jobs are safe. If they underperform while their colleagues are showing high returns, they're out on the street. Unfortunately, when the music stops, the casualties are high as people rush for the exits. That's why we lost practically nothing in 2000 and just 23.1% in 2008, compared with 38.5% for the S&P 500. Nonetheless, the fund managers' strategy is probably correct for their own self-interest, although not necessarily their clients'. I suspect few lost their jobs as long as they were near the market average loss.

Should You Gamble?

I think I just made a pretty convincing case for not following the crowd, but let me reinforce it with a few reasons why the bubble might deflate sooner than expected, a possibility that Grantham himself acknowledges. Two things that almost converted me to a bull were recent strong auto sales and large increases in home sales, along with the recovery in home prices. Housing especially, has an outsized effect on the economy. However, after further research I became less enthusiastic.

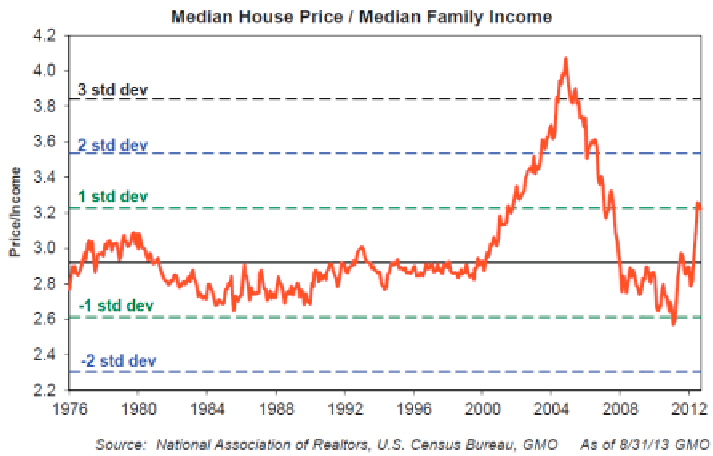
As it turns out, the very same driver of the credit bubble in 2004-2007 (besides Fed largesse) is back in full force. Securitization. Subprime auto-loan-backed securities are projected to set a new record in 2014. Collateralized loan obligations (CLOs) are close to all-time highs after almost disappearing in 2009. The proportion of all-cash deals for homes purchases has doubled since May, *to 42%*. Why is this a problem? Because this doesn't represent normal economics. Very few people buy homes for cash to live in. This is investor money.

Again, why is that a problem? Because it is another wave of speculation and it's accelerated by what Mauldin calls "an almost desperate reach for yield and shouldering of risk." I have no way of ascertaining what percentage of this buying for rentals is by individual investors, but the drive for yield has spawned a new raft of REITs investing in stand-alone homes. These shares are sold like mutual funds to people looking for income, who are now being tricked into the same trap they fell for with mortgage-backed securities a few years ago. The result will be the same.

The level of subprime debt won't be the deciding factor here, the weakness of the investment cash flows will be. Managing groups of stand-alone houses is far more costly than managing apartments or offices. I don't know how long it will take for this to go sour on the investors, but in the meantime, it is distorting the price of housing significantly, making it less affordable for owner-dwellers. The following graph is alarming:

Since April, the number of mortgage applications has plummeted, while homebuilders, flush with confidence over rising home prices, have increased housing starts parabolically. Meanwhile, as the next chart shows, the ratio of the median home price to median family income is rising back into the nosebleed territory it has only seen once in the last 40 years. Right now it is only one standard deviation above the mean, but that mean was stretched by the bubble and 2009 crash.

Except for that period, it may be closer to two standard deviations, meaning it is farther away from the prior norm than 95% of all data points. I don't know how far off the reckoning is, but this will is unlikely to end well if it continues. The Fed has not learned anything from its past adventures.



Our Plan

I currently have no plans to significantly increase our allocation to common stocks. We will keep an eye out for bargains that emerge due to specific circumstances, but we're not likely to buy the market as a whole. We will maintain our gold positions in case of high inflation, although I hope to find a good opportunity to convert them back to common stocks rather than options. We may also buy more preferred stocks for the High Income Portfolio, since I think a period of deflation or very slow growth is also a strong possibility. There are so many never-before factors at work here that it's impossible to be sure which scenario will eventually play out.

For now, I would be judicious in buying stocks in the portfolios. I'm not seeing any clear firming in our emerging market stocks yet, so I'd focus more on dividends. It's hard to say whether letting cash lie fallow will eventually bring a better return via lower stock prices than we will make on dividends while we wait for the big slide. You may have to make that decision based on your cash flow needs. I'm currently looking at a few more preferreds that I may recommend within the next few weeks.

There are no portfolio updates this week.

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That's it for today. I look forward to talking with you again soon.

Jack

Questions? Write to Jack at: jack@jackadamo.com

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