ALAMAR
CAPITAL MANAGEMENT

January 16, 2015

The markets did very well in 2014 after an even better 2013. While we made money for our clients, we underperformed the broader equity market primarily because of our smaller company bias, large cash holdings and underperformance from some of our longer-term holdings. Our equity holdings were up 4.2%, after fees. Since inception five years ago, we have returned 17.4% annualized, net of fees.

We began the year with one of our investments (DirecTV) being acquired by ATT and closed out the year with another investment bought out by private equity (Petsmart). Since inception we have had a number of our investments acquired at substantial premiums by corporate acquirers and private equity and we expect that trend to continue.

Over the course of last year, as stock prices ran up, we steadily raised our cash holdings such that we ended the year with over 20% of the portfolio in cash. While we would like to be more invested in stocks, we have found it difficult to find attractively priced stocks in this environment. In stark contrast to investor sentiment when we began, there is now widespread optimism everywhere. According to a recent Barron's Magazine poll, not a single Wall Street strategist expects a market decline in 2015! Indeed, expectations are for another double digit return this year. Over the last 5 years the S&P 500 has more than doubled and valuations are beginning to look stretched. In our opinion, the time for investor exuberance is in the rear-view mirror. We will explore this further in the rest of this note.

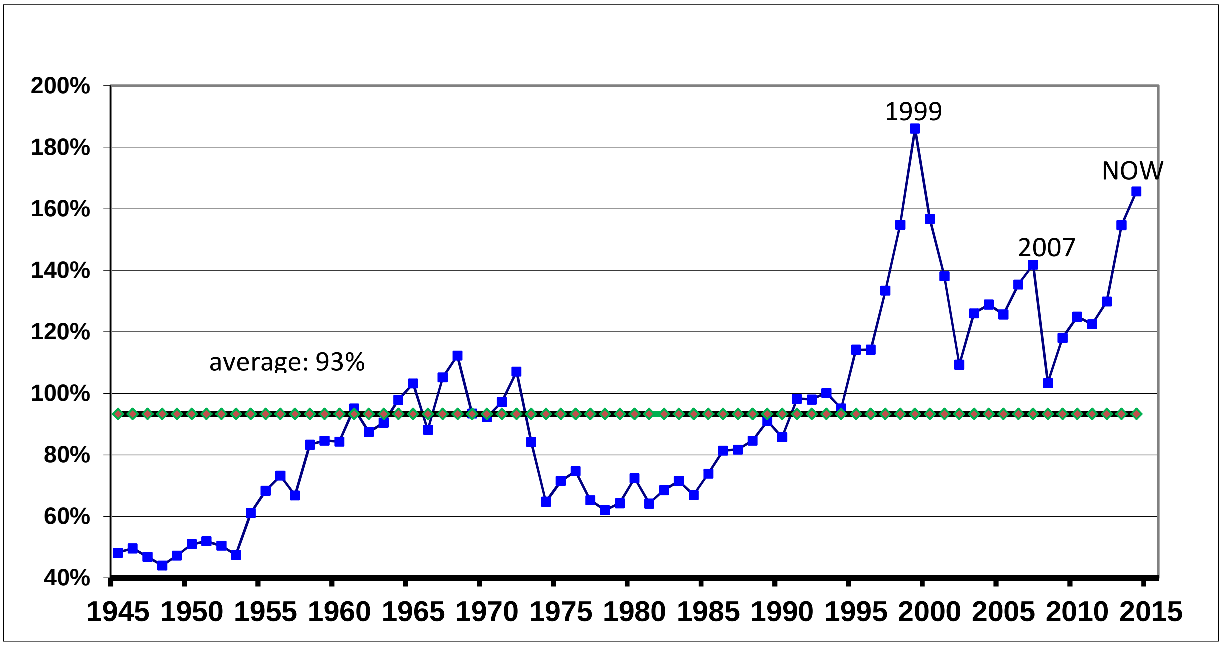
During the course of our investment analysis we also keep an eye on other asset classes such as bonds and real-estate. We have discussed our thoughts on bonds in previous writings but have not addressed real-estate before. In this note, for the first time, we will also discuss what we are seeing in the US real-estate market.

EQUITY VALUATIONS

We believed it was an opportune time to invest when we began Alamar five years ago. The stock market had been obliterated due to the crash of the financial and real-estate bubbles. The economy was slowly climbing out of the Great Recession and investors were fleeing equities in droves for the safety of cash and Treasuries. We found plenty of well-managed businesses at attractive stock price valuations in that environment. We knew that provided the economy did not suffer another catastrophic drop (the dreaded double-dip), these companies would do well and their share prices would follow accordingly. Fortunately for us, the economy rebounded, albeit anemically, and we capitalized on the opportunity to generate strong returns. The picture now, however, is almost the opposite of what we saw 5 years ago.

For instance, one of our retail holdings (JoAnn Stores) was acquired by private equity firm Leonard Green in 2010 for a bit over 6x cash flow. Fast forward 5 years, another of our retail investments (Petsmart) is being acquired by a different private equity firm (BC Partners) for a much higher multiple, 9x cash flow. We bought Family Dollar at our inception in 2010 for 4.5x cash flow and the company will now be acquired by either Dollar General or Dollar Tree for over 10x cash flow. We see similar examples in other industries and we were curious if this was a market-wide phenomenon. One of our favorite valuation indicators, espoused by none other than Warren Buffett, is to look at total market value to nominal GDP. Instead of equity value we use enterprise value by adding debt and subtracting cash on corporate balance sheets. **Figure 1** plots this ratio since 1945.

Figure 1: Value of US Businesses as % of GDP



Source: *Thomson, BEA, Federal Reserve*

As seen in the figure, the average for this ratio in the post-war period has been 93%. That is, the total value of publically traded US domiciled companies has averaged roughly 93% of total US economic output. When we started in 2010 this ratio was 118% and it has now reached 166%. It is now higher than the ratio in 2007, just before the onset of the Great Recession, and only the internet bubble of 1999 surpasses the current value. The ratio could go even higher from here and surpass the 1999 levels, however we are cautious. Chuck Prince, ex CEO of Citigroup, on the eve of the sub-prime meltdown, had the infamous quote "As long as the music is playing, you've got to get up and dance." While the music is still roaring in the current cycle we are not enthusiastic participants; we are starting to look for the exit.

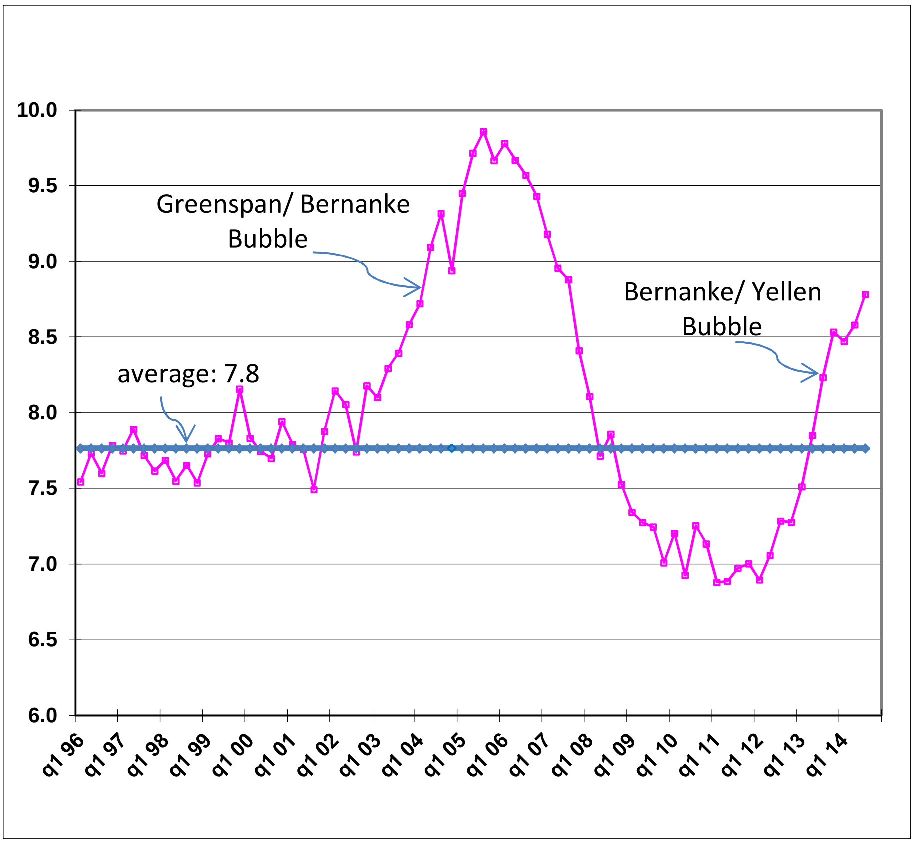
We were curious if we would find similar valuation problems in other asset classes. So, we took a look at US residential real estate.

US RESIDENTIAL REAL ESTATE

During the course of our equity research we analyze numerous home builders as potential investments. These companies provide a good window into the state of the housing market and have helped us in the past in timing our entry and exit into and out of real estate investments. We track over 10 US home builders with operations across the nation. These builders represent over a third of the overall market and we feel they are a good proxy for the state of the market.

Over the long-run, home prices cannot grow faster than personal disposable income since the savings from income must be used to pay-off the purchase of a home. In the short-term there may be deviations from trend growth as we saw from 2003 to 2006, but eventually the laws of economics reassert themselves. To plot the graph below, we obtained national average new home prices from the builders we follow and calculated a ratio of this price to personal disposable income. **Figure 2** plots this metric since 1996.

Figure 2: New Home Price to Personal Income



Source: Company Reports & BLS

As seen in the plot, the ratio was fairly consistent until mid-2003 when the easy money policies of the Federal Reserve under Chairman Greenspan and loose lending practices led to a house price bubble of historic proportions. Economic forces eventually caught up with the bubble and by late 2006 the party was all but over and the dancers were forced off the floor. As has happened so many times in history (for a great review we recommend Kindleberger's book, *Manias, Panics, and Crashes: A History of Financial Crises*), the mania was followed by panic and then a historic crash. Notice in the figure that the time spent in the bubble (above the average trend line) was almost exactly the same as the time spent in the crash (below the trend). This is as it should be for the excesses built up during the mania need to be wrung out to bring the system back to equilibrium.

Unfortunately, as the Figure shows, we are now in the process of building another housing bubble once again due to easy monetary policies by the Federal Reserve. While we have not reached the peaks of the prior boom we are nevertheless more than 1 standard deviation above trend. Another 10% increase in home prices will get us back to the prior peak. History is in the process of repeating itself.

CONCLUDING THOUGHTS

Market valuations are beginning to look frothy to us. Much optimism is starting to be priced into stocks as seen by the high prices paid for acquisitions, near record merger & acquisition volume, booming initial public offerings (IPO) and private company fund-raisings at substantial valuations. We see similar dynamics at play in the residential real estate market as well, in particular for new homes. We believe easy monetary policies are partly to blame for this frothy environment and we are having difficulty finding attractive investments. Notwithstanding the euphoria, we continue to look for attractive investments in a disciplined fashion. While we continue to see growth, albeit anemic, in corporate earnings, valuations are stretched. Therefore we are maintaining a healthy cushion of cash to capitalize on opportunities we believe will arise as inflated investor expectations are not satisfied.

Thank you for your continued trust and confidence in Alamar Capital Management.

Disclosures