

# The Gazette

## What I would favor and what I would avoid in 2012...

First of all, let me wish you all a happy new year: Health, love and good returns on your portfolio. While we're on the subject, I like to start a new year with a quick portrait of the market opportunities that lie ahead. The opportunities that look most promising and the areas I feel should be avoided. As you now must have realized, I am a long term investor. I consider myself an owner of the companies I purchase (through the stock market). I hold my stocks on average for five years or more. So, I do not turnover my portfolio at the beginning of each year based on some combination of prognostics. But I like to do a survey of what I believe looks undervalued and what does not.

I know some investors (should we call them speculators?) that at the beginning of the year look at the year that just passed and sell what has "not worked" and buy "what has done well". This is not a winning strategy. In fact, one should look at only two variables: market price and intrinsic value (the latter needs a little more work). What is popular - and usually has done well lately - is rarely undervalued. Warren Buffett said a few years ago: Beware the investment activity that produces applause; the great moves are usually greeted by yawns.

So what would generate yawns today? First on the list: US financial stocks. For example, American Express is a solid company that has a unique brand name. They should earn around \$4.30 per share in 2012. And the stock is only \$48. In 2007, before the financial crisis, the company earned \$3.37 and the stock reached \$63. So the price to earnings ratio has fallen from 19 times to 11 times. The company has proven that it can survive the worst of financial storms. So its P/E should reflect that. Visa and Mastercard, for example, trade at 17 times earnings. Although its business model is more integrated than its two main competitors, Amex looks quite undervalued.

Many US banks also seem undervalued. Wells Fargo and M&T Bank, two of the best banks in the country, trade at around 10 times earnings. Another example of what looks undervalued to me is Goldman Sachs: it trades at close to a 30% discount to book value. To me, Goldman is the best investment bank in the World. It was founded in 1869 and has successfully navigated numerous recessions and bear markets. It pioneered the IPO (initial public offering) market like the 1906 IPO of Sears, Roebuck and Co. The company is the Rolls Royce of investment banking for many corporations.

Now if you look at the stock, it is at the same market level that it was a decade ago even though book value has increased by 250% (13% annually). I believe this an undervalued company.

I also see interesting investments opportunities in the tech arena. Companies like IBM, Texas Instruments and Google are – in my opinion – well managed and should warrant a higher valuation. Google is one of the best businesses in the World and trades at only 15 times this year's estimated earnings.

What would I avoid? Although many commodities have fallen in price lately, many commodity related sectors still look a little pricey. Personally, I would avoid gold related investments. Also, residential real estate prices in Canada are too high. A stagnation of prices (or even a fall in price) would have some consequences on the valuations of many related Canadian companies. Banks, for example, are cheaper than they were a few years back but they could be affected by a drop in real estate prices as consumers may experience financial troubles.

But the mother of all popular assets is easy to find: treasury bonds. Investors are still buying bonds over stocks by a large number. Ironically, they are avoiding stocks by arguing that western governments are drowning in debt. Their solution: they put their own money in bonds, the very same asset they consider dangerous. In other word, they are fulminating against high debt and at the same time they are putting all their money into it! And moreover, at very very very low yields. When it comes to money, human beings can often be self-contradictory. One consequence of high debt will eventually be more inflation. If inflation is 3-4% going forward, how can buying debt at 1-2% yield be a winning move?

The S&P 500 has a P/E of 12 times earnings or the equivalent of an 8% earning yield. Ten year treasury bonds yield 2% so their equivalent P/E is 50 times!! Looking at it this way, US stocks look much more attractive than bonds.