

## 2013 Second Quarter Investment Commentary

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“Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria.”

-Sir John Templeton

“The World Economic Forum ranks the U.S. 25th in infrastructure, well behind most of our major competitors...Studies show that every \$1 billion in infrastructure spending can create more than 20,000 new jobs....Regrettably, the only infrastructure spending Congress seems inclined to authorize is \$30 billion to build and man hundreds of miles of fence along our Mexican border. So as China is building modern infrastructure, we are looking to build our own Great Wall, except that we are keeping out farm workers instead of the Mongols.”

-Sheila Bair, former chair of the FDIC, as published in Fortune

“I want the economic wheel to keep turning. I don't care about Sharia law; I'm just looking after my business.”

-Sameh El Sahihi, Egyptian shop owner, as reported in Bloomberg BusinessWeek

On May 28, the DJIA closed at 15409, its 23rd all-time high of the year, and the S&P 500, closing at 1669, reached its 17th all-time high on May 21. Prices in equities and bonds weakened during June as the DJIA closed the month and quarter at 14910 and the S&P 500 at 1606. The record highs may be partially attributed to money flowing out of bonds and into large capitalized, dividend paying US stocks, as money managers sought “safety” and yield alternatives to bonds. Bonds finally began to weaken during the final weeks of the quarter after Chairman Bernanke hinted strongly that the Feds support for near zero interest rates will diminish as economic growth strengthens. The sell -off in bonds was fast and furious, probably overdone, and this hurt performance of any portfolio that held them. Fortunately, the accounts we manage don't hold a preponderance of bonds. We have been shying away from fixed income assets for the past four years, noting their historic low yields and valuations above par. The equity averages resumed their march towards additional record highs as we entered the third quarter after their slight June retreat, with the DJIA striking its 26th record high of 15484 on July 15 and the S&P 500 its 20th of 1683 on the same day.

Sooner or later there will be a shift out of the large cap, dividend paying, well-known companies and into lesser known ones. This should boost our returns above these well- known indexes. This may take longer than I expect, after all the bond run lasted about three years longer than I thought it should have, but it will take place. Meanwhile, we are happy with our gains. We are up an average of 5.5% in all accounts for the first six months of 2013, and look forward to continual appreciation in our positions. While our advance is less than that of the DOW (up 11.08%) or the S&P 500 (up 11.59%), our portfolios are more diversified and tailored to each clients' investment profile. Relative to 6-month CD's, which currently yield about .80%, bond investments (most are down for the year) and hedge funds,

up an average of 1.4%, we're ecstatic with an average of 5.5%. Using the Vanguard funds as proxies for the bond market, we note that the Total Bond Index Fund (BND) is down -3.9%, GNMA Fund (VFII) down -2.6%, Short-term Federal Bond (VFSTX) down -.5%, Intermediate Investment Grade Fund (VFICX) down -3% and finally iShares TIP Index Fund (TIP) down -7.7%. Our best performing portfolio was up 15.96% for the first six months.

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One of the most favorable characteristics about this market is that enthusiasm still can't be found. Investors are still scared and are not pouring money into equities. There is still too much trouble in the world, at least according to news casts, and this keeps enthusiasm at bay. Such an environment points to slower growth in equity values over a long period of time. I like this and we can take our time adding to positions during times of market sell-offs.

One such sell-off came during the closing weeks of June. We were fortunate to have added new cash to selected investments during the June 19-26th period. We'll wait for another shake-out between now and October to add again. Meanwhile, as we did during the first half of this year, we will accumulate our dividends while we wait.

I wish to touch on two topics during the balance of this letter: the value of periodic adding to your accounts and the global demonstrations currently taking place. Then I will offer updates on some of our winners and losers.

The volatility of equity prices never ceases to amaze me, as the mood over a stock, or the market in general, may change quicker than night turning into day. One day a company's stock price will be at \$116 and then fall to \$17 in what seems the blink of the eye. We observed this with Green Mountain Coffee Roasters (GMCR), Cree (CREE) and First Solar (FSLR) over the past year. In June 2011 Green Mountain Coffee Roasters was trading at \$116. We loved the product Green Mountain produced, but found the stock too rich for our purchase. The stock came under pressure because its' patent on the Keurig cups was due to expire in September 2012. The stock fell from \$116 to \$17 by July 2012. We had our fingers on the trigger at \$17.50, but couldn't pull it. Before too long it ran away from our comfort level and trades today at \$80. Cree and First Solar underwent the same trajectory. Fortunately, we grabbed a few shares of each for some accounts (those with available cash) and watched these rebound with us on board. We hope for the same action with Pen Growth Energy (PGH), Spyglass Resources (SGLRF) and Companhia Siderurgica Nacional (SID), all currently trading near their all-time lows. We hold these in just about all of our accounts. We added to all on weakness this year. All pay above average dividends, 14.8% in SGLRF's case.

To underscore the value of investing during times of market weakness, I offer another actual example from our files. A \$250,000 portfolio on July 2011 fell in value to \$210,000 by July 2012. Today it is worth \$282,660 with the same exact holdings. Had the investor added to this portfolio when it fell to \$210,000 and bought the same exact holdings, the overall gains would be 22.6% over the past two years or a little less than twice the 14% return on the original \$250,000. We've stated over and over again through the years that market timing is rarely successful over the long-term and we don't profess to be market-timers. But, stock picking has worked well for us. Don't lose heart when the value of your investments fall, most of the time when given sufficient time, they will recover.

We still have several of our purchases that we made in 2011 still under water. They will come around in the fullness of time and now, while their values are less than our original purchase price is the time to accumulate additional shares.

We had several big winners over the past six months. These more than made up for the losses in the laggards and fixed income holdings.

Great Batch (GB), an investment we originally made in January 2008, gained 41% over the past six months. We watched this stock fall to \$15.5 during our ownership before it reached its current price of \$36. We hold

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gains of over 65% since our purchase. Waiting five years to be rewarded underscores the fact that investing is a long-term activity. The quarter-to-quarter short-term focus of investors today should be ignored.

Power One (PWER) is up 54% since December 31st. Of course, we know that ABB will purchase the entire company at \$6.35 per share. We commenced our investment in PWER in 2004 and have been adding whenever the stock fell and we had cash available.

Cree (CREE), one of the recent fallen angels that we were lucky enough to jump into (for some accounts) jumped 88% over the past six months. We can never have enough of a position like this, but must be happy with that which we do own.

Boeing (BA) rose by 36%. We've held BA since 2002 when we made our initial investment at \$29.50. The stock is valued at \$107 today. Our overall gain since 2002, excluding dividends, is 221%.

Cedar Fair (FUN) rose 24% since the start of the year, not including its 6% dividend yield. We made our initial investment in FUN in 2004 and continued through 2009. We have 108% in overall appreciation, as the stock is valued at \$42 today. This stock fell as low as \$5.80 after the 2008 debacle. Apollo Global Management attempted to take the company over at \$11.50 in 2010. Fortunately, stockholders rejected this offer and were rewarded with the current fourfold increase in our stock price.

Vertex (VRTX) jumped 91% over the past six months. We commenced our investment in VRTX in 2001 and continued buying through 2006. Our overall gains today are 296%.

First Solar (FSLR) rose 45% through June 30. We hold shares of FSLR in only several accounts and these have overall gains of 65%. We began accumulating FSLR on December 2011, but the real winners in FSLR are those for whom we bought in 2012 when the stock tumbled to \$14. Today FSLR trades at \$48.

Marvel Tech. (MRVL) gained 61% through June 30. Proshares Financials ETF (UYG) gained 37.7%. Health-South (HLS) gained 36.4%. Brooks Automation (BRKS) gained 20.9% and Health Management Associated (HMA) jumped up by 68.7%.

Overall these results restore our enthusiasm in our work.

Our laggards during the first half of the year include: BHP Billiton (BHP) down 26.5%; Teck Comino (TCK) down 41.2%; Spyglass Resources (SGLRF) down 27.6%; Companhia de Saneamento Basico(SBS) down 25.3%; Companhia Siderurgica Nacional (SID) down 53.1% and Wal-Mart de Mexico (WMMVF) down 14.1%. You may ask why we didn't dump these or why do we still hold them. Well, despite the recent loss in value, we still have substantial gains over our cost in most of these positions and find the present weakness more of a buying opportunity than a cause to unload. We began our purchases in BHP in 2005 and still sit on gains of 126% even after the recent loss in value. TCK was originally spun out of Fording in 2008. We added during the market downturn of 2008-09 and still hold gains of over 400% in the accounts that have held since the initial spin-off. SGLRF, originally spun out of Provident Energy, currently posts losses in all accounts. Formerly PACE Oil & Gas, this company completed its merger with Charger Energy and Avenex Energy to form Spyglass in March. The company initiated a dividend in May and currently yields 14.8%, paid monthly. This Canadian oil & gas exploration company has virtually no U.S. analysts following the stock and therefore few promoting it. It hurts to hold this, as we're reminded of our losses every day we look at it. However, we're looking at this as a sleeper and with the dividend initiated are happy to collect our .0225 cent per month while we wait. We added to all accounts that hold SGLRF in June when the markets were weak. We began our purchases of SBS, a water and sanitation company in Brazil, in 2010

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and hold overall gains of 81% on these initial purchases. We used the recent weakness to add to our positions on June 19th. SID has been a perpetual bad investment for us. Our “brilliant” play on Brazil, the 2014 World Cup and the 2016 Olympics has proven less than stellar at this point. Nevertheless, hope springs eternal (or at least for a few more years) and we continue to accumulate SID. We also like the dividend, now at 5.6%. Wal-Mart de Mexico (WMMVF) has been a winner for us since 2003 when we began our purchases of this company. We have current gains of 295% in this position despite the recent 14% loss in value.

Overall just about each of our “losers” over the first six months of 2013 are long-term winners. And while, they may have brought our overall performance down a few notches, should more than make up for lost ground in the future.

Francis Fukuyama recently wrote an article in the Wall Street Journal concerning the demonstrations in China, Turkey, Egypt, Portugal, Spain, Tunisia, Brazil and elsewhere in our world. He frames these as economic issues rather than religious. These have more to do with lack of economic opportunity for educated, bright, internet-connected middle-class young people in these countries than whether one is Sunni or Shia. Governments are not able to keep up with the progress of their citizens and are therefore unable to provide opportunity to keep these minds productively engaged. Lack of economic opportunity is at the core of what is taking place. Steve Jobs was right in asking John Sculley whether he wanted to spend his life selling sugar water or changing the world. The computer, the smart phone and the internet opened the doors of communication for our globe. Governments will have to change in order to foster a climate that encourages innovation, property rights and fairness among its citizenry. Otherwise, they will be toppled. While potentially scary, these demonstrations are good a development for people globally.

I say the U.S., with all its blemishes, still provides one of the best environments for economic opportunity. However, this could change should we continue on a path towards closing down our borders and creativity. Much like China did in the 1435 when it commenced to close down its’ expansionary trading endeavors , only to lose its dominance in global affairs and innovation. Any country that follows the same path will find the same result.

The estimated global middle class will grow to 4.9 billion by 2030. This is up from 1.8 billion in 2009 according to the European Union Institute for Security Studies. Imagine: where will we fit in? Which investments shall thrive in such an environment? Mr. Fukuyama’s book, *The Origins of Political Order: From Pre-human Times to the French Revolution* may offer more insight into his thinking. If you have the time, pick up a copy.

The shares we bought during the June weakness include Ares Capital (ARCC) with a yield of 8.6%, Spyglass Resources (SGLRF) with a yield of 14.8%, Cia Energetica de Minas Gerais(CIG), an electric company in Brazil, yield of 8.1%, Companhia de Saneamento (SBS) yield of 2.6%, Veolia Environnement (VE), a French global waste services company, with a yield of 6% and Templeton Emerging Market Income Fund (TEI) with a yield of 6.8%. These add additional foreign exposure to our portfolios and round out our participation in the global growth story.

We are enclosing your six-month performance report (through June 30th) and your inventory of assets, as of the date of mailing, for your review. Chris and I review each of these personally before we mail them to you each quarter and often jot notes in the margins. Please consider these. Your overall yield on your investments is posted on the last page in the bottom right corner.

## **Michael J. Porro & Co. 2010 Third Quarter Investment Commentary**

Please give us a call should have any questions. We look forward to hearing from you. Any comment on my letter is most welcome.

In closing, I once again on behalf of all of us here, thank you for your continued business and confidence. Our best wishes for the remainder of your summer and autumn months.