Blue Chips with marked “scarcity and EM” exposure

From energy to agriculture infrastructure, harvesting “chokepoint scarcity”

August 2013

Opportunity

For qualified, strategically-oriented accounts capable of making satellite allocations and considering risk primarily as “long term impairment of capital/purchasing power” instead of near-term volatility, we would like to offer, pending sufficient interest, the option of investing in a US-centric Blue Chip portfolio (“the discretionary portfolio” or “the portfolio”) consisting of 21 stocks currently (15 or more positions be held at all times, the majority of which would constitute American multinationals). The equity ownership would be in enterprises focused on providing the energy, agricultural, and transportation infrastructure solutions that will prove so vital to enabling sustained emerging market (EM) economic/productivity growth while also capitalizing on the stout EM consumption growth that infrastructure buildouts will enable.

We believe that select US global corporations and the Swiss-headquartered Nestle, with material (15% plus) revenue or earnings contributions from developing markets and/or possessing powerful global brands, are exceptionally well positioned to capitalize on huge infrastructure needs and, by extension, the more rapidly growing emerging/re-emerging markets. Consider China and India. These two nations, with roughly 38% of the world’s population currently, together constituted over 45% of global GDP 190 years ago (Source: University of Groningen, Netherlands).

Moreover, these businesses, which will constitute the discretionary portfolio, often have the ability to exploit the large reinvestment needs of the home market while availing themselves of the higher organic growth opportunities beckoning in the population-dominating emerging markets related to relatively low per capita consumption and relatively high per capita savings in the same markets.

As strategic return on investment (ROI) is highly correlated to what one pays for an earnings stream in the first place, the attractiveness of a discretionary portfolio needs to also be considered along these ROI determining lines. Specifically, if the S&P 500 can currently be purchased for 18.4 times trailing GAAP earnings while featuring a 1.9% dividend yield and a 13% ROE, our equally-weighted discretionary portfolio can currently be purchased for 19.1 times trailing GAAP earnings while featuring a nearly indentical 1.8% dividend yield and a 22% ROE. Upshot: the discretionary portfolio can be purchased for a 4% P/E premium to the S&P 500 while offering substantially superior EPS growth prospects related to the 69% higher portfolio ROE (Sources: Standard & Poors, company quarterly results, Yahoo price quotes).

In addition, we would like draw the “sustainable earmarks of differentiation” characteristics of the discretionary portfolio companies, as a group, to your attention:

1. Feature dominant products/services sold globally and often have sizable recurring revenue streams.
2. Bring substantial trademarks to bear.
3. Have large, material-to-revenues patent portfolios.
4. Tend to be self-financing or free cash flow generating, suggesting shareholder returns will not be diluted through excessive share issuance or external financing
5. Offer visible franchises that appeal to clients’ sense of business success.
6. Have unparalleled global and local distribution, service, and manufacturing capacities in terms of depth and breadth.
7. Command a unique product/service/brand that cannot be easily replicated, e.g., GE gas turbines, CAT 250 ton mining trucks, Monsanto GM seeds, Schlumberger “directional drilling” technology, Apple iPhones, or Disney’s Mickey Mouse !

8. Achieve sustained high normalized ROIs (ROEs with comparably low balance sheet leverage).

Portfolio holdings' "enterprise valuations" (net debt adjusted market caps) will be regularly monitored and compared to fundamental developments and to estimated intrinsic value to determine the attractiveness of portfolio positions. The portfolio management team brings substantial US domestic and thematic/global macro knowledge to the table while also offering multi-decade, "bottom-up" (individual company) experience in the US equity market.

Market commentary

The US economy, in a by now familiar refrain, keeps on tabulating weak real growth. High non-corporate debt levels, growing regulatory and tax burdens, and lingering weakness in the labor participation rate suggest that we will remain in a subpar growth mode for the foreseeable future. Nevertheless, US corporate profitability has risen on the back of cost-cutting and international growth. With lean staffing and comparatively low energy costs, Corporate America is primed for accelerated global and especially emerging market top line growth.

In the interim, however, corporate profits are losing steam, what with sluggish global economies and sales growth at a crawl (Q2:13 S&P 500 revenues are expected to advance by just 1.1% year-over-year). In fact, the recently completed quarter was the fourth out of the past five quarters in which S&P 500 sales grew more slowly than the US economy (in nominal terms).

So how will equity market caps fare in the current environment? Valuations, not economic growth, tend to determine near-to-mid-term stock prices. Valuations take their cue primarily from interest (discount) rates as well as from the supply of and demand for equities. One can argue that stocks still haven't fully discounted today's "quantitative easing" ("QE") impacted, record low discount rates, which would bode well for (higher) multiples of earnings should our "yield deprivation/financial repression" landscape remain intact going forward. What about demand for equities relative to supply? Will it be sufficient to sustain/enhance current valuations of earnings power?

Let's step back briefly. During the 12 years through year end-2012, US pension funds started to diversify away from domestic equities, increasing exposure to both international equities and alternative investments, such as hedge funds and private equity. Evidence shows that in the year 2000 pension funds' allocations were 65% equity-based; by the end of 2012, equities accounted for 52% of pension fund asset allocations. Needless to say, this negatively impacted, at least at the margin, demand for US equities. Portfolio reallocations away from domestic equities were at least partially offset, however, by robust purchases of US government bonds by the rest of the world and by a dramatic expansion, over the past nearly five years, in QE, which has helped to sustain a generational trend of perpetually lower interest (discount) rates, de facto supporting domestic equities' relative attractiveness (Sources: Bloomberg, JP Morgan, Credit Suisse, FT, Towers Watson).

QE has left savers with no yields at the short end and with lacking real yields on 10-year government bonds. Meanwhile, investors can purchase investment-grade equities with earnings yields of 5 - 6% offering a dividend yield (on the S&P 500) of 1.9%, not too far below the current 2.6% 10-year Treasury yield. And this is prior to considering "locked in" dividend increase potential, which tends to reflect underlying EPS growth over time. In addition, vastly superior, to nominal government bonds, equity-based inflation return protection is on offer, because companies can at least partially pass on rising costs.

In 2000, the 1-year trailing P/E on the S&P 500 reached 28. On the heels of a 22% rise in the index over the past year, the current S&P 500 valuation based on 1–year trailing GAAP earnings is 18.4, a 15% premium to the average trailing P/E valuation for the S&P 500 of 16 over a 108-year period. Clearly, the powerful rally during the past 12 months notwithstanding, we are nowhere near the massive overvaluation reached in 2000. And, for a host of reasons, including a desire for improved transparency, liquidity, counterparty risk minimization, and dividend growth potential in a "yield deprivation" world, pension fund equity allocations are unlikely to go lower, pointing to at least moderately constructive equity demand. (Sources: Standard & Poor's and Bloomberg.) On balance, then, it would appear that a period of equity index consolidation beckons.

Market and portfolio risks:

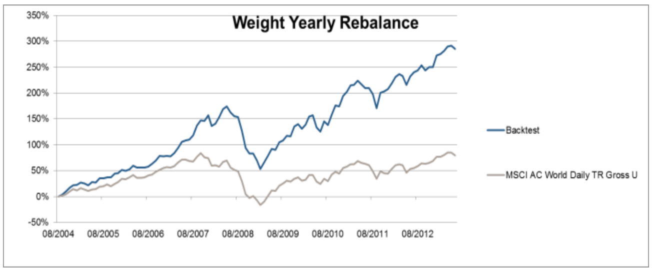
1. Sharply rising discount rates -- from generationally low, "QE-impacted" levels -- associated with pronounced increases in either inflation or sovereign solvency issues could offer substantial equity valuation headwind, pressuring NPVs/stock prices.
2. "Reversion beyond the valuation mean" (P/Es dropping below the long-term average valuation of 16 times trailing GAAP earnings); traditionally, new secular bull markets have commenced from trailing GAAP P/Es of 8 to 10, not the current 18.4 multiple.
3. Cessation of material stock repurchases would negatively impact, at least at the margin, the supply of and the demand for equities, implying lower valuations http://www.factset.com/websitefiles/PDFs/buyback/buyback_6.19.13 http://www.forbes.com/sites/chuckjones/2013/07/01/share-buybacks-are-not-shrinking-sp-500-share-counts/.
4. Reduced domestic (US) demand for equities associated with aging baby boomers increasingly selling stocks to either offset yield starvation-based income needs and/or to fund retirement may also create secular equity valuation headwinds.

5. The aging business cycle: as regards the post WWII period, we have been in an unpredented fiscal/monetary stimulus-based economic “recovery” for the past four years. Historically speaking, at this stage of the business cycle, the likelihood that a recession will commence increases monthly, especially when considering the particularly unsustainable nature of this so-called recovery. Earnings, which are but “6% of top line residuals,” tend to plummet (decline 30% – 50%) in a recessionary period, pressuring stock prices.
6. A record high corporate profit to GDP ratio, which, historically speaking, suggests broad-based pressure on earnings power could be in the offing http://greenbackd.com/2013/04/19/jeremy-grantham-profit-margins-are-probably-the-most-mean-reverting-series-in-finance/.

Conclusion

In all, somewhat constructive strategic valuations, attractive (albeit it historically lacking) relative yields, inflation protection, and pronounced emerging market earnings growth exposure represent the “Blue Chips with marked scarcity and EM exposure” portfolio opportunity. For graphic depictions of strategic prospects, please turn the page.

Hypothetical (backtesting-based) portfolio performance from 8/2004 through 6/2013:



Sources: Bloomberg and CS

Other: a “buy and hold” strategy would have resulted in 334% portfolio performance over same time period; the MSCI AC World Index is considered by many investors to be “the” global equity index yardstick.

Dan Kurz, blogger

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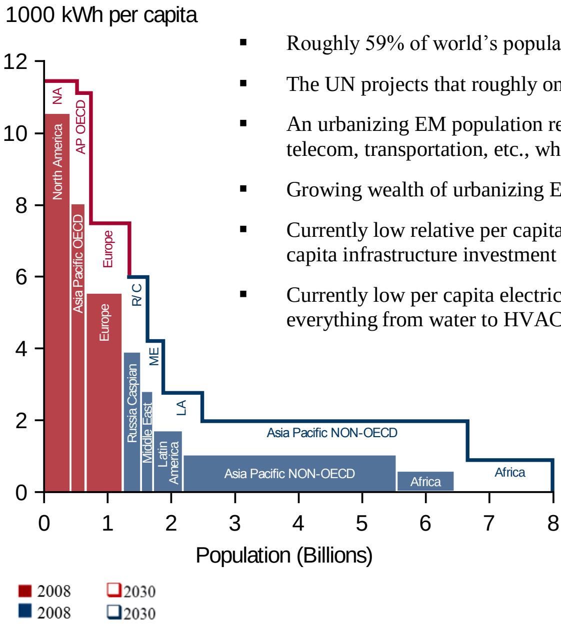
Indicative portfolio “monetization opportunity” charts in energy, agriculture, and EM consumption realms:

EM urbanization/growth/higher energy consumption led by heavily populated Asian geography

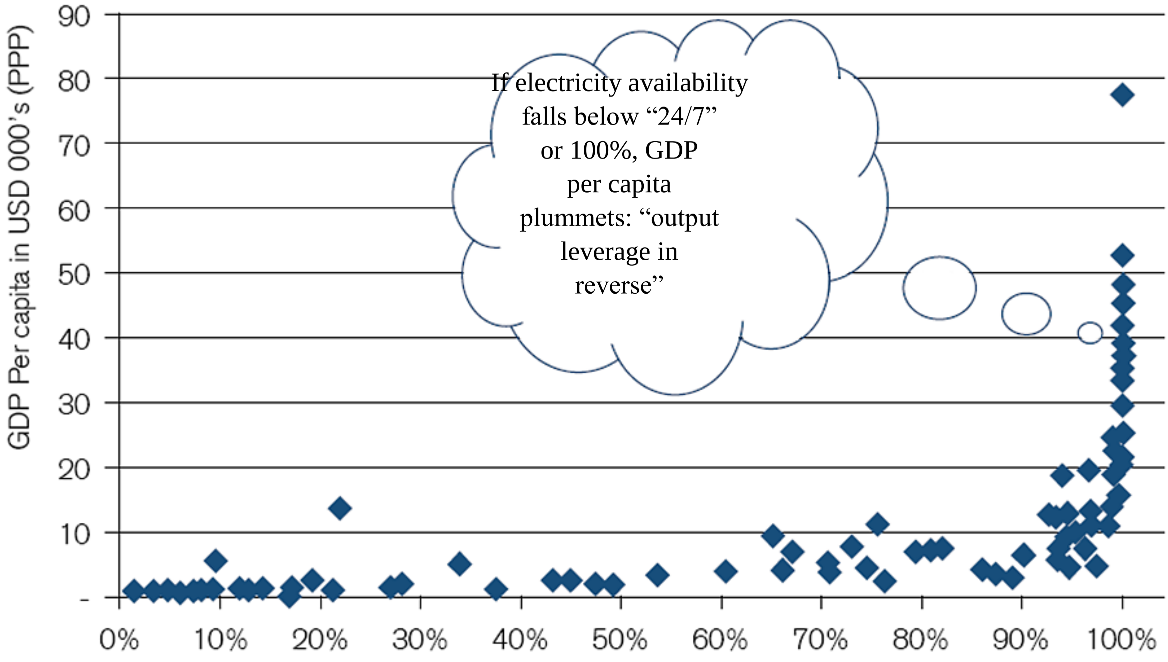


- Roughly 59% of world’s population of 7.0bn currently resides in Asia Ex-Japan
- The UN projects that roughly one billion people will move to the cities in Asia alone over the next 20 years
- An urbanizing EM population requires leveraged increases in key infrastructure such as water, energy, power generation, telecom, transportation, etc., which will also boost productivity/living standards as labor gets replaced by machines
- Growing wealth of urbanizing EM consumers will further increase broad-based infrastructure usage
- Currently low relative per capita electricity consumption of non-OECD regions is indicative of both relatively low per capita infrastructure investment levels and of material EM infrastructure investment growth potential
- Currently low per capita electricity consumption is also directly correlated with low per capita consumption levels in everything from water to HVAC to white goods to electronics to transportation to food to entertainment

Sources: ExxonMobil, World Bank, World Energy Council

Select portfolio firms capitalizing on EM energy infrastructure/consumption growth: GE, CAT, BA, GOOG, PG

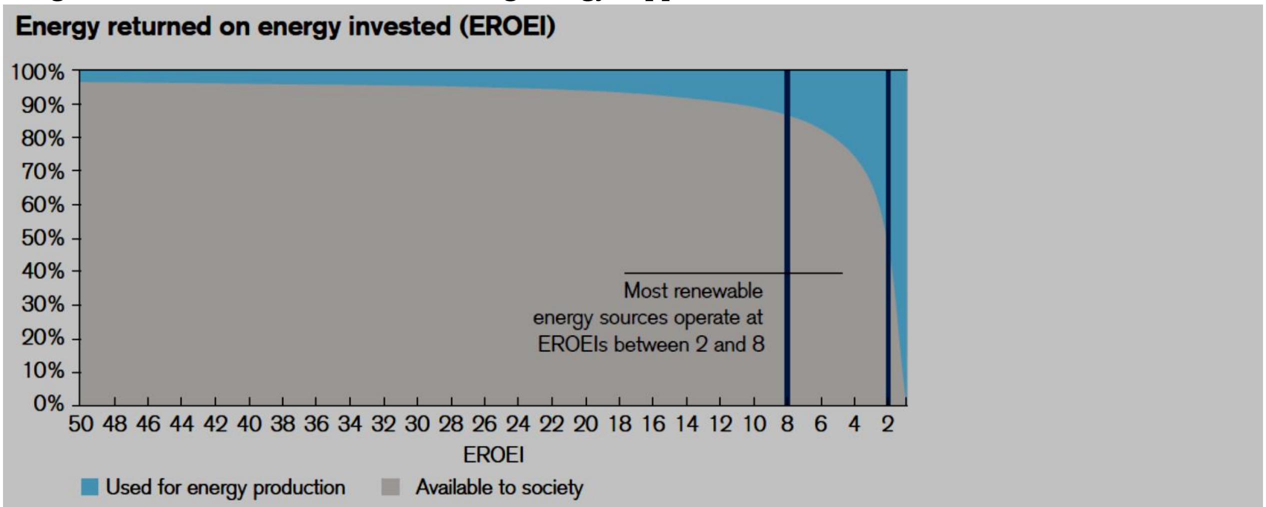
Output/electricity dependency linkage:
GDP/capita (PPP terms) for 99 countries vs. electricity availability (horizontal axis)



Sources: IAEA; CIA World Factbook, WNA, IIER 2010

Select portfolio firms capitalizing on power dependency: GE, SLB, XOM, CAT

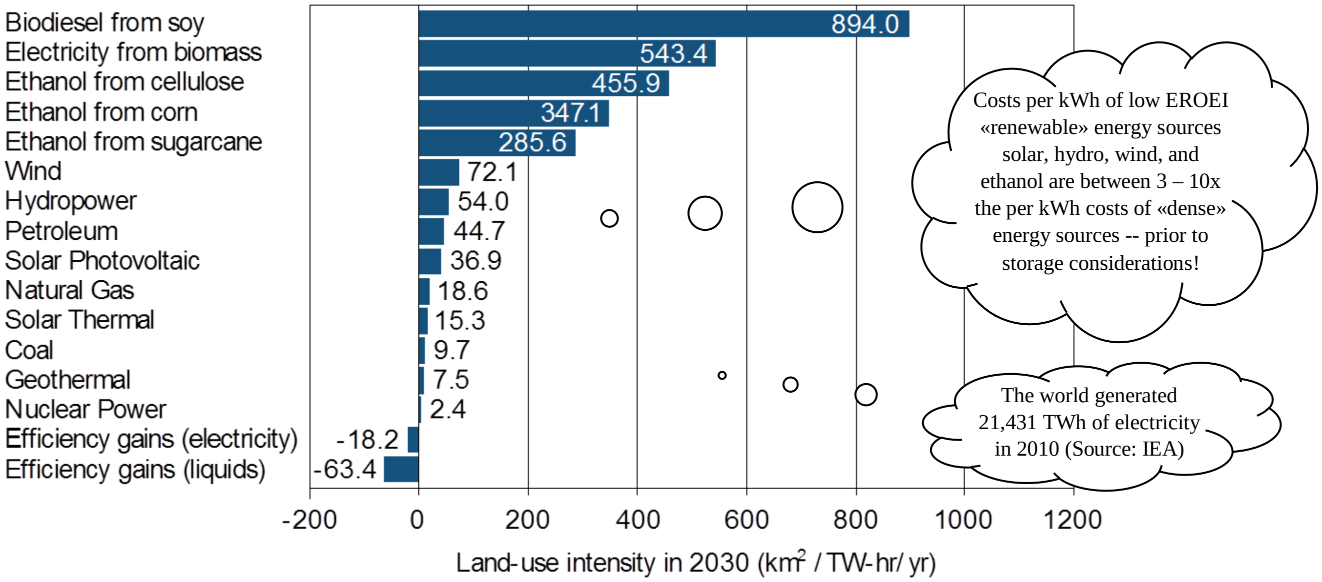
Lower EROEI and declining energy density (heat generated per unit volume) impact:
Larger share of GDP devoted to assuring energy supplies!



- 100 years ago, oil's EROEI was roughly 100:1 in "oil just below the ground" Siberia and Texas (offshore drilling EROEI: 5:1!)
- Over the past decades, energy production averaged "only" some 5% of GDP or an EROEI of 20:1
- As such, energy supply's economic significance is thus viewed as "minor" by mainstream economists and investors
- A declining EROEI will fundamentally change macro allocations and dense energy asset valuations (scarcity factor)
- *Upshot: dense energy and energy infrastructure should be strategic growth markets featuring rising asset prices!*

Sources: http://resourceinsights.blogspot.com/2008/09/net-energy-cliff.html; http://www.eoearth.org/view/article/152557/; EIA; http://Gregor.us

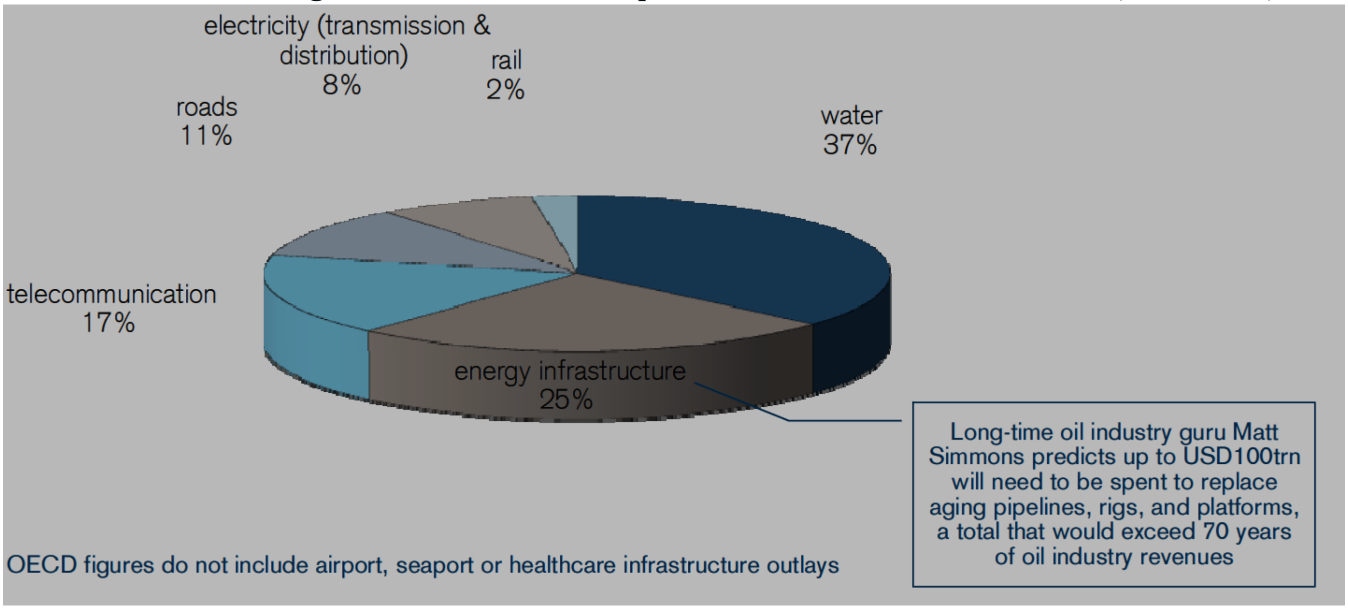
Projected land-use intensity per terawatt-hour per year
(The lower the energy density and/or lower the EROEI, the greater the land use intensity)



Source: http://www.plosone.org/article/info:doi/10.1371/journal.pone.0006802. Please note: values shown are for 2030, as measured in km² of impacted area in 2030 per terawatt-hour produced/conserved in that year. Numbers provided are the midpoint between the high and low estimates for different techniques. For liquid fuels, energy loss from internal combustion engines is not included in this calculation.

Select portfolio firms capitalizing on decreasing EROEI and rising energy scarcity: SLB, XOM, CAT, GE

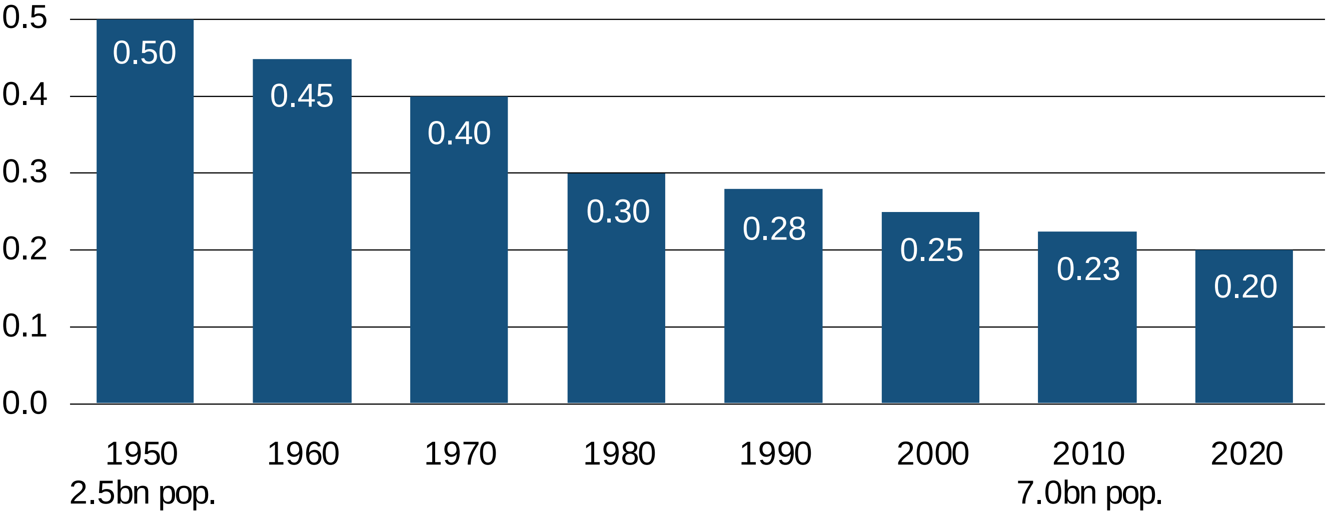
Estimated cumulative global infrastructure requirement allocations 2010 to 2030 (USD71 trn)



Source: OECD Global Infrastructure White Paper

Select portfolio firms capitalizing on infrastructure spending growth: SLB, XOM, CAT, GE

Per capita world arable land is dwindling
(hectares per person)



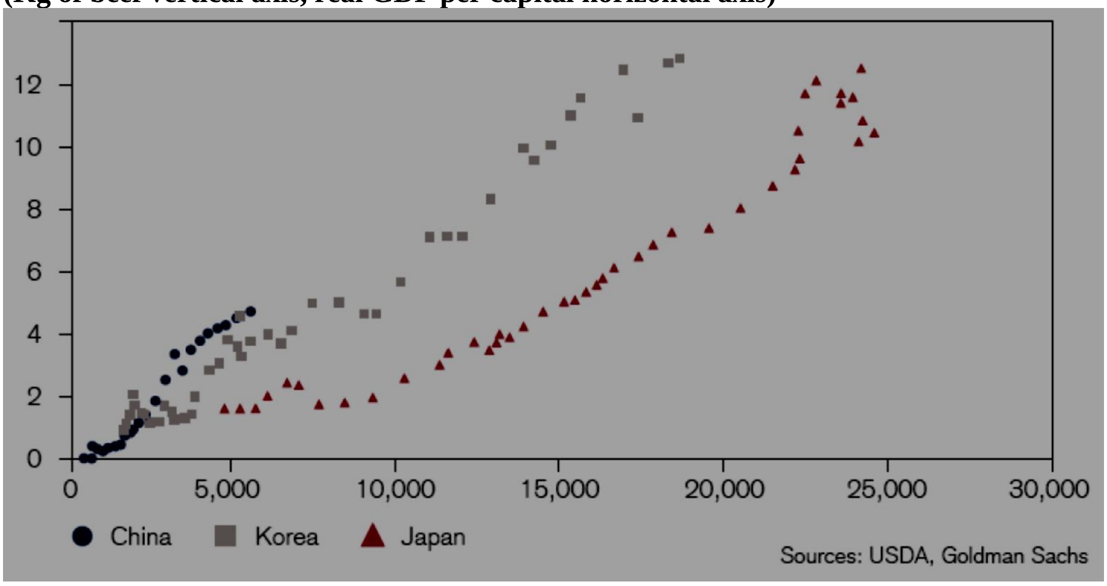
Sources: FAOSTAT, UN, Enviromental Health Perspectives
(Data are rough estimates and can vary depending on assumptions – data shows relative trend)

Agriculture assets, especially farmland, water, and infrastructure/fertilizer-related, remain attractive given:

- Constructive *supply/demand* metrics and the likelihood of substantially higher grain prices
- The positive implications of higher grain prices for farmer incomes and equipment purchases

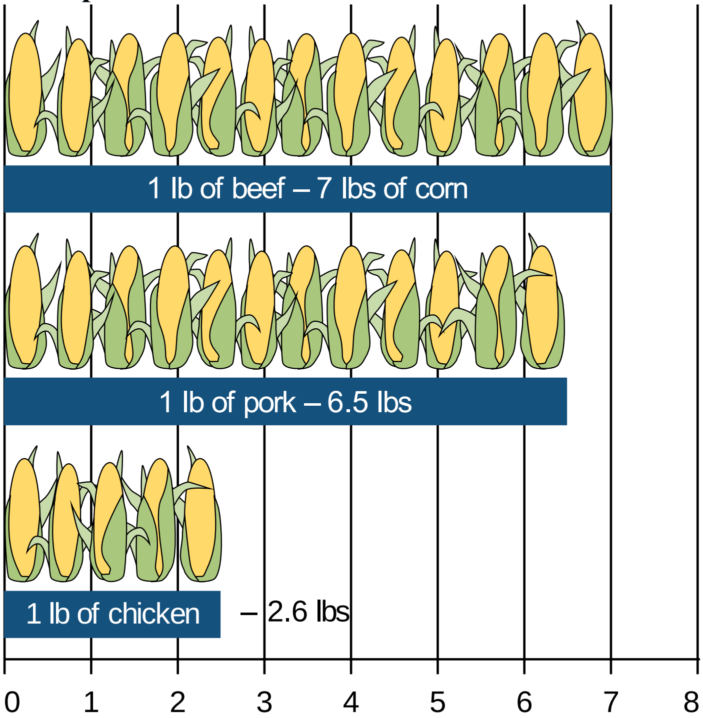
Select portfolio firms capitalizing on arable land scarcity: DE, MON, MOS

Beef consumption vs. real USD GDP per capita in PPP terms
(Kg of beef vertical axis, real GDP per capital horizontal axis)



Select portfolio firms capitalizing on meat-based diet trends and water scarcity: DE, MON, MOS, NSRGY:US (Nestle)

Meat production is feedstock and water intensive

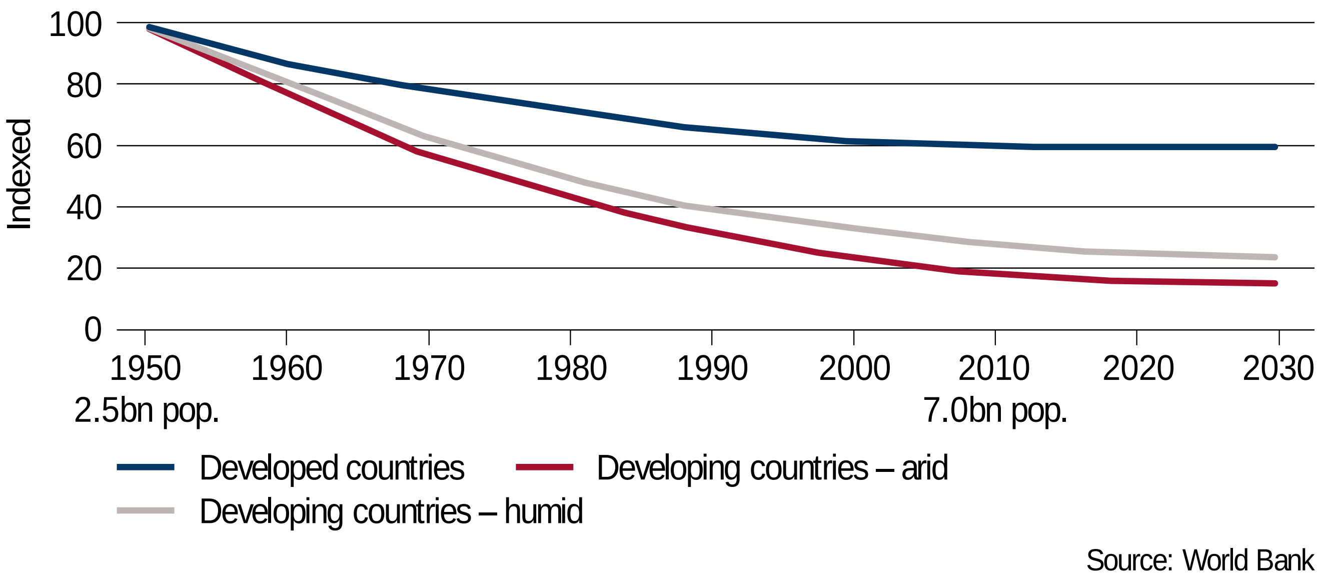


Sources: USDA; Arjen Hoekstra, University of Twente, World Bank, worldwater.org

Dietary shift towards more EM meat consumption will increase demand for grains and farmland as meat production is very grain intensive

... Moreover, between 1,150 – 2,000 liters of water are necessary to produce one kg of wheat. In contrast, some 16,000 liters are required to produce one kg of beef (or, between 8 – 14x as much water!)

Indexed per capita water availability compared to 1950



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Air travel-based transportation growth estimates

Key indicators
2011 to 2031

Growth measures	
World economy Gross domestic product (GDP)	3.2%
Airplane fleet	3.5%
Number of passengers	4.0%
Airline traffic Revenue passenger-kilometers (RPK)	5.0%
Cargo traffic Revenue tonne-kilometers (RTK)	5.2%

Demand by region
2012 to 2031

Region	New airplanes	Value ($B)
Asia Pacific	12,030	1,700
Europe	7,760	970
North America	7,290	820
Middle East	2,370	470
Latin America	2,510	260
CIS*	1,140	130
Africa	900	120
Total	**34,000**	**4,470**

*Commonwealth of Independent States.

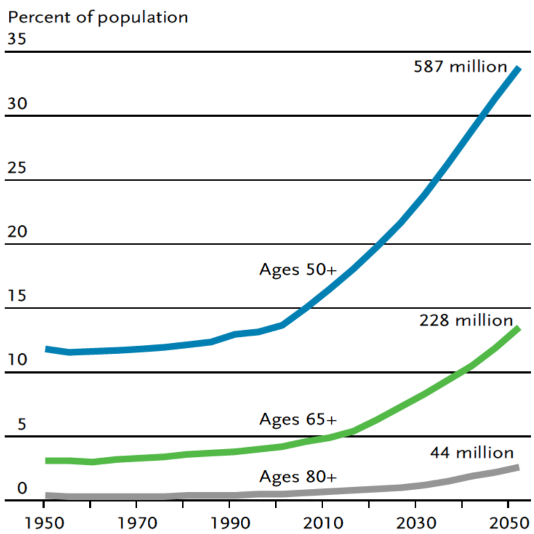
Current Market Outlook
2012–2031

Source: Boeing

Portfolio beneficiaries: BA, GE

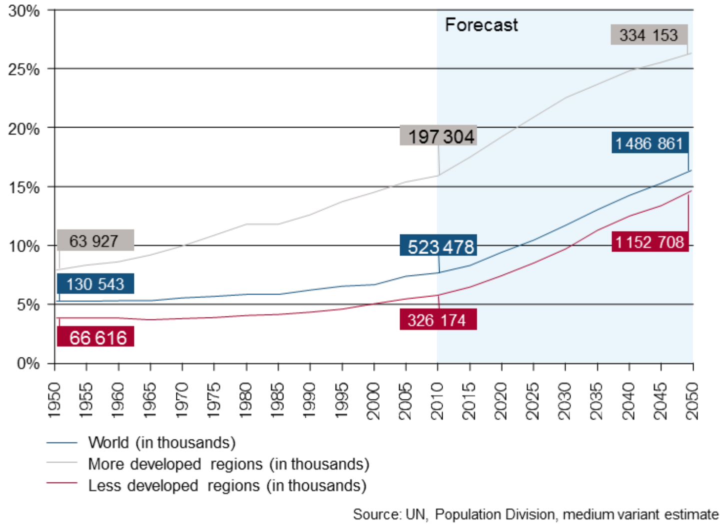
EM and global aging

India's elderly are projected to become an ever increasing share of the population



Source: United Nations Population Division, *World Population Prospects: The 2010 Revision* (New York: United Nations, 2011), accessed at http://esa.un.org/unpd/wpp/index.htm, on March 13, 2012.

A greying world: population 65 plus as % of total



- Senior ranks projected to increase from 7.6% of total population in 2010 to 16.2% in 2050
- EM manifesting this aging trend most: over next 40 years, EM senior ranks projected to shoot up 180% vs DM (developed markets') 70% rise
- China's (1.3bn population) old-age dependency ratio* is set to rocket from 11% in 2010 to 38% by 2050 (Beijing's 32-year one-child policy impact)
- Average annual healthcare spending for those aged 65 and over four times those aged 18 – 49!

  * Old-age dependency ratio: population aged 65 or over/population aged 15 – 64

Sources: UN, OECD, BLS, Kenneth W. Gronbach

Portfolio beneficiaries of a huge increase in aging-based global healthcare spending: JNJ, MDT