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Where The Cheap Stocks Are---Come Hell Or High Water

***Is "value investing" dead? Far from it, says Jon Shayne, whose bargain-hunting style will likely endure no matter who wins the presidential election or what horrors Mother Nature might whip up.***

If you follow the stock market, Jon Shayne is worth a good, long listen. Especially now.

(Also, check out his blog: **http://www.jonshayne.com/2013_04_01_archive.html**)

A disciplined buy-and-hold guy, Shayne manages $180 million for high-net-worth individuals, corporations and foundations, mainly in Tennessee. Like all value investors, he thrills at unearthing **solid companies trading at below-average prices.** The kind of companies that, as Warren Buffett said, would still be around if the market were to shut down for 10 years—let alone for two days after a devastating hurricane.

This game takes patience, and Shayne's has served him well. Since his firm's inception in March 1995, his stock picks have returned a smidgeon over 13% a year (net of a modest 1% annual management fee), versus 8.4% for the S&P 500 index. Including cash and Treasury bonds, Shayne has clocked a net 10.2% annualized return, with less than half the volatility of the broader stock market.

Trouble is, truly good values have been increasingly hard to find. While the market retreated a tad after a rash of **weak corporate earnings reports** and **ominous**

pronouncements by the International Monetary Fund, stocks are still very expensive by historical measures. And as for finding safety on the sidelines, the Federal Reserve's tireless printing presses have done to Treasury yields what Hurricane Sandy just did to the northeastern coastline.

Shayne's dilemma and ours: Get in the game—even if you have to pay up for the privilege—or watch your capital get gnawed by inflation. "There are periods when it's easy to find stuff, and periods when it gets pretty hard," says Shayne. **"The environment is more difficult than it has been because it is more uncomfortable to hold cash."**

I wanted to know if time-honored valuation methods—on which Shayne and other value guys rely—were still up to the task in this technology-driven, highly globalized modern economy. The answer has massive ramifications on the ebbs and flows of trillions of dollars. Shayne balked at going on the record (he's as private as he is intelligent), but after some cajoling he agreed.

What began as a casual chat turned into an 18-hour master class on equity investing—and more importantly on what it takes, even in the face of great pressure, to **think for yourself.** "If my toolkit stops working, the market system is broken, and we've entered into some kind of other political economy," avers Shayne. "If it stops working, then [the stock market] is the least of our problems."

If history is any guide, Shayne's spadework and conviction may soon hit serious paydirt. For more on why—as well as a treasure map for finding your own undervalued gems—read on.

Above The Beaten Path

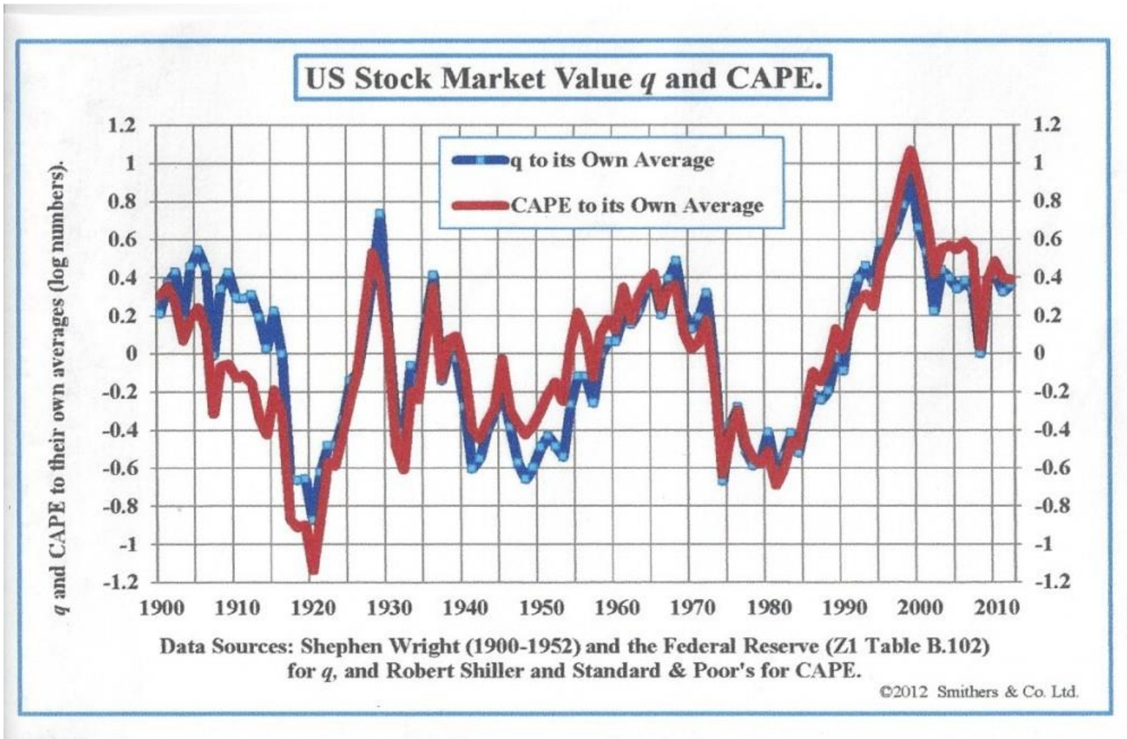
Shayne has grappled with an overheated market for some time. While data show that "value stocks" (those that trade at a modest price relative to a company's earnings) outperform the market over the long run, "growth stocks" have beaten up on their value brethren of late. For the ten years ended June 30, the Wilshire US Large Cap Growth index grew at a 6.1% annual clip, versus 5.2% for the Wilshire US Large-Cap Value index.

Over the last 18 months, Shayne's struggle has intensified—for four reasons:

1. Stock prices are high compared to companies' overall earning power.

The price of a company's stock is, of course, based on how much money the market thinks that company will earn in the future. For a good portion of the last 20 years, Shayne points out, investors have been willing to pay more—often a *lot* more—for those potential earnings.

To see what he means, check out the striking chart below, compiled by Smithers & Co., a London research firm.



The red line tracks "CAPE"—the "cyclically adjusted price-to-earnings multiple (P/E)" of the S&P 500, calculated by Yale economist Robert Shiller. (The "adjustment" is in Shiller's attempt to capture an entire business cycle by plotting the average P/E over the previous 10 years, rather than over the commonly used trailing 12 months.) Here, CAPE is plotted "to its own average"—meaning that, relative to its historical performance, every point above the "0" line suggests the market is overvalued, while anything beneath means it is undervalued.

By this measure, Shayne moans, the stock market—aside from the 2008 financial crisis—has been considerably north of its historical average during his entire money-management career. *(Quick note for math geeks: The chart is plotted on a logarithmic scale. So, if you want to know—in actual percentage terms—how much the market is overpriced in terms of CAPE, you have to convert the numbers on the chart to standard numbers. Do that and you'll find, as of June 2012 (the latest plot point on the graph), that* ***the market is 49% overvalued****, not 40%, as the graph appears to show.)*

The blue line confirms that Shiller was onto something—and that prices indeed look quite lofty. The line plots a nifty metric called "q" (a Smithers-modified version of "Tobin's q," named after another Yale economist named James Tobin). "q" measures the value of the market divided by the amount that investors would have to pay to replace all of the assets held by all of those companies.

The notion here: If the replacement value is significantly below public market value, then eventually investors will choose to start their own companies rather than buy overpriced slivers of ones that already exist! That's essentially what happened during the dotcom debacle: Stocks prices ballooned, more entrepreneurs piled in, competition increased, and the market crashed to earth.

The beauty of CAPE and "q," says Shayne, is that they are highly correlated though mathematically unrelated. When "q" is laid atop CAPE, the lines move nearly in lock-step. (One interesting divergence occurs from 2003 to 2007, when the market looked considerably more expensive by CAPE estimates. A plausible reason: "q" doesn't include non-financial companies, while CAPE does. Which stocks were growing especially inflated during that period? That's right: bank stocks.)

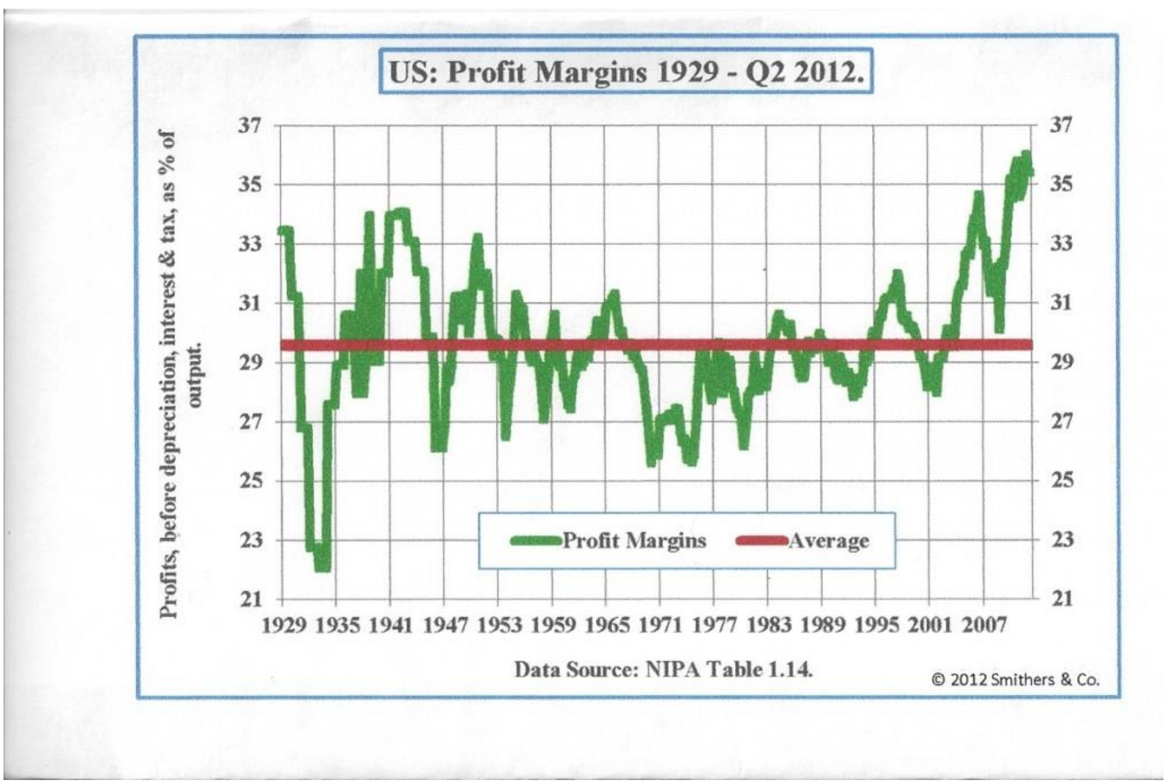
So CAPE is high and so is "q." Those two metrics alone spell frustration for value guys like Shayne. But there's much more.

2. Profit margins are way above their historical average.

Price-to-earnings multiples only tell you so much. To really understand how badly prices are out of whack with reality, you have to take a closer look at the "E" in P/E.

Say, for instance, the market P/E was at its historical average but corporate earnings were abnormally high. When earnings eventually receded (as they always do), sooner or later stock prices would have to fall with them to maintain the average overall P/E. Now imagine both the P/E *and* corporate earnings are unusually high—in that case, stock prices would eventually have to come down *a lot*.

That second scenario is where we are now. Since 1881, the S&P 500 has traded at an average P/E of 15.2. As of mid-October, the market P/E had crept up to 21.5. Meanwhile, profit margins are notably high, as shown in the chart below, also compiled by Smithers:



Aside from a brief stint during the latest crisis, the chart shows that corporate profits as a slice of overall economic output (GDP) have hovered above their historical average *for the* *last 17 years*. Since the crisis, those profit margins have soared to 20% above the red trend line. (Note: The NIPA data, on which the chart is based, includes all corporate output, or roughly 50% of U.S. GDP.)

In short: We are in overheated territory and it would take scorching growth to support these price levels going forward. Shayne makes few predictions about how fast the overall economy might grow in the coming years, but what is painfully obvious is that continued plodding growth (or worse) will sting profits margins—and that will hurt stock prices.

Again: Relative to history, both the overall market P/E and corporate profits are abnormally high. At some point—and Shayne takes this prospect seriously—margins may revert to the mean, taking stock prices down with them. So what's taking so long?

3. Government intervention masks the true health of the economy.

The 2008 financial crisis may be history, but Shayne thinks the remedies to ease the pain will have harmful ramifications. Some examples:

- **Yawning deficits.** The U.S. government has racked up trillion-dollar deficits four years in a row. What happens when lawmakers finally decide to close the gap? Spending will go down, taxes will go up, or both. Result: Profits, and stock prices, will suffer.

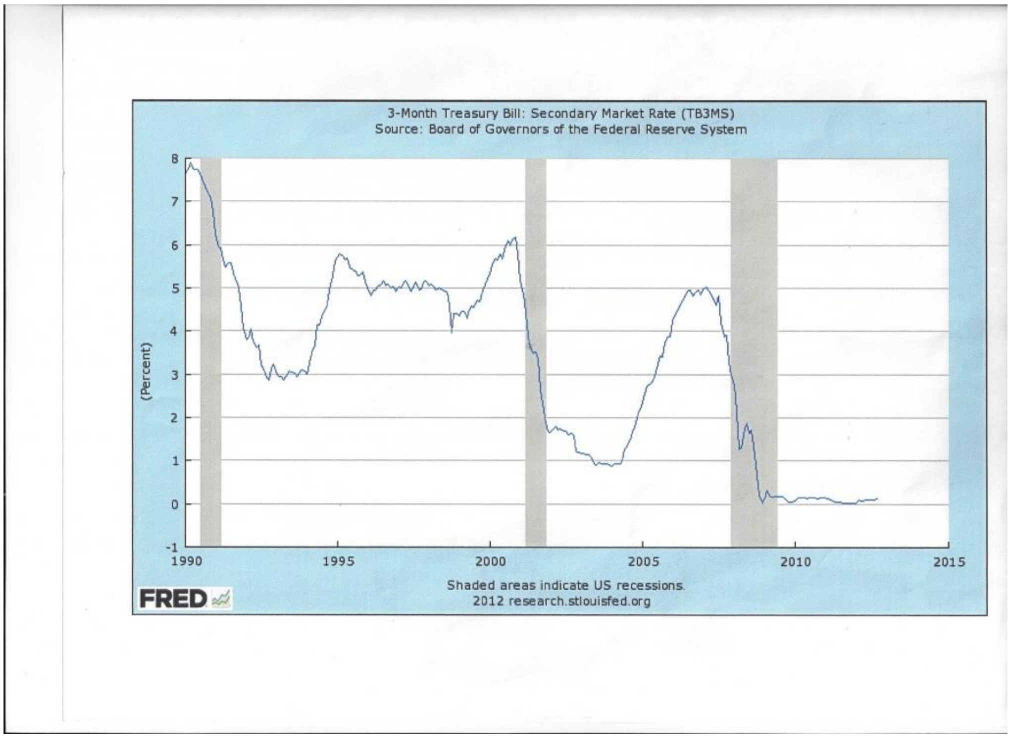
- **Perceived/implied guarantees.** Before the crisis, some banks were too big to fail. Four years and a flurry of mergers later, some are now way too big to fail. That implicit government backstop lowers their cost of capital and artificially inflates profits.

- **Money supply.** The Federal Reserve has printed trillions of dollars to keep interest rates low and charge up the economy. Result: Bond yields sink, stocks flourish.

"Think about where things would be if these things hadn't happened," says Shayne. "Profits would be lower. Asset values would be lower. And these things cannot be sustained indefinitely."

4. No Safe Haven

In years past, Shayne could confidently park assets in Treasuries and money market funds while he dug for deals. Today a full 26% of Shayne and Co.'s assets under management are in low-risk, highly liquid stuff. Too bad the Fed aims to keep short-term rates bumping along near zero through 2015. This graph, from the Federal Reserve Bank of St. Louis, says it all:



Welcome to a hard-core value guy's perfect storm: historically high P/E multiples and profit margins, massive market-propping stimulus programs, and flimsy protection against creeping inflation.

"Fortunately it can't possibly go on," says Shayne. "And I'm greatly looking forward to it."

Forging The Framework

Shayne has a soft demeanor, kind eyes and a fast-spreading smile. Lanky and slightly hunched at 6'3", he lives in oxford shirts, fleece vests and slacks. (In the seven times we've met, he never wore a suit.) Shayne has a near-obsession with clarity and accuracy; he can pause up to 20 seconds while pondering his next phrase, the gears turning for all to see. When the words finally come, they often contain the answer to the original question along with a slew of related thoughts, and maybe a reference to a good book or two. The most prolific blasts tend to be followed by a self-deprecating "Was that helpful?" (it always is), or "I'm sorry, you probably didn't need to know all that."

Then there's Shayne's alter ego, Merle Hazard. The name is a play on country music legend Merle Haggard and "moral hazard"—the concept, on hideous display in the latest financial crisis, that humans take greater risks if there's a good chance they won't suffer the consequences. Merle pokes fun at policy makers in twangy, animated ditties like "**Fiscal Cliff**." (For Merle's entire catalog, **click here**.)

Shayne's father was a real-life "Mad Man" at McCann Erickson in Manhattan, and later as a brand manager for Lever Brothers, before joining the executive ranks at Werthan Bag, a cotton- and-burlap bag maker, established in Nashville by his wife's great-grandfather in 1895. Young Jon went to Harvard, where he studied music theory and philosophy, and also wrote for *The Lampoon*. After graduation he took a job as a researcher at a law firm, and later crunched numbers in PaineWebber's investment banking department in New York. Finance was a far cry from chord progressions, Shayne says, but "I knew it was important and that I didn't understand it."

Shayne's investing role model was **William Ruane**, who roomed with Shayne's father after business school. A savvy stock-picker, Ruane would become a close friend of Warren Buffett and eventually launch the storied Sequoia Fund. Ruane kindled Shayne's fascination with Buffett, and inspired him to read piles of studies on behavioral finance. Shayne added a law degree from Vanderbilt University, biasing his course selection toward securities law, which he saw as "a better version of business school."

For all his research, **Shayne is the first to admit that value investing—particularly now—takes plenty of fortitude. "It takes a lot of independence of thought," he says. "The main thing is having a framework by which you're not whipsawed by what the public says."**

Having a framework is one thing—true conviction very much another. Shayne derives his, in part, from the idea that "you can know the world through thought," he says. That was a little meta for my taste, so I asked for an example.

"Einstein basically sat there and figured out that space was bent," Shayne went on. "He was looking at classical physics and the laws of electromagnetism. The speed of light was different in both laws, both of which work. But there's only one universe, so it couldn't be true. That is thrilling to me: Just through thinking you can produce something of great value." Suddenly worried I might think he equated stock picking with parsing time and space, he added: "Doing this with securities is much less admirable than what Einstein did."

Shayne's office, 10 minutes from downtown Nashville's honky-tonk bars, is a Spartan setting fit for a value guy: drab filing cabinets, some family photos, various investment books and binders, and a few paintings. Shayne doesn't spend a lot of time entertaining clients, preferring to share his thoughts on an occasional phone call or in a quarterly letter. He also writes a blog to "let them know that I'm still mentally sound," he says.

Aside from a flow of company filings, Shayne's daily reading regimen includes the *Wall Street Journal*; the *Financial Times* ("they get some benefit from being at a distance, like when you pull away from a large building," he says); Jack Ciesielski's *Accounting Observer*; and a handful of blogs including *Calculated Risk*, *Naked Capitalism*, and Donald Marron's (head of the **Tax Policy Center**) **blog** on federal tax policy. Shayne also studies *Outstanding Investor Digest*, a compendium of letters from money managers to their clients.

With so few new picks to show for it, how does Shayne know if he's spending his time productively? "At some level you don't," he admits, brow furrowing. "Generally the company-specific stuff is more important, but I find myself puzzling more lately over the macro stuff [such as the direction of interest rates]. I don't know exactly the right amount, in terms of time spent."

Seconds later his bunched expression melts into a smile: "But if you don't trust your own taste, what are you gonna trust?"

Mining For Gems

Value investing is essentially a two-step process: **Find good companies and buy them at attractive prices. "The average company traded at 14 times earnings over the last century," says Shayne. "If I can find good companies trading at that multiple of normalized earnings or lower, that's what I'm ultimately looking for."** By "good companies" he means stable businesses with solid market positions and business models he can clearly understand; by "normalized earnings" he means those unenhanced by accounting gimmickry (more on that in a minute).

Step 1: Finding good companies.

Shayne generally **doesn't believe in holding more than 10 stocks at a time.** That's because (as Buffett did) he views being a shareholder for what it fundamentally is: owning real pieces of real businesses, rather than trading mere bits of paper. "If you really follow that approach, how many private companies would you want to own?" says Shayne. "If you own seven, I don't think you'd say you own too few."

For Shayne, building a solid case on a stock is a manual process that starts by thumbing—one page at a time—**through the *Value Line Investment Survey***, which contains financial snapshots on 3,500 companies. Shayne isn't partial to company size or industry (though he generally avoids airlines); if all adds up, he's willing to invest in everything from a small bank to a large construction concern. His "dream dates" are established companies that, over the span of at least a decade, boast the following characteristics:

- **Solid return on equity:** Generally 14% or better.
- **Low debt:** Preferably no more than the company could pay down with three years worth of earnings.
- **Heavy insider ownership:** "If the CEO owns so much stock that his salary is an afterthought to him, that's only to the good," says Shayne.

If *Value Line* yields a contender, Shayne will build a file on the company—including recent annual and quarterly reports, proxy filings, interviews with investor-relations officers, and any interesting press clippings. He now has hundreds of files, many started years ago, in the hope that one fine day the shares will be cheap enough to buy. Shayne also builds files on unusually awful companies (before or after they tumble) and on curious economic topics, like the recent housing bubble. It's "not unlike a professor of abnormal psychology might collect case **studies**, or a butterfly collector might pin down odd and interesting specimens," he says.

At some point, Shayne examines the "quality" of the reported financials. There are plenty of ways, within acceptable accounting rules, to make companies look healthier than they actually are. (Shayne shies away from international stocks because he has "some mistrust" of the bookkeeping overseas.) In recent years U.S. accounting rule-makers have cracked down on the sleight of hand—tricks like not expensing **stock options** and using so-called synthetic leases to lower tax bills—but plenty of dicey maneuvers persist.

Here are five Shayne looks for:

- **Accrued reserves:** If the percentage of reserves for damages is lower than the industry average, reported earnings will look higher than they really are—an aggressive accounting treatment. Bad sign.
- **Special charges:** A one-time write-off (say, for a plant closure or a product recall) is one thing; a consistent stream of special charges make reported earnings look better than they are. Avoid.
- **Depreciation dance:** Spreading depreciation charges over a dubiously long period of time artificially inflates earnings.
- **Pension liabilities:** "The accounting is impenetrable," says Shayne. "Assume the liability is double."
- **Overseas earnings:** Companies report earnings they make overseas, but many don't account for the taxes they will have to pay when they repatriate those profits—thus inflating their reported earnings. "Every seven years or so, there's a brief tax holiday declared, and then the companies pull [their earnings] back at a low tax rate," says Shayne. "It's a political cycle."

There are more subtle measures of quality, too. For example, Shayne is quick to ding a company if its annual letter to shareholders doesn't detail its missteps—or missed opportunities—made during the year. "Do they look upon their shareholders as people to be sold to?" he wonders. "True fiduciaries will take pains to remind you of things you haven't thought of."

Step 2. Buying at attractive prices.

Shayne has some comforting news for do-it-yourself stock pickers. Unlike many Wall Street analysts and portfolio managers, he rarely constructs elaborate valuation models. (These intricate spreadsheets—synching a company's income statement, balance sheet and cash flow statement—allow analysts to tweak their price targets by quickly adjusting assumptions for key variables like sales growth and cost of capital.) Shayne also rarely visits company executives or takes plant tours. Most of the time, a legal pad and pencil will do; anything more, he says, is false precision.

"The goal is to find things that are so clear I don't have to [build models]," Shayne explains. "It should be obvious enough. If it's not, you're cutting it too close."

That strategy rules out a lot of choices. The last time Shayne bought shares in a company he didn't already own—a small position in Walmart—was *in late 2009*.

Shayne jealously guards the names of (the few) companies he has in his sights now. "In general I'm not big on money managers giving out their ideas, because other people may pick them up," he says. He was willing, however, to share the names of some companies he owns and why he piled in.

- **Sigma-Aldrich [SIAL]**. When Shayne first bought its shares in March 2000, the St. Louis, Mo. chemical maker was already a favorite among research laboratories—and they don't switch suppliers very often. The company fortifies its position thanks to a fleet of salespeople with scientific degrees. "It's an example of a true franchise," says Shayne. "It was cheap because it wasn't an Internet stock in the Internet bubble. There were these start-up, Web-only chemical companies with 1% of Sigma's revenue and a market cap equal to Sigma's, which made absolutely no sense." Including dividends, the shares (now trading at $70) have since compounded at nearly 18% a year.

- **Heartland Express [HTLD]**. This North Liberty, Ia. trucking company turned a mundane business into an art form by using experienced drivers and hauling freight for customers willing to pay up for the privilege. "It's white-shoe trucking," says Shayne. When Shayne first bought the firm's stock in August 1998, founder Russell Gerdin then owned roughly half of the company—and its proxy filing contained few names because few lieutenants earned more than the minimum required to list their salaries. "They were very cheap," recalls Shayne. "I liked that." When Gerdin distributed stock to employees, he gave from his own stash so that existing shareholders didn't get diluted; better yet, adds Shayne, "the accountants made him take a charge against earnings for contributing the stock, which was understating the earnings." Heartland's shares, now at $13.50, have climbed at a 10% annual clip since Shayne got in.

- **Sysco Corp. [SYY]**. Headquartered in Houston, Tx., this food-services distributor "got cheap during the 2008 crisis when people thought no one would eat at restaurants again," says Shayne. "I went back to the '74 recession to see if their revenues went down, and they didn't." It wasn't a perfect proof, but it was enough to whet his appetite. It was also enough, with the stock now at $31, to rack up a 13% annualized gain since November 2008.

- **Berkshire Hathaway [BRK-B]**. An ardent Buffett fan for 25 years, Shayne has made seven pilgrimages to Berkshire Hathaway's annual investor meeting in Omaha, Neb. (In 2011 he even brought along his 16-year-old son, David, who started his high school's first investment club.) Berkshire has eked out a more modest 6% compounded return since Shayne first invested in August 1999, but that's still double the S&P 500's performance since then.

(Shayne is quick to point out that, in some cases, he bought additional shares later on, some of which returned more or less than his original purchases.)

Of course, some bets went south for a while before recovering. One of them, **USG Corp. [USG]**, stayed there: After Shayne bought the gypsum-maker's shares in late 2007 and early 2008, at an average price of $36, the stock has fallen to a recent $25. "I've lost some money on that one," he grumbles.

If buying is a science, selling is more of an art. "Good growth justifies a low-20s "Hold" multiple in a lot of cases," says Shayne. Finding an attractive stock trading at an even higher multiple can be done, he adds, but they are few and far between.

Shayne has toyed with other kinds of securities, such as real estate investment trusts, the occasional stock index fund (to get quick exposure to the overall market), and even a mortgage-backed securities fund. He particularly respects Robert Rodriguez, manager of the FPA New Income Fund, in Los Angeles, who took heat for calling the dotcom and housing bubbles before they popped.

Ultimately, though, stocks are still where Shayne feels he can generate the highest returns for the risks he's willing to take. "If you buy stuff for less than it's intrinsically worth, and you are in no hurry to sell it, and as long as the system continues, as long as property rights are secure, you'll make a decent return and maybe better," he says. "You just have to put up with the logical thing looking totally wrong for 3 to 5 years, or even longer sometimes."

Bottom line, Shayne adds: “I wouldn’t think of any other way of investing.”

Have any thoughts on value investing—or on any other effective stock-picking strategies for that matter? Feel free to comment on this post.