



## Edited Transcript

# Value Investing During Worldwide Quantitative Easing

## Chart 1

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**Presented to**  
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I would like to thank you for inviting me and Century Management to be part of this wonderful conference. As I was preparing for this program, I thought that sharing my experiences and lessons learned during the early 1970s, when the country had a high rate of inflation, might be of interest to you as a value investor. I believe this is a relevant topic today, because we may experience higher inflation at some point given the Federal Reserve's—and for that matter most of the world's—embracement of quantitative easing. Although I'm not predicting it, and I am hoping it does not happen, it is possible we could experience a repeat of the 1970s, and therefore, we need to be prepared. The five points I hope to cover today are listed on Chart 2.

## Chart 2: Main Points

Most Important - Only three things matter when it comes to stock valuations: **interest rates, inflation, and the fundamentals of a company.**

Inflation can take hold and when it does, it can move rapidly.

In periods of inflation and deflation, multiples will come down quickly, affecting valuations.

Risk of inflation/deflation requires more flexibility in investment choices.

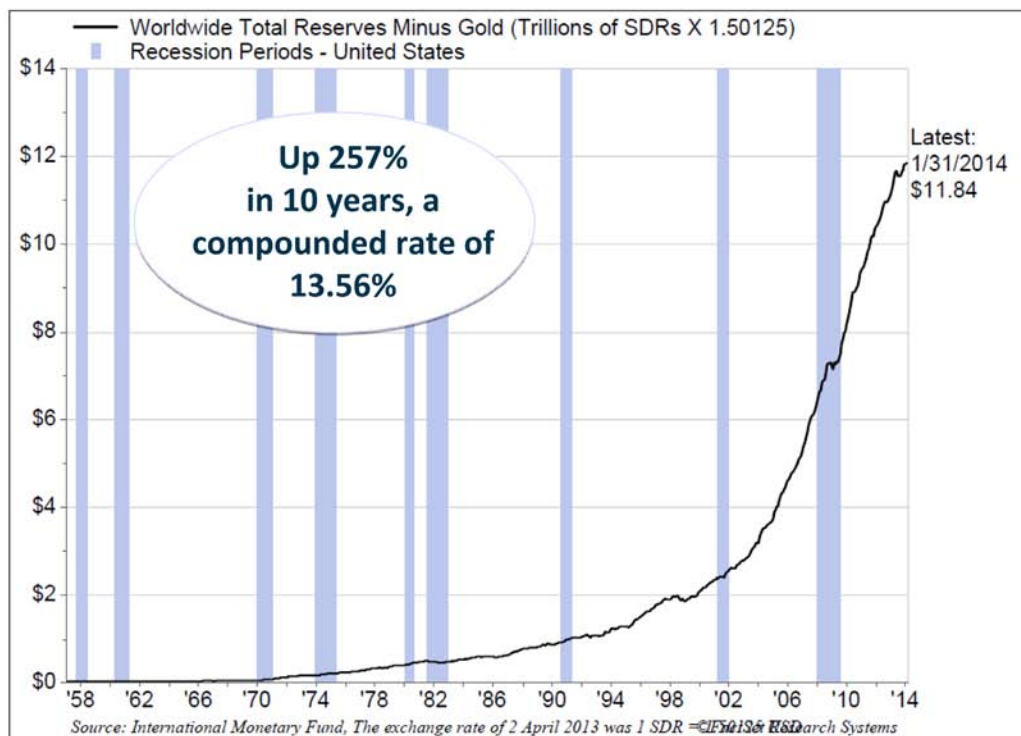
Once the U.S. goes through what will be a challenging period, U.S. stocks, for the long run, will be a good investment.



First, I believe that only three things matter in understanding stock valuations: interest rates, inflation and fundamentals of the business. Next, it is very important to understand that once inflation begins, it can increase very rapidly. You really have to be on your toes so you can react quickly if inflation begins to occur. In addition, whether we experience inflation or deflation, I believe multiples could come down quickly, which will affect stock valuations. The most important point in this quantitative easing environment is to be flexible in your investment allocation. I believe that the unwinding of worldwide quantitative easing is going to be very challenging and that it will create a lot of volatility in the markets. However, once the U.S. goes through what I believe will be a very challenging period, I think the U.S. will be the place to invest and that U.S. stocks will be one of the best investment choices for the long run.

Let's now look at worldwide quantitative easing on Chart 3. We pulled all the central banks together to see how much money they have created. This is truly extraordinary. Over the past 10 years, there has been a 250% increase in the world's money supply. That's a compounded rate of 13.5%. This is not sustainable! Now, individual countries have done this over the years with disastrous results. But there has never been a time in history when the whole world was printing at the same time. This is truly unprecedented. If you would have told me 10 years ago this was possible, I would not have believed it, but here it is.

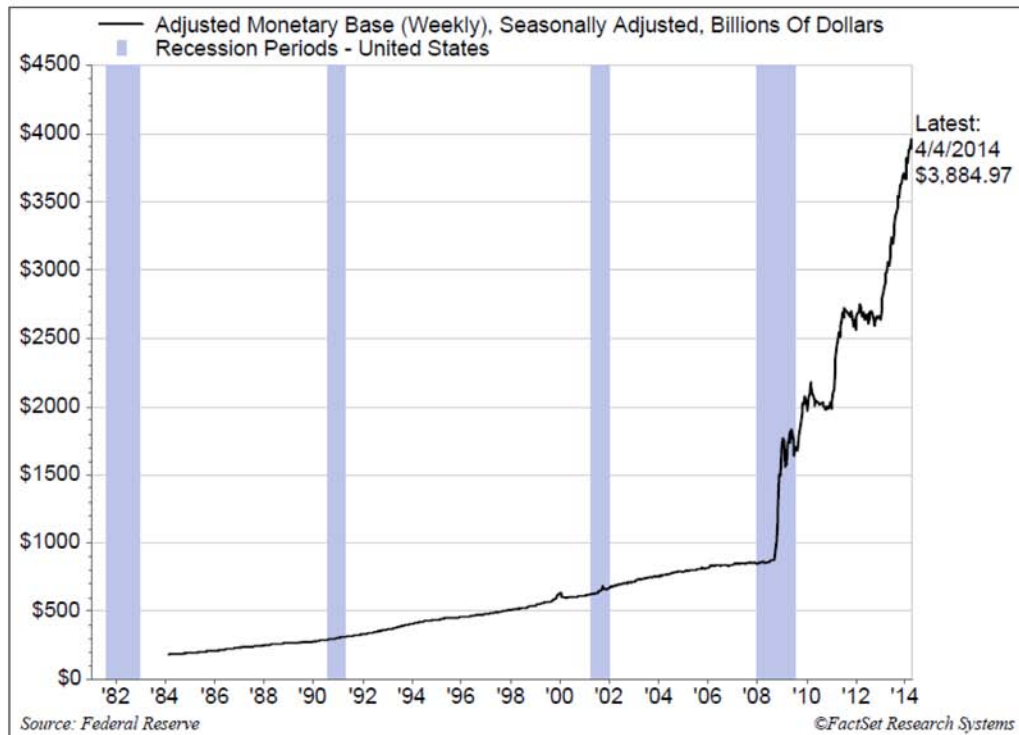
**Chart 3: Worldwide Quantitative Easing**





Moving on to the U.S., Chart 4 takes a look at the U.S. monetary base. Now, the world has created about \$8 or \$9 trillion of new money over the past 10 years. As for the U.S., our printing represents roughly one third of this worldwide total. The United States has printed almost \$3 trillion of new reserves over the past five years, and the U.S. balance sheet is almost \$4 trillion dollars.

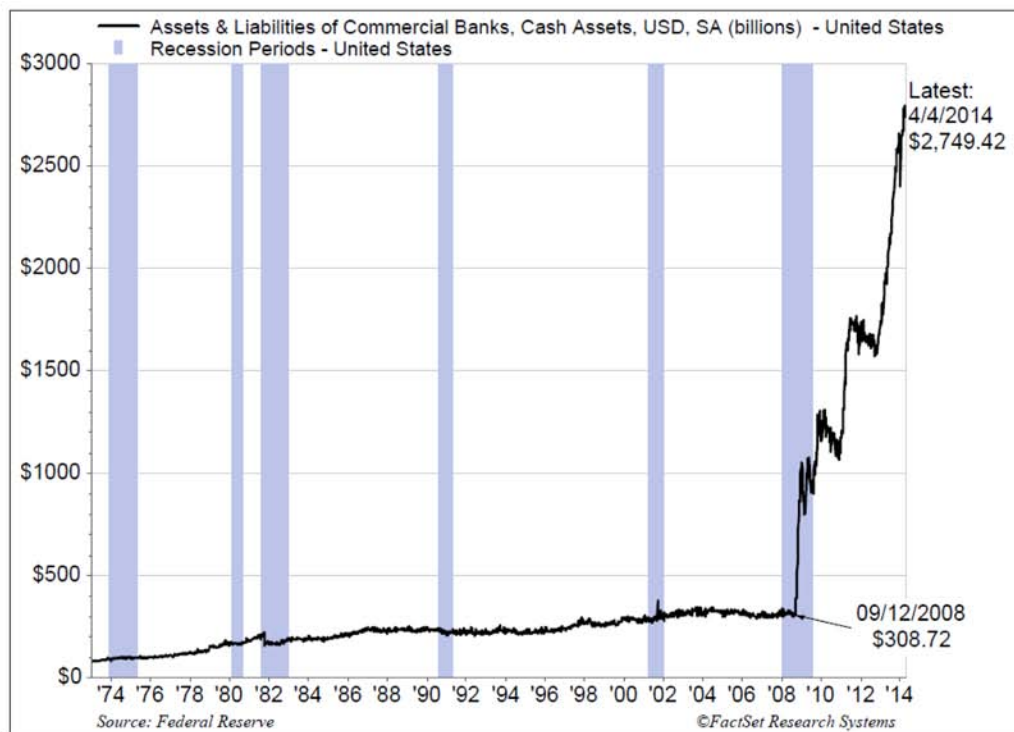
**Chart 4: U.S. Monetary Base**





You would think that this kind of printing would be creating a lot of inflation. The reason it hasn't is on Chart 5. All the money that is being printed is staying in the banks. It's not being lent out in large numbers, so it's not going into the economy. This is the reason we have not had disastrous inflation. We've had a little bit of inflation, certainly more than one and a half to two percent as reported by the CPI, but we haven't had that high-risk inflation. The reason the banks aren't lending the money out in a material way is that the Federal Reserve pays them interest on these reserves. So the banks are very happy to hold onto the money. The danger is that the economy recovers, the interest rates go up, and the banks start lending it out. That's when you have a problem. So this is the first thing to watch; that is, what's happening to the bank reserves, because if they begin to decline, this could be an early sign that higher inflation is coming.

**Chart 5: U.S. Bank Cash Assets**





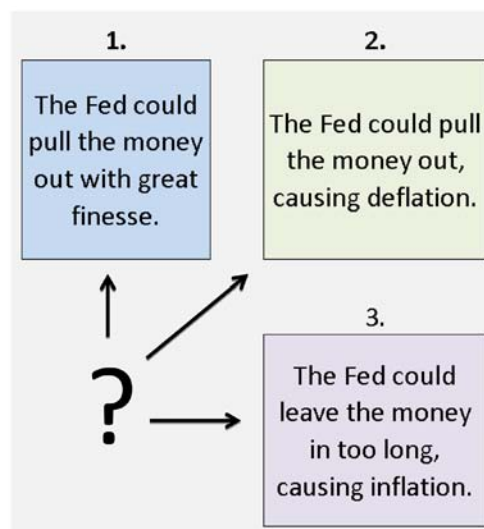
Now, I have thought long and hard about how we could get out of this situation, and I have concluded there are only three ways, as seen on Chart 6.

1) The Fed can pull the money out with great finesse. This is the ideal situation. This is, in fact, what we're hoping they are able to do.

2) The Fed can pull the money out altogether, and that would likely cause a serious recession and possibly deflation. I will show you an example of this with Japan in a few minutes.

3) The Fed could leave the money in the system too long, waiting for inflation before pulling it out. To me, this is the most dangerous scenario because if the banks are in the process of lending it out, the inflation rate could begin to rise, and if it's anything like the 1970s, it could rise rapidly. At that point, it would be very difficult for the Fed to get inflation under control without causing major disruptions to the economy and the market.

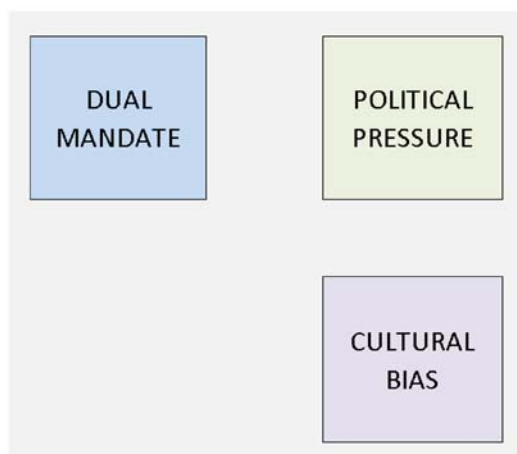
**Chart 6 : Possible Outcomes of U.S. Quantitative Easing**





Now let's move on to Chart 7 and I will give you the three reasons why I believe there is a risk of the Fed leaving the money in too long: 1) The Federal Reserve has a dual mandate, 2) The Fed is under tremendous political pressure, 3) There is a cultural bias in the U.S. to avoid a depression. These are the three things that are working against the Fed.

**Chart 7: Reasons the Fed is Unlikely to Finesse It**



Let's start with the first one, the dual mandate. As you all know, the Fed has a mandate for both price stability and maximum employment. There was a study done in 1998 by long time **Federal Reserve Bank of Richmond staff economist Robert Hetzel Ph.D.** It's called, "**Arthur Burns and Inflation.**" You can get it online, and I would suggest that anyone who is interested in this subject read this paper, because you will read some very shocking things about what happened during the 1970s. In addition, it will give you tremendous insight in understanding Fed policy, the issue of maximum employment, and the political pressure that the people at the Fed have to endure.

Looking back to the early 70's, as inflation was gaining momentum, the **Fed Chairman was Arthur Burns.** He was one of the top economists in the world, and he was an inflation hawk. He was truly against inflation. Yet he presided over the greatest inflation this nation has ever experienced. So how did this happen? Well, when you read the critique of Chairman Burns by Dr. Robert Hetzel, you will see exactly what happened, and this is what concerns me today.

Now listen to what Chairman Burns said when he made the decision not to use monetary restraint as inflation was skyrocketing during the 1970s. These words were taken from the minutes of the Federal Reserve (Board Minutes. 11/6/70. Pp. 3115-17), "*The prospects were dim for easing cost-push inflation. The only thing the Fed can do is impose monetary restraint.*" That's what they should have done. They went on to say they "*did not believe that the nation would accept a 6% unemployment rate, so they would forego the opportunity of monetary restraint because it's a conflict of interest with maximum employment.*"

The bottom line is that they were more concerned about what the nation would think about 6% unemployment, rather than worrying about the inflation. Therefore, based on the dual mandate and the prevailing mood of the country, Chairman Burns did not feel the Fed should show monetary restraint. Instead, the Fed chose to imple-





ment price controls, and you all know how that worked out. The price controls of the 1970s made matters a lot worse, and they created a real disaster in the stock market.

**Now, here's the point. Did Chairman Burns know what to do? Absolutely! Was he able to do it? No! And this is the thing that you have to keep asking yourself when you listen to the Federal Reserve minutes. You can see how concerned they are with the unemployment rate, and yet there is a risk of this high inflation.**

Besides the dual mandate, there is the political pressure that the Federal Reserve must endure. I don't envy being in that position. **After leaving the Fed, after the disastrous 13.5% inflation, Chairman Burns gave a speech that he called "The Anguish of Central Banking."** Here's what he said, *"Once it was established that the key function of government was to solve problems and relieve hardships, not only for society, but for troubled industries, regions, occupations or social groups, the government's programs, cumulatively was to, impart a strong inflationary bias to the American economy."* In other words, all the social programs that were started under Lyndon Johnson in 1965 created tremendous pressure on the Fed to keep printing money in order to pay for them. Well at that time, the spending on the mandatory expenses of the federal budget was 31%. Today, this mandatory spending is roughly 57%. So, if there was a lot of pressure due to government programs back then, think about how much pressure there is today, when 57% of all of the expenses go to fund the government's social programs. The cost of social reforms went hand in hand with full employment and so did government regulation.

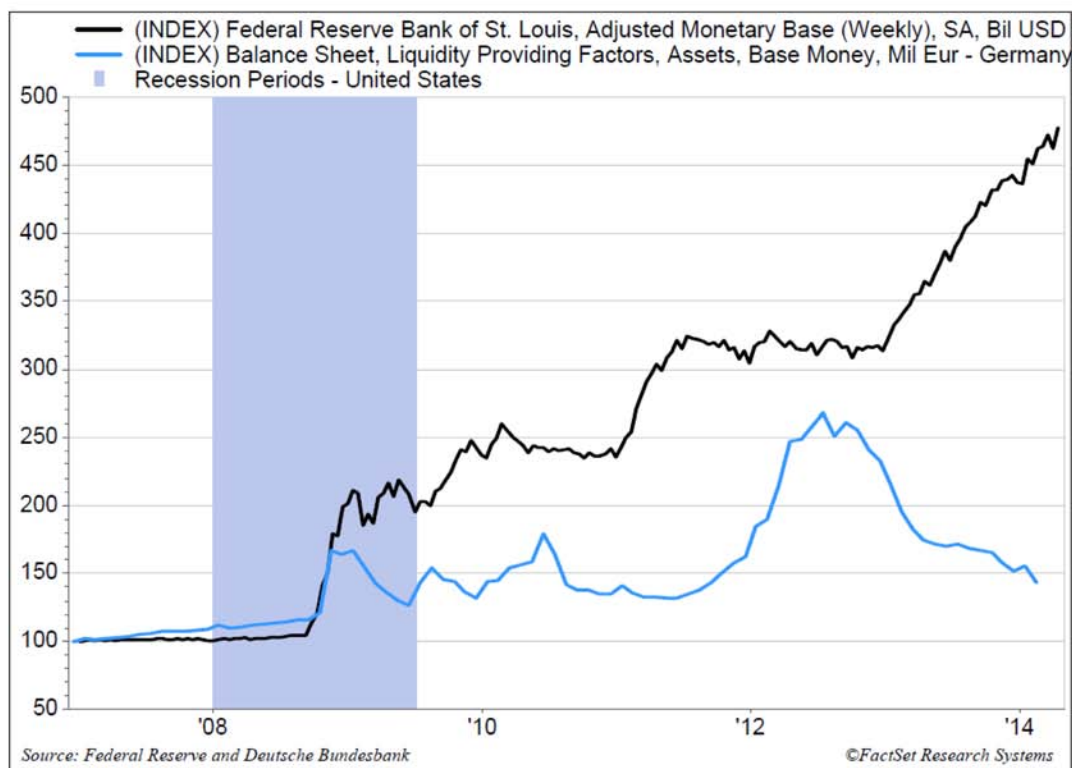
Chairman Burns went on to say that it is his conclusion that *"...it is illusory to expect central banks to put an end to inflation. That does not mean that the central banks are incapable. It simply means that the practical capacity for curbing inflation that is driven by political forces is very limited."* So there you have it straight from the horse's mouth. Your Federal Reserve is no more independent than your local congressman.

We have talked about the Fed's dual mandate and the tremendous political pressure they must endure. Now let's talk about the final problem and this is huge; it's our cultural bias. I'm going to show you the difference between what nations experience. By studying the cultures of nations and companies, you can see that we are influenced a lot by where we were born, who our parents were/are, and so forth. It's a cultural pressure. When you look at companies, you can see that the culture of a company is set by its leaders. When you look at the experience of the United States during the 1929 Depression, most economists who have studied it have concluded that one of the big problems was that the Fed cut the money supply when, in hindsight, they should have expanded it. Because of this, I believe the Fed is going to make sure to never cut the money supply. From what I can see, they are really taking that lesson to heart. If you look at all the quantitative easing, you don't have to worry about the Fed cutting the money supply. But the danger I see is that the generals are always fighting the last war. The last war was the 1929 Depression. The future war may be inflation, and I'm not sure how much attention they're paying to that. **But this is the cultural bias of the United States.**



As we move on to Chart 8, we can review the cultural bias of the U.S. with that of Germany. I think Germany is a great example of just how much of a difference a culture makes. The top line on the chart represents the quantitative easing in the United States. The bottom line represents the money supply created by the German bank. You can see that Germany did a little quantitative easing in 2012 and early 2013, but they immediately pulled it back. In my opinion, the culture of Germany is the complete opposite of the culture of the United States. Now, why does Germany have a strict and frugal approach to managing finances and why are they so keen on fighting inflation? The reason is due to the inflation that Germany experienced during 1913 to 1923.

**Chart 8: Cultural Bias -- Germany vs. U.S.**



You heard about it, you read about it, now let me give you a couple of examples just to show you how bad their inflation was. In 1913 Germany, you could buy an egg for 0.08 pfennigs, which is equivalent to roughly \$0.08 cents. Ten years later in 1923, that same egg cost 5,000 German marks. Just three months after that, that same egg cost 80 billion German marks. Let me give you one more example. In 1913 Germany, you could buy a pair of shoes for 12 German marks. Ten years later in 1923, that same pair of shoes cost 1 million German marks. Just three months after that, that same pair of shoes cost 32 trillion German marks. So basically, the German mark became worthless. They also had a huge depression. It was one of the most horrible things that can happen to a nation. I believe this type of rapid inflation is far worse than a depression, because you lose all confidence in government and everything else.

You can now see why the German culture is pulling that short-term stimulus money back out of the system. They fear inflation, and, in my opinion, they are doing the right thing. As for the United States, it's more worried about a possible



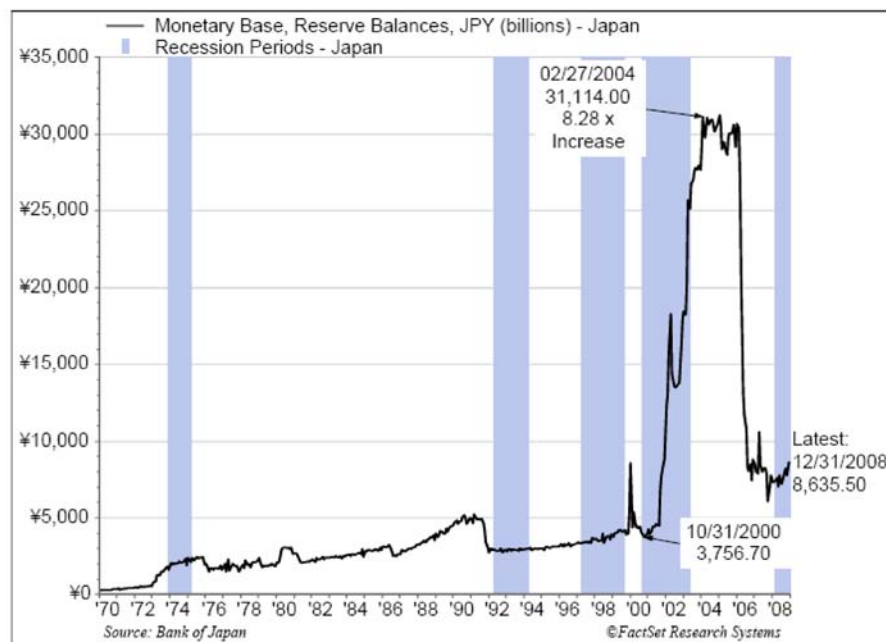


depression, and I agree that that's a terrible thing that we should do everything we can to avoid. I'm not judging one culture versus the other. I'm just trying to explain the difference between the cultures.

So these are some of the issues that the Federal Reserve has to deal with. Again, I am really hoping that the Federal Reserve is able to finesse its way out of this situation. I am rooting for them. I am praying for them. I am hoping they can pull it off, **but it's not the way you want to bet, at least not with real money.**

Now let's look at the second possible outcome which suggests that if the Fed pulls the money out altogether or too fast, we could have deflation. We have a precedent for this in Japan. On Chart 9, we can see a history of Japan's money supply from 1970 through 2008. When looking at this chart, I want you to keep the data points in your mind, because I'm going to show you a chart of the stock market in just a minute that will look virtually identical to this chart. But here you can see that from 2000 through 2004, Japan ran up their money supply eight times the original base.

Chart 9: Japan: Money Supply I

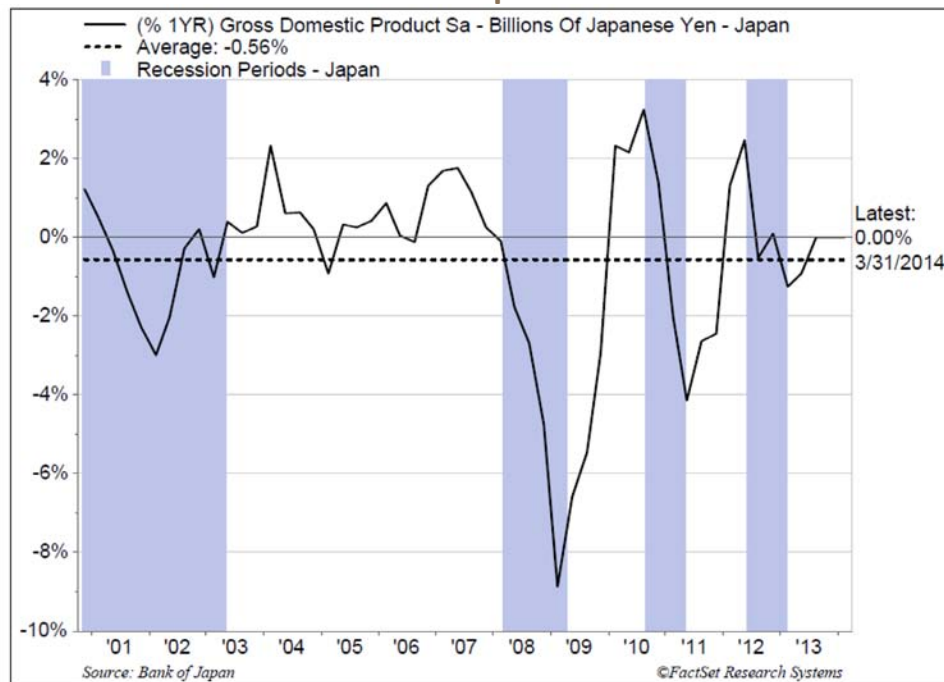


Now just to show you how extraordinary that is, today in the U.S., we are about four times the original base, so Japan actually went even further than we have gone. After pumping up their money supply, they kept it in there for roughly four years and then they started pulling it back. You can see that they eventually pulled it all the way back to the baseline.



So, what happens when you do that? Chart 10 shows that because they pulled the money out in its entirety and did so at such a rapid pace, the economy literally went into deflation. There was no growth for 15 years. Matter of fact, in the last five years they were minus 1.6% growth. On average, their growth rate over the last 15 years was minus 0.56%. There was literally a negative average growth rate for 15 years! As of March 2014, after 15 years of an average negative growth rate, they are now only at 0.00% growth. That is the cost of pulling out all of the money too rapidly.

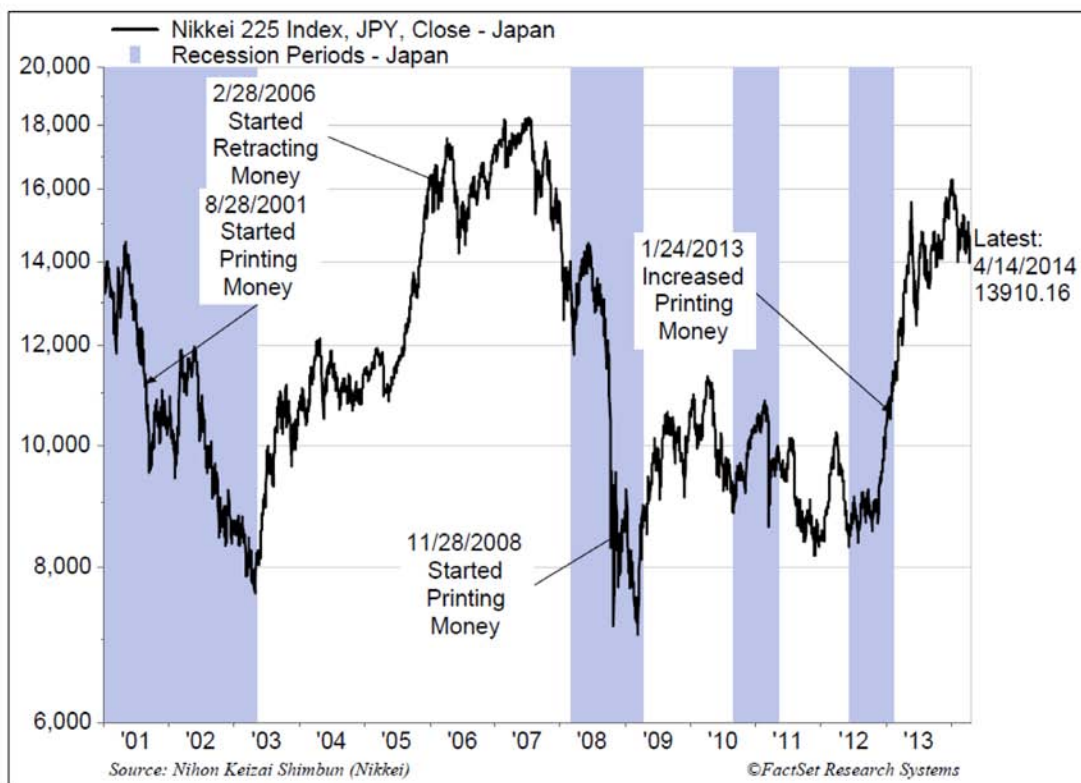
**Chart 10: Japan: GDP**





Now, let's look at the stock market. Do you remember I showed you Japan's money supply on Chart 9? Let's compare the data points on that chart with the Nikkei 225, Japan's stock market, on Chart 11. At the bottom left hand corner, you can see Japan starting to print in 2001. They were finally able to stabilize the market as it hit bottom below 8,000 in 2003. Then they printed in a big way, which in turn helped run the market up to about 18,000. Then, in 2006, they began pulling the money out. But look what happened to the market when they did this. It made a complete reversal and it actually ended up lower than the previous 8,000 bottom. To reverse this decline, they began to put the money back into the system in 2008. They stabilized the market, and ran it up a little bit. The market was just kind of moving back and forth in a trading range, and then in 2013, they got real serious about printing money and look what happened. In one year, the market took off from 10,620 to 13,009, up 30% in one year. Was this increase due to fundamentals? I doubt it. Every time they printed, the market went up, and every time they pulled it back, the market went down.

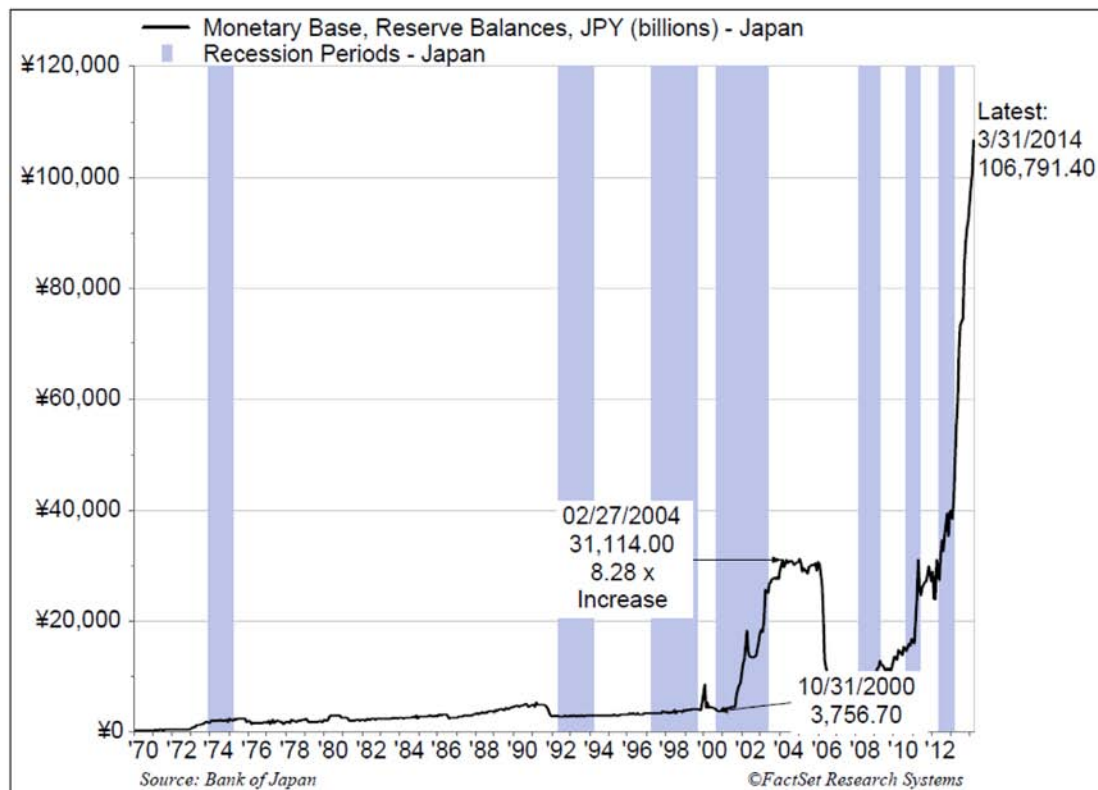
**Chart 11: Japan: Stock Market**





Now take a look at Chart 12. This will show you how serious they are about printing money. This is truly extraordinary. Do you remember that big move we saw on Chart 9 when Japan increased their money supply 8 times? Well, now this is just a little blip on the screen when you compare it to the present increase in their money supply. Japan is totally committed to printing money to stimulate growth. But they are just one of the many countries doing this. Again, what we are seeing today is truly a worldwide quantitative easing.

**Chart 12: Japan: Money Supply II**



Up until recently, the Fed hasn't shown any inclination to pull money out. Basically, they're just slowing down the printing. They haven't talked about pulling the money out, but —and this is what I want to make you aware of today—I believe that the Fed at some point, when the inflation starts to show up, they're going to have to start pulling this money back out, and when they do, it's going to be a very challenging situation. The difficulty will be that when the Fed starts pulling this money out, this will have an effect on some of the bubbles they have created by printing all this money. We already got a taste of this in February 2014 as the Fed started tapering. They didn't pull the money out of the system, but just tapered their debt purchases. You saw the worldwide bond market start to fall off because everybody's been chasing yield. People that ordinarily would not take extra risk for a higher yield find themselves buying foreign debt and junk bonds, among other things, just to get some income. But when the Fed starts actually pulling the money out of the system, I believe it's going to put a lot of pressure on these debt markets, put a lot of pressure on stock markets around the world, and put a lot of pressure on the economy. So it remains to be seen whether the Fed has the political



will to withstand the pressure that will come if we start going into a recession.

I want to make this point. We do have the potential for a wonderful finesse move by the Fed, and we can live happily ever after. We also have the potential of a deflationary cycle, and, based on the history of this country, I believe that when the Fed starts to get into real problems and markets start to swoon, they'll go back to printing, just like Japan. This is my own personal opinion. You can come to your own conclusion, but I want to make you aware that these are all possibilities. I believe when you look at all these situations and variables, that in the end the Fed is probably going to keep the money in the system too long and it will likely start to cause inflation.

Now, let's move on to Chart 13 to review the various measurements of inflation. If we were to just look at the CPI, it keeps telling us that we don't have much inflation, maybe 1% to 2%. How many of you here today believe that inflation is less than 2%? Let me see your hands. How many of you believe that inflation has been more than 2%? Look around the room. There are not too many people that believe the CPI.

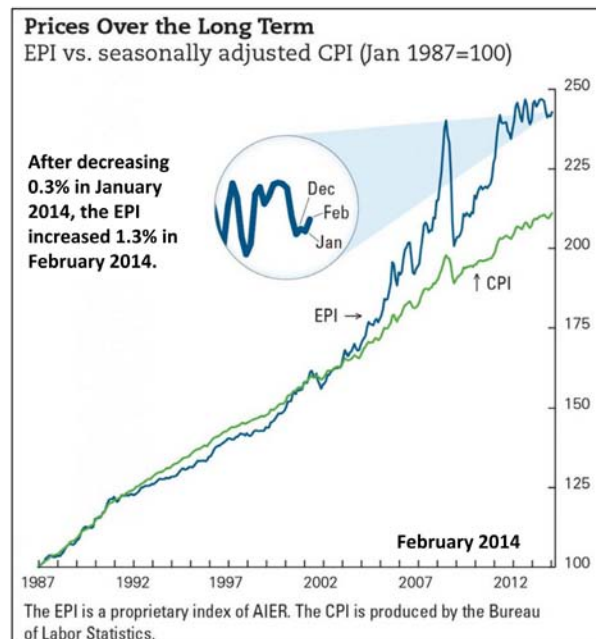
As an alternative to the CPI, there is an organization called the **American Institute for Economic Research** which publishes what they call an Everyday Price Index (EPI). This organization was started by Colonel E.C. Harwood (1900-1980) in 1933. After graduating from the U.S. Military Academy and having served in the U.S. Army, he wanted to create an organization that would conduct independent, scientific, economic research to educate individuals, thereby advancing their personal interests and those of the nation. Specifically, they created the Everyday Price Index to show people how much inflation the average person is experiencing.



If you look at Chart 13, you can see the top line represents the EPI while the bottom line represents the CPI. According to the EPI, the U.S. has averaged 4.2% inflation over the last 10 years, compared to the CPI of 2%. I just wanted to bring this EPI measurement to your attention.

For those of you who are interested, there is one more interesting measurement of inflation that was created by two professors at the MIT Sloan School of Management. It's called **The Billion Prices Project**. This is an academic initiative that uses prices collected from hundreds of online retailers around the world on a daily basis to study high-frequency inflation data across countries and sectors. I encourage you to take a look at this study as I believe it will give you information on inflation, as well as some reasons why the CPI may appear to understate inflation, even if it's not intentional.

**Chart 13: Everyday Price Index (EPI)**







Before I begin to share with you some of the lessons I learned from the inflationary period of the early 1970s, I want to give you a little bit of monetary history to show you that what we're leading up to did not just happen. It happened over a period of 30 to 35 years. Every political party contributed to this one way or another, so you can't blame it on any one person or any one party. It is part of the collective culture of this country and it's going to have to be dealt with eventually. But here's what happened. Chart 14 shows that in 1879, the United States had ended the Civil War and went on the gold standard. Everything was very good at that time, stable economy and so forth.

## Chart 14

**1879 – After the American Civil War, the U.S. goes on a gold standard.**



Source: *Brief History of the Gold Standard in the United States*, Congressional Research Service, June 23, 2011

Then World War I came. Chart 15 shows that in order to finance the war, the government temporarily suspended the gold standard. This allowed the U.S. to print money out of thin air to finance the war. As a result, with all of this money coming into the economy, it created a boom in commodities.

## Chart 15

**1914 – To finance World War I, the gold standard is temporarily held in limbo as exports are banned and the minting of coins drastically reduced.**



Source: *Central Bank Gold Reserves, An Historical Perspective Since 1845* by Timothy Green, *World Gold Council*, November 1999

It is important to note that whenever you print money, it's eventually going to seep into the commodities and they are going to skyrocket, and that's what happened. However, while it created a big boom, like all booms, there eventually was a bust in 1921.

## Chart 16

**1921 – The excess money created during WWI causes a commodity boom and bust.**





Chart 17 highlights that in 1922, after that commodity bust, the United States got together in Genoa and created what they called the Gold Exchange Standard. The Gold Exchange Standard allowed you to create more money, but it had to have a 40% backing by gold. So we have now transitioned from a pure gold standard to a Gold Exchange Standard in which 40% of the currency was backed by gold.

## Chart 17

**1922 – The Genoa convention establishes a gold exchange standard.**



1880s	1890s	1900s	1910s	1920s	1930s	1940s	1950s	1960s	1970s
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Source: National Bureau of Economic Research

Everything was basically fine for the dollar until 1965 when President Lyndon Johnson came into office. He created the Great Society. Most of the major government programs that are in effect today can trace their roots to the Great Society programs, and you can see how these programs have expanded dramatically over time. While well intentioned, the funding for the Great Society programs became a problem. (See Chart 18)

## Chart 18

**1965 – The legal definition of a dollar is changed from 1/35 of an ounce of gold to a “Federal Reserve Note”.**



1880s	1890s	1900s	1910s	1920s	1930s	1940s	1950s	1960s	1970s
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Source: Report to the Congress of the Commission on the Role of Gold in the Domestic and International Monetary System - Volume II, March 1982



President Johnson also had to finance the Vietnam War. So how do you pay for these new Great Society programs and finance the war? There's only one way, you print. So by 1968, there wasn't enough money, so he dropped the link to gold from a 40% backing to 25%. This gave him a lot more room to create money. (See Chart 19)

### Chart 19

**1968 – Johnson reduces the gold backing of the dollar from 40% to 25%. This helps finance the Vietnam War and fund the Great Society programs.**



Source: *Brief History of the Gold Standard in the United States*, Congressional Research Service, June 23, 2011

Well, the foreigners got smart. They finally realized that the U.S. was going to continue to print money and reduce the value of the dollar. In response to this increased printing, between 1968 and 1971, foreigners took their dollars and converted them into gold. They did this in such a big way that it created a run on the U.S. gold reserves. The United States literally lost half its gold reserves during this time because so many people were converting dollars into gold. (See Chart 20).

### Chart 20

**1968 to 1971 – Seeing the dollar's decline, foreigners start converting their dollars to gold.**



Source: *Cato Institute*

So, what did the U.S. government do? Chart 21 points out that in 1971, President Nixon saw no other way out. He could either risk losing all of the country's gold reserves, or he could give up the remaining link between gold and the dollar. He chose the latter, and removed the backing of the dollar with gold. In other words, he changed the convertibility of the dollar into gold. And that was it. The dollar was no longer backed by gold. From 1971 to today, the dollar has just been floating on an everyday basis and you can see what happened to its value.

### Chart 21

**1971 – Nixon suspends convertibility of the dollar into gold, and it becomes a fiat currency.**



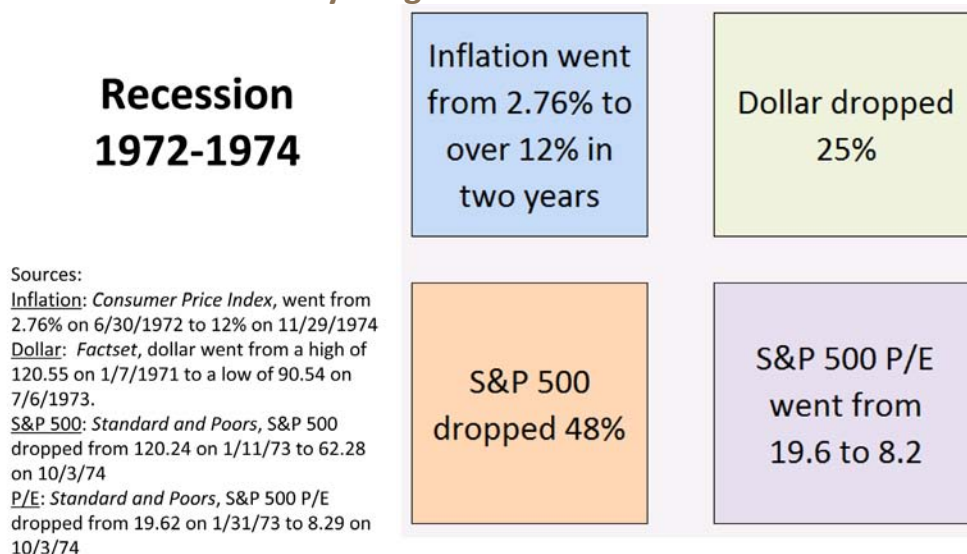
Source: *Brief History of the Gold Standard in the United States*, Congressional Research Service, June 23, 2011



Now, let's take a look at the consequences of removing the link between gold and the dollar. Chart 22 shows you a summary of some key repercussions of the monetary and fiscal policy decisions that started in 1965 to fund the Great Society programs and the Vietnam War. Now, here is a very important point I want to make. It took eight years (1965 to 1972) to build up to high inflation. However, while it took time to build, once inflation showed up, it was like lightening and it moved very quickly.

Inflation went from 2.76% to 5.6% in one year. It literally doubled in one year! Then it more than doubled again as it went to 12% in two years. So, the first consequence of delinking the dollar from gold and increasing spending is that inflation went from 2.76% to 12% in two years. This is very important to understand. **While it may take years to build it, once inflation comes, it is almost unstoppable.**

**Chart 22: Consequences of Monetary & Fiscal Policies, Starting in 1965 to Fund the Great Society Programs and the Vietnam War**



It was about that time in 1974 when I was starting Century Management that I went and heard a world currency expert by the name of Dr. Franz Pick. He was an Austrian economist who studied every world currency. I think he had studied over 500 currencies at one time or another. He was an advocate of the gold standard. He believed that gold, silver and natural resources could hedge you against inflation. To me, he was like an Old Testament prophet. So I studied his work, listened to his tapes, and bought his books. At the conclusion of my studies, I decided that he was right about gold and how to hedge against inflation.

Wanting to get more information about inflation, I remembered what my dad had told me. He said, "If you want to understand inflation, you must talk to the Europeans. The Americans don't understand it." So I decided to go to Europe, and I talked to as many people as I could about inflation. When I came back from my trip and had concluded my research, I decided to buy Swiss Francs, which did very well. I also bought silver claims on Swiss reserves. It was illegal to own gold at the time, but you were allowed to buy gold coins as they were considered collectibles. I also bought British Sovereign coins which were selling for a small premium over gold bullion. This



provided a great inflation hedge at that time, and they really helped to protect the portfolios, because as you well know, from its peak, the S&P 500 went down nearly 48%, hitting a bottom in 1974. However, according to Ibbotson, from January 1969 to January 1975, small-cap stocks declined 58%. It was literally a financial disaster. But the lesson I learned from the 1970s is that you can do a lot to hedge your portfolios by purchasing natural resources, gold stocks, silver stocks, mining companies, and some of the other cyclical types of companies, or basically everything most growth investors would never buy. But if you're a value investor, I believe there are opportunities in those areas and we'll talk about them more a little bit later.

Anyway, Franz Pick was giving a lecture about the time that Nixon delinked gold from the dollar. He had this thick Austrian accent and he said, *"You know I don't understand it. Here I am at this seminar and you people are smiling and you're sitting around and the United States President has just given a decree that's going to turn the dollar into toilet paper. You should be out in the street causing a revolution, not sitting in here."* He then went on to say, *"I don't know why we don't put these people (i.e. government officials in charge of the dollar) against the wall and shoot them."* He was that upset about it.

When the lecture was over and the question and answer session began, somebody in the group asked Dr. Pick what he thought about second mortgages. I thought he was just going to take the guy apart. He said, *"Listen, I just told you your dollar is going to be toilet paper and now you want to know what I think about second mortgages!"* Anyway, I got the impression that Dr. Pick didn't like what was going on and this really made an impression on me.

Now I want to bring to your attention a very important quote by Robert Hetzel, an economist with the Richmond Federal Reserve, that I think applies to today's situation, and that is the quote on Chart 23. It reads, *"Experience in itself does not make people wise. Economists need to examine and learn from historical experience in order to avoid repetition of mistakes."* I think this is true of economists. I think it's even truer of money managers. There is nothing better than studying your mistakes. You can study your successes and pat yourself on the back, but that's not where you learn. You learn from your mistakes. One of my favorite quotes is by an author, James Allen, *"You either learn by wisdom and knowledge or suffering and woe and you continue to suffer until you learn."* So, this is how we learn. You either learn by suffering or by wisdom and you can make your own choice. I can tell you that studying through wisdom is a much easier way to go. Matter of fact, it took me about 20 or 30 years before I came to that conclusion, so I am a student of wisdom now.

### **Chart 23: Lessons From the 1970s**

***"Experience in itself does not make people wise. Economists need to examine and learn from historical experience in order to avoid repetition of mistakes."***

***Robert L. Hetzel,  
Economist, Richmond Federal Reserve***

Source: "Arthur Burns and Inflation," Federal Reserve Bank of Richmond Economic Quarterly Volume 84/1 Winter 1998  
[http://www.richmondfed.org/publications/research/economic\\_quarterly/1998/winter/pdf/hetzel.pdf](http://www.richmondfed.org/publications/research/economic_quarterly/1998/winter/pdf/hetzel.pdf)

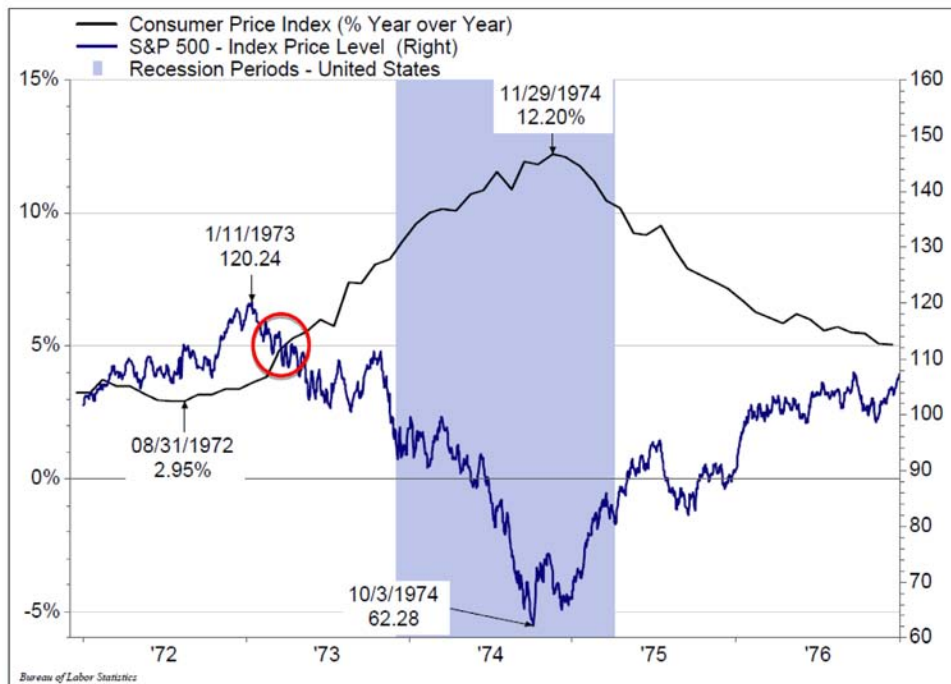




Another one of my favorite quotes, especially when talking about this subject, is by Cicero. He said, *“To stumble twice against the same stone is a proverbial disgrace.”* So with that in mind, let’s take a look at the 70s and see if we can learn from it. Let’s hope we never have to go through that kind of financial distress again. But let’s also be mentally prepared so if we see the signs that inflation is coming, we can react to it.

Now, here’s the first thing that I learned about inflation. Looking at Chart 24, the top line is the CPI. You could see as the CPI went up, the stock market went down. What most people don’t realize is that there is a tipping point where inflation is no longer helpful to an economy. Take a look at the left-hand side of the chart and you can see that inflation was around 2.95% in 1972. During this period the market was actually going up. **So we can see that 1%, 2%, or even 3% inflation can be very positive for the stock market. It means the economy is strong. It means it’s growing and everything is wonderful when you have low inflation. But once inflation picks up and crosses that 4% threshold, the stock market begins to decline.** Now look at this chart. When inflation was below 3% in 1971-1972, the market went up about 20% by January 1973. But the minute inflation crossed 4% to 5%, boom! The stock market declined and it did so rapidly. So, you want to watch for signs of inflation. The minute you see it above 3% or 4%, you’re going to have to start adjusting your stock market multiples, because if you don’t, the market is going to do it for you.

Chart 24: CPI vs. S&P 500







Now, let's take a look at Chart 25. This chart covers over 40 years of data. If I had to pick one chart today for you to study it would be this one, because it will show you how quickly a change in inflation can affect your multiples. You can see that at 0% to 1% inflation, you don't have very high stock market multiples. Why is that? Because the economy is weak, it's not growing very much and the earnings are kind of sporadic. Once inflation gets to 2% or 3%, you get a little bit higher multiple. And at 3% to 4% inflation, you get your maximum multiples. **But look what happens when inflation crosses 4% and goes into the 4% to 5% category, the P/E multiple drops from 20.87 to 14.33. This is a 31% decline. And then when inflation goes over 5%, the P/E drops to 9.98, another 30% decline. So when you get above 3% inflation, just another 1% or 2% more can have a significant impact on the stock market and your portfolios. This is critical to understand as a portfolio manager. You need to watch inflation and be prepared to adjust the multiples.**

**Chart 25: CPI (Inflation) vs. S&P 500**

Inflation	S&P 500 P/E
0-1%	15.37
1-2%	17.70
2-3%	20.37
3-4%	20.87
4-5%	14.33
Over 5%	9.98

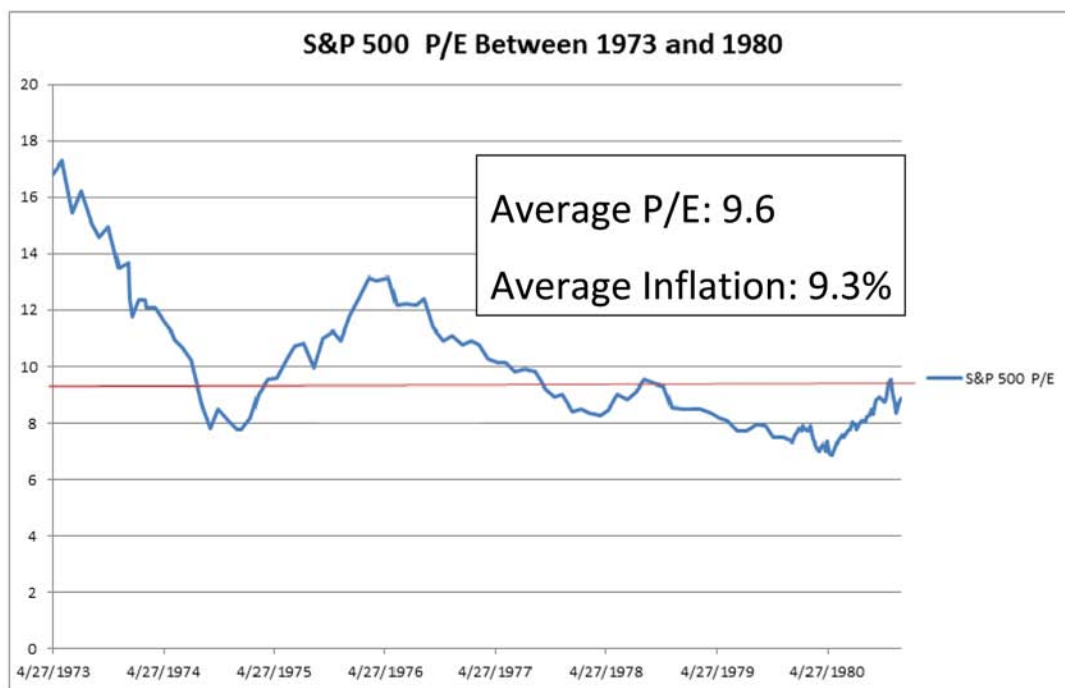
Lowest P/E (5/9/1980)	
13.28%	6.85

Source: Bloomberg, Bureau Labor Statistics



Now let me show you just how quickly that happened in 1973. Chart 26 shows that in January 1973, when inflation went from 2.76% to 4.48% in 10 months, the stock market multiple went from 17 to 12. In other words, in a period of 10 months, the multiple declined 30% because of this 2% increase in inflation. So we must watch inflation very carefully. Now, on your smaller companies, they can get hit even more. Chart 26 also shows that the average inflation rate from 1972 to 1980 was 9.3%, and the average stock market multiple was 9.6. This was more than a 50% decline for the multiple, as it started around 18. I should also mention that in the early part of this period, from 1972 through 1974, the stock market declined 48% and the dollar dropped 25%. Again, we need to keep an eye out for inflation, because once it crosses that 4% to 5% threshold, we will see a drop in the equity markets.

**Chart 26: S&P 500 P/E through 1980**

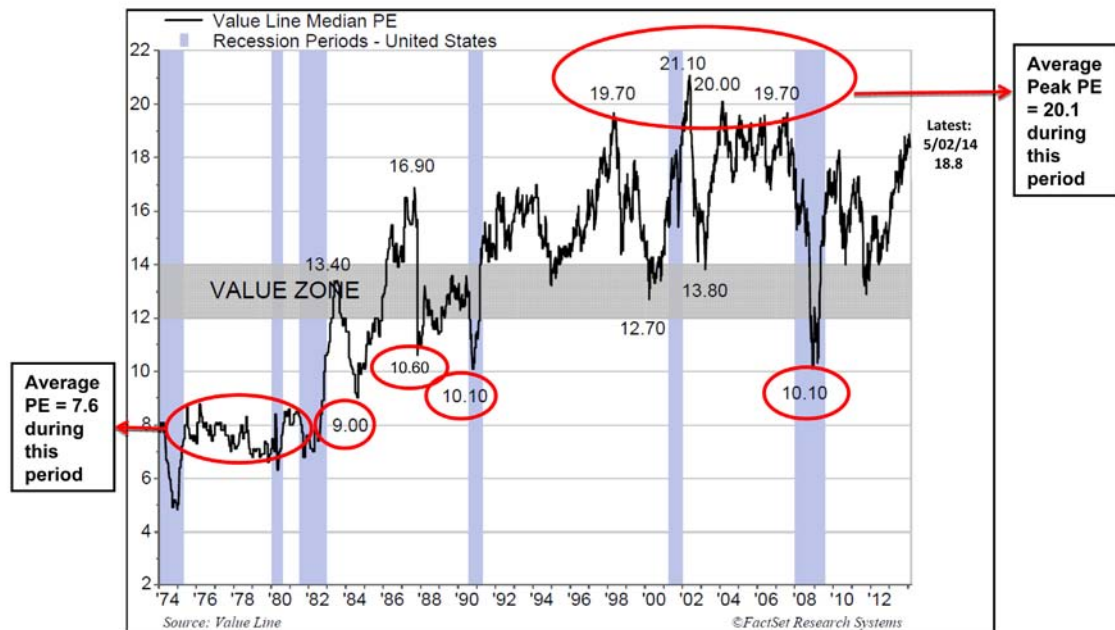


Source: Bloomberg



We just reviewed what happens to the average P/E of larger companies during inflation. Now let's review Chart 27. This chart shows the median P/E for the Value Line Investment Survey®, a composite of 1,700 companies. This is one of my favorite charts when looking at the overall market.

**Chart 27: Value Line® Median P/E**



Every week for the past 40 years, I have tracked the Value Line® median P/E. What I like about it is that it's not an average P/E. Rather, it's a median P/E. I don't like averages because when you have an average, you can find times like during the tech bubble when as few as 10 companies, due to their size, materially impacted the average P/E ratio of the S&P 500 to the upside, while the rest of the market, that is, that average stock, had a P/E that was trailing off. So by using a median P/E, you get the midpoint, and in this case, the midpoint of 1,700 companies. Another benefit is that Value Line® uses two quarters of past earnings and two quarters of forward earnings, so it is not all projections, unlike the S&P 500 that uses all forward earnings.

By using the median P/E of the Value Line® composite, I believe we can get a better estimate of how the average company performed. You can see at the bottom left of this chart, when inflation was averaging over 9%, the average median P/E was 7.6, and it got as low as 5 to 6. So, when you look at the average- to smaller-sized companies, they are a huge risk once you get high inflation.

Now, you've heard the idea that stocks are a hedge against inflation. Yes, they can be but not during accelerated inflation. The only time stocks are a hedge against inflation is when you buy them at the low multiples of 8, 10, and 11 times earnings. Then they will be a wonderful hedge over the long run. But, if you buy stocks with higher multiples when inflation hits, you're most likely going to take a 40% to 50% hit before you start getting the hedge. So, in my opinion, the only thing that higher multiples hedge is capital gains. Higher multiples are not a help when you have accelerated inflation.



During more normal inflationary times, those under 4%, Chart 27 shows that the median P/E typically hits bottom around 10 times earnings (see 1984, 1987, 1990, and 2009). So, I believe using 10 times earnings is a very good multiple at the bottom of the market given inflation rates under 4%. Now you see at the top, the earnings peak is at roughly 20 times. So this gives you a good range, 10 times earnings at the bottom and 20 times earnings at the top. As of May 2, 2014, we are at 18.9 times earnings, so we hope we don't experience high inflation, because you know what's going to happen to these multiples if inflation hits. Again, I'm not saying this is going to happen, but if it does, that's the situation we will be faced with. So you can see the damage that inflation does to portfolios once it hits.

Now let's take a look at Chart 28, as there are a few things I want to bring to your attention regarding the bond market. If we have deflation or a recession, owning long-term bonds could actually help you. So if you believe that we are going to have deflation, long-term bonds would certainly be a good hedge for your portfolio. Now, if you do see deflation coming and the bonds appreciate, I believe you should take that opportunity to sell the bonds, because if you don't sell them before inflation kicks in, you could be in a position of having an unrealized loss for 20 years. Let me give you an example. In the early 1970s, inflation was running around 2.7% to 3.5%, and 10-year Treasury bonds were yielding 6% to 6.5%. Then inflation hit and went up for seven years, reaching highs of 13.5%. You can imagine what happened to the bonds. The 10-year Treasury bonds plummeted, reaching yields of 13.5 to 15.8%. But here is the most important point—**even though inflation started declining in 1980, the bonds still hung in there, because once you have an inflation psychology, people believe it's likely to go higher. They've been hurt by it, and they don't believe it's going to stop, so they keep holding onto the bond and its high yield. We were getting 7% or 8% real rates of return in the early 1980s, which is extraordinary because you normally only get 2% or 3%. The reason we got those real rates of return is that people did not believe that inflation was going to subside.** So when you look at the round trip that took place in bonds, even in 1990 the interest rates were higher than they were in the early 70s, bond investors lost for 20 straight years. Remember, if you see inflation coming, while you have to be diligent in watching out for your stocks, you have to be even more diligent about your bonds.

**Chart 28: 10-Year Treasury Rates 1971-1990**

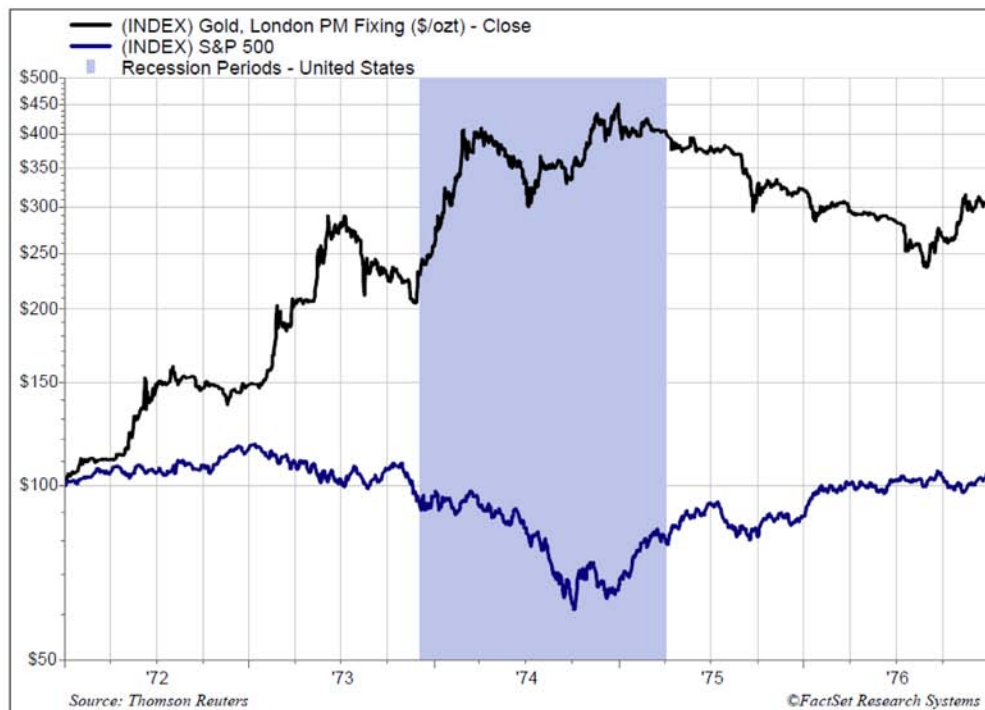




As we move on from talking about bonds, if you believe we are going to have inflation, be sure that you buy companies that have only long-term debt, because if you buy companies that need to refinance their debt in the next 5 or 10 years, and we're going through a period of high inflation at that time, these companies are going to pay more for refinancing their debt. However, in a higher inflationary environment, it may be very difficult to get financing at all. Companies with a lot of debt, especially shorter-term debt, could actually be in jeopardy. So, if you see that we are heading into an inflationary environment, you should own companies that have only long-term debt or preferably no debt at all.

Now let's move on and take a look at Chart 29 to see how we can protect ourselves during higher inflation. This chart shows that if you invested \$100 in gold in 1971, it would have gone up roughly 350% by the end of 1976. During this same time, had you invested \$100 in an S&P 500 index, you would barely have your money back over this same time period because the stock market dropped more than 48% in the middle of this period. Obviously, if you can buy gold at the right price and at the onset of inflation, it could serve as a very good hedge for your portfolio. By the way, in February we wrote a report called **Inflation, Gold and Gold Mining Companies** and in March we wrote a report called **Gold Valuation Analysis**. Both are on our website and available to anybody who is interested. It might give you some thoughts about this subject.

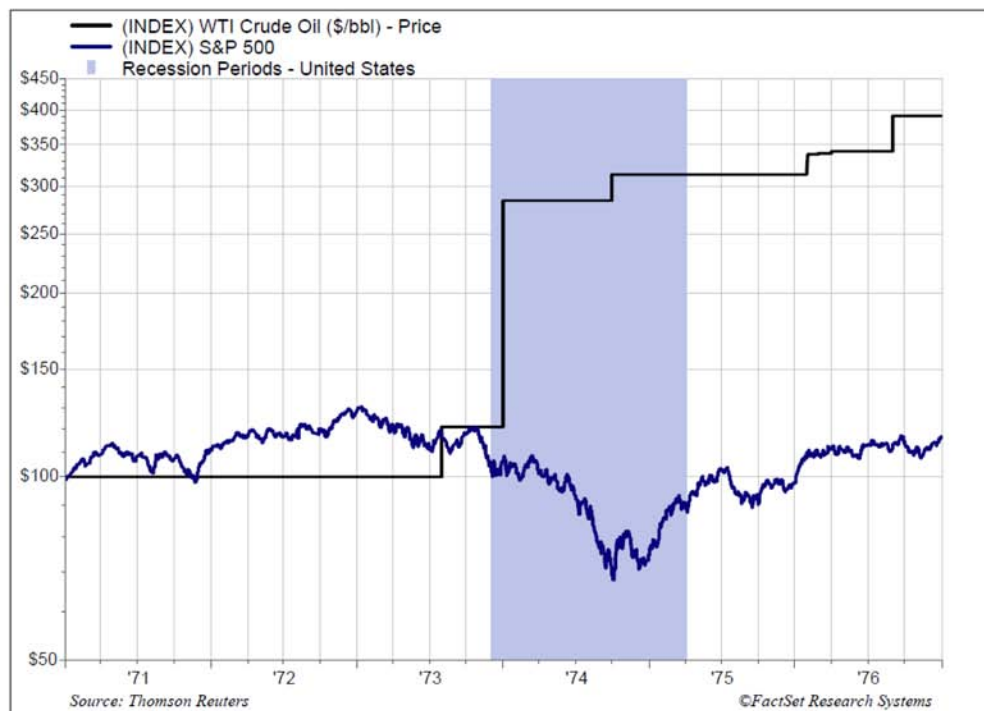
**Chart 29: Gold vs. S&P 500: 1971-1976**





Now let's take a look at Chart 30. It shows that oil is an excellent inflation hedge. You can go back 70 years and see that oil really helps protect you against inflation, almost as good as gold. So, I think that oil would be another great way to invest your portfolios to protect yourself from inflation. Whether you buy actual oil companies or companies that service the oil industry, I don't think it really matters all that much. Just owning securities that are somehow related to oil would make a big difference.

**Chart 30: Oil vs. S&P 500: 1971 through 1976**

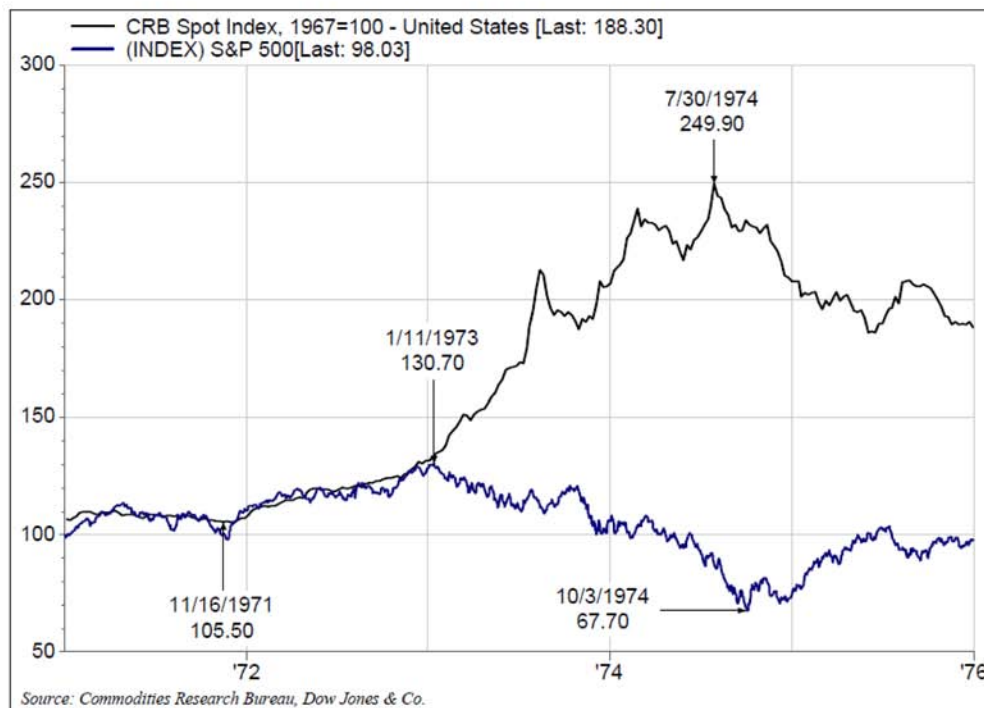






Now, if you're not inclined to buy gold or oil or any individual commodity, you can take a position in a commodity index or ETF, where you could buy a diversified basket with all the different types of commodities. On Chart 31, I am showing the CRB Commodity Index, which consists of just 19 commodities. But by buying this index, you wouldn't have to do any management. The only thing you must do is buy it right. Just like any stock, you must evaluate it. You can see in 1973-1974, the CRB Index went up 150%, while at the same time the S&P 500 went down 48%.

**Chart 31: CRB Commodity Index vs. S&P 500**

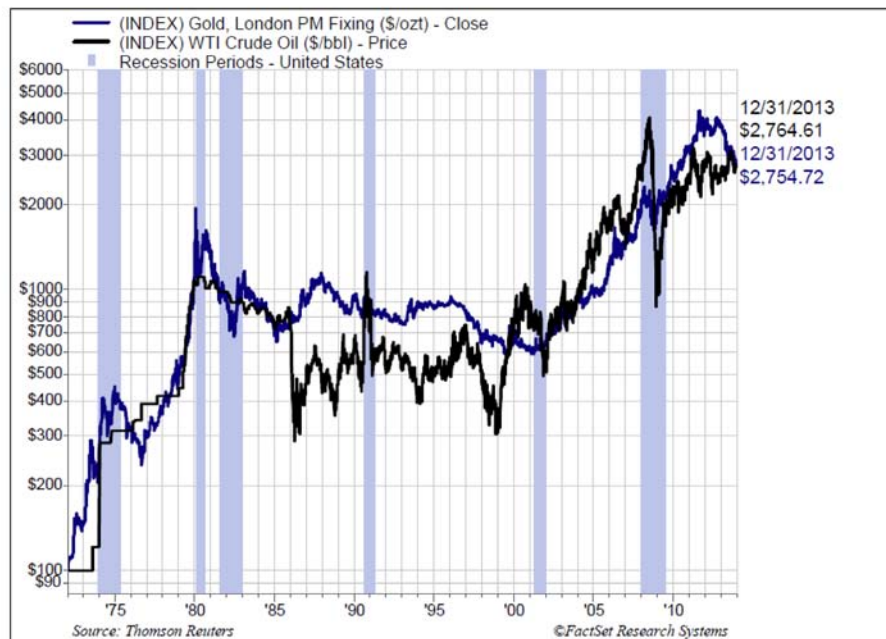


Now, I'm not suggesting that you need to put a lot of money in these commodities. I believe that if you have 10% or 15% of your portfolio in commodity-related businesses or individual commodities, or a combination of these investments, you could do a lot to protect yourself against a stock market decline caused by high inflation.



Now let's look at Chart 32. This chart shows that over the long run, it would not matter whether you bought gold or oil. If you had invested \$100 in gold in 1971, when it was no longer backed by the dollar, it would have grown to \$2,764 by the end of 2013. However, if you had invested the same amount in oil, it would have grown to \$2,754 during the same time. Only a \$10 difference! So, if you're not inclined to own gold because you don't believe in it or you don't feel comfortable owning it, or don't know how to evaluate it, oil companies and related companies could be just as good a hedge, if you buy them right.

Chart 32: Gold vs. Oil



Now let's look at the summary on Chart 33. During the inflationary period of the 1970s, gold went up 350%, oil went up 300%, and the CRB Commodity Index went up 150%, while the S&P 500 went down 48%. **You can see that during inflation, having a portion of your portfolio invested in natural resources, mining companies, timber companies, real estate, anything that has substance to it, what we call hard assets, would be great things to own.**

Chart 33: What Happened to Your Investments in the 1972-1974 Recession?

If you bought gold:	↑ 350%
If you bought oil:	↑ 300%
If you bought the CRB:	↑ 150%
If you bought the S&P:	↓ 48%

Source: Bloomberg



As we take a look at Chart 34, I want to make a very important point and be very clear about it. **Whatever you buy as a hedge, it is very important that you buy it just like any other value investment you make. You don't want to run out and buy one of these hedges regardless of price, because if you pay too much, it might hedge you against making a profit. Always remember to focus on value and the price you pay for that investment.**

Chart 34 provides a good guideline when looking at commodities. We took every commodity on the board and asked ourselves what the maximum was that commodities dropped from their peaks. In the case of metals, the maximum decline was about 66%; for energy it's 74%; agriculture it's 63% and the average of these three categories of commodities dropped 67% from the top.

When you look at these commodities, I don't think you should even become interested in them until they're down 45% to 50%. But once they are, I would start studying the fundamentals, look at the values, and determine where you want to buy. So where are we today? By looking at Chart 34, you can see most commodities are not a buy today based on their values, even though they might prove to be a very good investment over time. For this group of commodities, the average decline from their peak was 42%, and right now they're down 21% from the top. So I think they are definitely something to watch, but I don't think most commodities are in a value zone today.

Commodities are up about 100% over the last 10 years, and during the inflation of the 1980s, they went up roughly 300%. So I don't think it's too late to buy commodities to hedge your portfolio. But as I said before, you want to wait for the right values before you buy.

Now, when looking at the individual commodities, we think a couple of them today are coming into the buy zone, and one of them is silver. Historically, silver goes down approximately 77% from its peak. Today, at +/- \$19 per ounce, it's down about 63% from the top. So I think it's worth researching, and if it were to drop in price from here, I think you could consider a dollar cost averaging approach to silver. It's the kind of thing that you could start to tiptoe into. I'm not necessarily recommending it. I'm just giving you an idea as I think it's worth looking into if the price drops further. But this is just one of many examples. You need to do your own homework to get comfortable with it before putting it into your portfolio.

**Chart 34: Commodity Price Declines From Their Peaks**

Commodity	Max Decline	Average Decline	Current Decline
Average Metals	-66%	-39%	-25%
Average Energy	-74%	-44%	-14%
Average Agriculture	-63%	-42%	-22%
Average Total Commodity	-67%	-42%	-21%

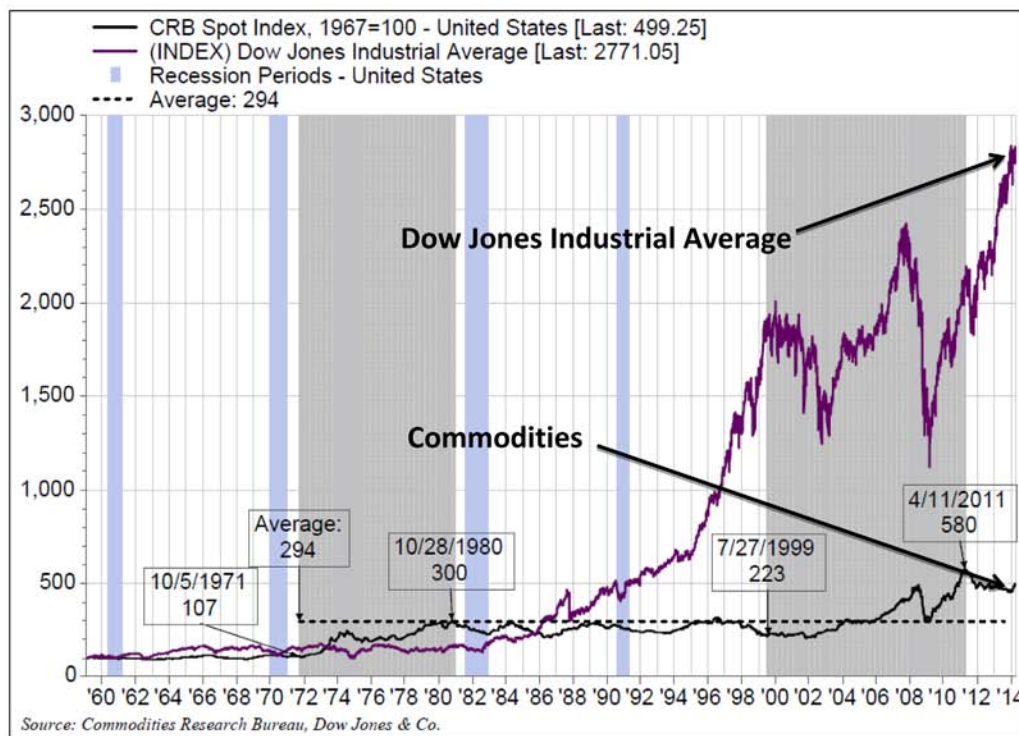
Time Frame: Starting date varies for individual commodities, ending date is January 31, 2014. Source: Bloomberg



While I have shown you how to remain flexible in your thinking and how to hedge against inflation by using commodities, I don't believe that commodities are the best place to invest over the long run. Chart 35 shows you why.

The bottom line on the chart represents commodities. The top line on the chart represents the Dow Jones Industrial Average. You can see if you had invested \$100 in commodities in 1971, you would have \$580 in 2014, which is not a bad increase. However, had you invested in the stock market, you would have \$2,700 today. You can see by this simple example that, **over the long run, the stock market is the place to be, even though it can go through disastrous declines in the short run.**

**Chart 35: CRB (Commodities) vs. Dow (Human Ingenuity)**



The reason I believe that the stock market will always be better than commodities over the long run is that commodities are just a raw product. However, when you buy a company, you now get the human ingenuity of the leadership and the employees, and this is what makes America so great. This is one of the reasons why people from all over the world come to the United States. It's because we allow human ingenuity to flourish. When you combine human ingenuity with raw materials and cash, you have a recipe for wealth creation. This country has created \$74 trillion in net worth, that's after all the debt, and most of it was generated through human ingenuity and creativity. Now, just to show you flexibility, I can't think of any money manager who was more flexible than T. Rowe Price.



T. Rowe Price, in my opinion, was one of the greatest money managers. He was a growth manager and had a tremendous record over his career. But after years of focusing on growth, there was a specific period of time when he changed course. In 1965, he wrote an article about how all the government social programs were going to cause inflation because the government would need to print money out of thin air in order to pay for them. To paraphrase, he said, I'm changing my attitude towards this, and in 1969, he sold his growth stocks and in turn created a mutual fund called the New Era Fund. What really impressed me was what he bought in this New Era Fund. Here is one of the great "growth stock" managers, and he thought you should buy gold, gold mining stocks, timber, real estate, oil stocks, natural resources, etc. And these are exactly the types of investments he ended up buying in this New Era Fund.

While he did have approximately 20% of the fund invested in some of his favorite growth stocks, the rest of the investments were commodity based. The New Era Fund performed extraordinarily during that time. During the period of high inflation and deep stock market declines in the early 1970's, **his New Era Fund produced an annualized, net-of-fee return of 13.9%, versus 8.8% for the S&P 500 from 1972 - 1980.**

T. Rowe Price is a great example of a money manager who did everything right, and remaining flexible was a big reason for his success. When studying Mr. Price, I was so impressed that an individual could think one way for 30 years and then all of a sudden completely change his mind. This takes a lot of courage, and it obviously paid off. As I mentioned earlier, I see three potential outcomes of our country's current financial situation: 1) The Fed can finesse it by pulling out the financial stimulus while trying to grow the economy and reach full employment. This is what I'm hoping for, 2) The Fed pulls out the stimulus too fast and risks deflation, 3) The Fed keeps the stimulus in too long, and we could have high inflation.

Now here is where I see the biggest risk of inflation. Most people are looking at commodity prices and wage inflation and believe that wage inflation is not that bad. The common thought is that before we have higher inflation, we're going to have wage inflation, and there will be plenty of time to adjust and get ready before high inflation hits. **While I certainly believe that higher commodity prices and higher wages are an effect of higher inflation, what I think most people are not thinking about is higher inflation can take place due to a drop in the dollar.**

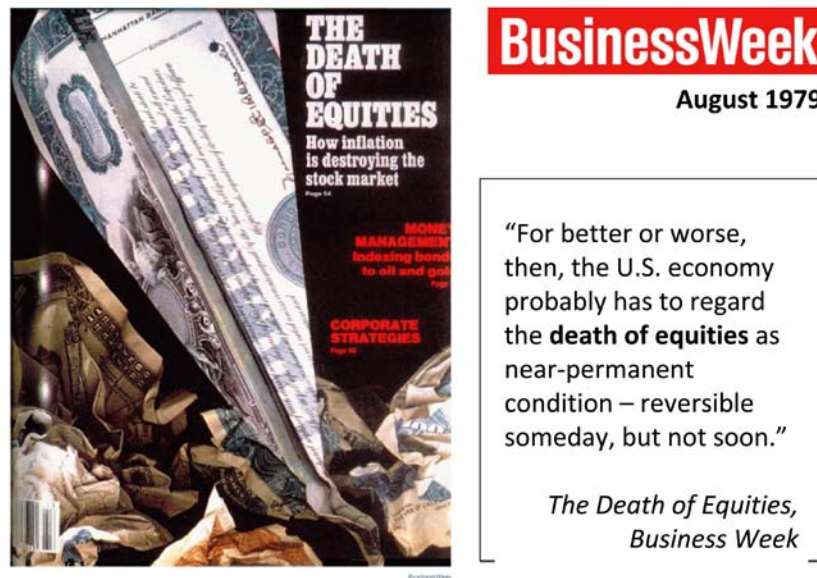
During the 1970s, this was one of the reasons we had high inflation. I even wrote an article about it at the time. People lost faith in the dollar. As an example, at that time the Arabs went so far as to say they were not going to accept dollars; they wanted gold as payment for their oil. In the 1970s, the dollar was crashing on all fronts, the stock market was down, and inflation was up. I can't think of a time in my 45-year career when there was more pessimism.





However, it was also during this time that the stock market had been through a terrible bear market from 1968 through 1974 and, based on our fundamental analysis, was oversold. Yet, in August 1979, right at the height of all this maximum pessimism, Business Week magazine published their now famous article titled, “The Death of Equities - How inflation is destroying the stock market”.

Chart 36



To capture the essence of the article, you can see the quote on Chart 36, “For better or worse, then, the U.S. economy probably has to regard the death of equities as near-permanent condition- reversible someday, but not soon.” Just six months later, the stock market took off. It went into a bull market that lasted 20 years. **You can see that some of the greatest opportunities emerge during times when pessimism is high, confidence is low, and everything is down.**

Chart 37: Dow Jones: 1980 to Present







While I was reading about all the maximum pessimism regarding our economy and stock market, I was also looking at stocks that were trading at 4 and 6 times earnings. I remember thinking that at these prices, how could I go wrong. I thought, what's going on here? So I studied the dollar and inflation and wrote an article in the fourth quarter of 1979 titled, "Don't Sell America Short". (See Chart 38)

### Chart 38

by Arnold Van den Berg  
(As Published in Showcase USA, Winter Quarter 1979)

These would be the technical reasons why an individual or company might take a positive approach to dollars, products and America in general. However, the main reason for support is that the dollar has *value*. Value has always been the overriding influence in any investment or financial market in the long run. With all of the obvious problems many people have lost sight of what America offers—political stability, a democracy, private ownership of assets, no currency restrictions, equal opportunity, the highest level of technology, and dollar based capital markets that are the largest, most flexible and most diversified in the world. In addition to that, it has manufacturing plants and equipment, stocks, and real estate that is available to owners of foreign currency at discounts from 15 to 35 percent compared to a year ago. And to owners of dollars, it offers opportunities not available in any other currency. American products are still the best and, at this precise time, they are the best bargain because of the depressed dollar.

Here is what I said in that article. I talked about how cheap the dollar was and I concluded with this statement about America. "With all the obvious problems, many people have lost sight of what America offers—political stability, a democracy, private ownership of assets, no currency restrictions, equal opportunity, the highest level of technology, and dollar based capital markets that are the largest, most flexible, and most diversified in the world."

I wrote this article 35 years ago, and I still believe this is the situation today. In my opinion, there is no other country in the world, if we get it together, that can compete with the United States, even with all the issues facing the U.S. today. To me, the U.S. is the place to be over the long run. However, if people lose faith in the dollar—and there are many indications that they are—you can have the dollar drop. When this happens, it will cause huge increases in commodity prices, and then you know inflation is on the way. **So, it's not only the traditional measurements such as increasing wages that can cause inflation. Inflation can also occur due to a drop in the dollar.**

Just to give you an example of how foreigners are addressing our weak dollar, the Chinese have put together currency swaps with other countries to avoid trading in U.S. dollars. They now have contracts with Australia, New Zealand, the European community, and Russia. They are working diligently on diversifying out of the U.S. dollar. In addition, the Chinese have accumulated an enormous amount of gold. I believe, one day, they're going to come out with either a gold-backed currency or something similar, and if that happens, that could present real problems for the dollar.

Let me give you an example. The federal government is creating roughly one trillion dollars of new money every



year that is being sold to foreigners. Nearly seventy percent of this debt has a maturity date that is less than 5 years. This means that over the next 5 years, we have to turn over all the debt in the United States owned by foreigners. If at the end of 5 years people in China, Europe or any other country who own our debt, are no longer as enamored with the U.S. dollar or U.S. Treasury bills as the Treasury is...then what happens?

**If foreigners don't buy the new debt that will need to be issued, then the federal government has one of two choices: they either have to let the bonds go down in price until they find buyers, which means interest rates will rise, or they have to step in and buy that debt themselves, which is what they're doing today.**

**However, if the Fed has to step in and continue to buy bonds when inflation is moving up, this will be a signal to the world that they have no intention of slowing down the printing or stopping it altogether. As a nation, the risk is that if we don't get our financial act together and people lose faith in the dollar, we could have a currency crisis. In my opinion, if things don't change soon, we could actually see a currency crisis somewhere over the next 3 to 5 years.**

**While we are likely to be faced with challenging financial times in the years ahead, I am still a big believer in America over the long run. In my opinion, America is still the greatest country in the world and that is why I always like to mention what makes America great and why I wrote my article, "Don't Sell America Short".**

#### **What America Offers**

- Political stability
- Democracy
- Private property rights
- No currency restrictions
- Equal opportunity
- Highest level of technology and innovation
- Strong military

It is for these reasons that people from all over the world come to America for a better way of life, and why businesses continue to build their businesses here. It's the reason that our soldiers have died for this country and servicemen continue to risk their lives today. It's the reason why my family came to this country from Amsterdam, Holland, after going through the Nazi concentration camp of Auschwitz.

I believe America continues to offer great opportunities for anyone who is willing to work hard and pursue their dreams. And from an investment perspective, I believe that with a little patience, discipline, and flexibility, there will be great opportunities for value investors.

Thank you very much.



## For Century Management Clients

As stated in this edited transcript, there are three ways the Fed can address the quantitative easing that has taken place (see page 5): 1) they can pull the money out of the system with great finesse, and that's what we're hoping they are able to do, 2) they can pull the money out altogether and risk serious recession or deflation, or 3) they can leave the money in the system too long and cause inflation.

One of the main reasons we believe the Fed will err on the side of inflation is summed up on page 7 in the quote by former Fed Chairman Arthur Burns, *"...it is illusory to expect central banks to put an end to inflation. That does not mean that the central banks are incapable. It simply means that the practical capacity for curbing inflation that is driven by political forces is very limited."* If this outcome happens, we would like you to know how fast inflation can take hold once it begins (see page 18).

In preparation for an inflationary outcome, our average all-cap value portfolio now owns approximately 12% to 15% in gold and silver mining companies, as well as 12% to 15% in the energy sector. **Importantly, we bought these companies because they were also cheap based on our normal valuation process.**

Whether inflation takes hold or not, we believe we are holding solid, absolute values in these commodity-based sectors that, over time, will prove to be good investments. On the other hand, if inflation does occur in the future, we also believe these companies will prove to be good inflation hedges that will help protect the portfolios and the purchasing power of the dollar (see pages 20-21 and 25-28).



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If you should have any questions regarding the contents of this presentation or wish to receive a copy of our Form ADV Part 2, please contact Scott Van Den Berg at Century Management. The phone number for Century Management's corporate office in Austin, Texas is 1-800-664-4888 or 512-329-0050. We are located at 805 Las Cimas Parkway, Suite 430, Austin, Texas, 78746. We can also be reached on the web at [www.centman.com](http://www.centman.com).



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