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2015: How Bad Was It?

2015 was a disappointing year for investors. Even without much economic turmoil the markets acted as though disaster was just around the corner; over-reacting to bad news and ignoring positive news. The final returns for asset classes were, in a word, ugly. If you measure the stock market by the S&P 500, it returned just over 1% for the year, and that includes the benefit of dividends. If you measure the stock market by the Dow Jones Industrials, it was down roughly 2% for the year.

Looking for diversification in international stocks? Developed economy stock markets, as measured by the EAFE index (Europe, Australia, and Southeast Asia), lost more than 3% for the year, and emerging market stocks were down almost 20%. Depending on the quality and maturity of the bond index you look at, bond indices returned anywhere from positive 2% to negative 2%. And commodities were awful, with gold down roughly 10% for the year and oil and natural gas each down more than 40% for the year.

In the midst of such a skittish environment, it is probably a good time to re-visit some basic investing truths. We'll do so with the help of Benjamin Graham (1894-1976; author of *Security Analysis* and *The Intelligent Investor*, "father" of modern investment analysis), Warren Buffet (Chairman of Berkshire Hathaway, one of the wealthiest men in America, and student of Ben Graham), and some real-life examples from the past year.

An Investment Primer:
First, some thoughts on valuation: what it is and, more importantly, what it isn't. Any investment is purchased with an expectation of a return. The price paid for an investment is paramount to the return derived. The easiest security to price is a bond with a constant coupon payment. If I pay par for a bond ($100), and it has a coupon of $5 per year for ten years, then I receive my principal back at the end of ten years and it is simple to calculate a return of 5% annually.

However, if I want to earn 10% for the same bond, I can pay no more than $75 for the bond. Then, I will receive $5 per year in interest payments, and accrue $2.50 per year in appreciation of the bond (I paid $75, but will receive $100 in principal back at the end of ten years). Simply speaking, I will have had a 10% annual return. For those of you more inclined to math, there are more factors to consider (compounding, the time-value of money, etc.), but for our purposes the premise is accurate.

Owing to the vagaries of the economy, specific credit-worthiness of companies and governments, and general emotion of investors, bonds rarely sell for par value after their issuance. That is why some bonds sell for discounts, and some bonds sell for premiums, to their par value. However, each investor knows the coupon the bond pays, the length of the term of the bond, and what they are willing to pay for it. Calculating the return they expect to receive (if held to maturity) is simply mathematics.

How then to value a stock? First, we must realize what a stock is. "A stock is not just a ticker symbol or an electronic blip; it is an ownership interest in an actual business, with an underlying value that does not depend on its share price."[1] Therefore, to purchase a stock simply because "it is going up" and we think someone will buy it from us at a higher price IS NOT a sound way to value a security. We are buying ownership in a company, not just a piece of paper.

Second, since stocks do not pay a constant coupon every year, what are the attributes that we look for as a return on our stock investment? Dividends are a great place to begin, but we need to realize that no sound, growing company pays out 100% of its earnings in dividends. Dividends, although the most tangible return of earnings to a shareholder, are paid only after the operating needs of the company, capital expenditures, debt repayments, and the other necessary cash outlays of a company.

As a company grows, not only can it increase dividends but its book value increases too. Also known as intrinsic value (for you Warren Buffett fans), book value is one measure of the earnings a company accumulated over the years, and not paid out in dividends or repurchased in treasury stock. As it can be measured against the stock price, book value is a useful tool in measuring relative valuation ratios (Price/Earnings, Dividend Yield, Price/Book Value, Price/Sales, etc.), but probably is a more useful as a measurement of growth. If a company's book value is increasing each year, the company is profitable and able to reinvest those profits in other profitable enterprises.

As alluded to earlier, the Price/Earnings ratio is a valuation measure to determine if a stock is "cheap" or "expensive" relative to the market, its peers, and its own history. As a rule of thumb, a P/E ratio is roughly the same as the earnings growth expectations of a company. If a company has a P/E ratio of 10, the general consensus is that the company can grow earnings at about 10% a year. When there are discrepancies between the P/E ratio and the reasonable growth assumptions for a company, there is a good chance that a stock is significantly over-valued, or under-valued, from the true value of the company.

And in the end, that is what stock investors seek to do: to capitalize on discrepancies between the true, underlying value of a company and the price of its stock. Over time, the price of a stock and the value of the company should eventually converge. As Mr. Graham put it, "In the short run, the market is a voting machine but in the long run, it is a weighing machine."[2] Or, in our terms, prices can be much too high for a stock, or much too low for a stock, based on popularity and biases instead of true valuation.

What Are They Really Buying?

Here is a great example of the voting vs. weighing concept. In 2011, Berkshire Hathaway began buying shares in IBM; over $10 billion worth, as a matter of fact. At the time, Mr. Buffett said he was not concerned with the quarterly earnings reports, or short term results, but rather with the long term prospects of a changing company. Then, in 2012 he stated that he wished the stock price would languish for a while so he could buy more. From his letter to shareholders:

> The logic is simple: If you are going to be a net buyer of stocks in the future, either directly with your own money or indirectly (<u>through your ownership of a company that is repurchasing shares</u>), you are hurt when stocks rise.
>
> You benefit when stocks swoon. Emotions, however, too often complicate the matter: Most people, including those who will be net buyers in the future, take comfort in seeing stock prices advance. <u>These shareholders resemble a commuter who rejoices after the price of gas increases, simply because his tank contains a day's supply.</u>[3]

After hitting all-time highs in 2013, shares of IBM quickly retreated. Since that time, the stock has gone from over $200 per share to less than $135 per share. And, Mr. Buffett has continued to purchase IBM, although he readily admits a loss of almost $3 billion from his $13 billion investment.

Recently, a writer at The Motley Fool took issue with him in an article entitled "Why Warren Buffett is Wrong About IBM". In the article, he compares Berkshire's investment in IBM to other tech companies over the past several years. And he specifically compares IBM stock to Amazon stock. We will not belabor the specifics of the article; however he focused almost exclusively on Amazon being a better investment than IBM strictly on its stock price (i.e. a piece of paper, an electronic blip). Both companies have changed over the years; Amazon extending its retail and entertainment reach, IBM re-inventing itself from a seller of computer hardware and software into a provider of services and data. Here's what each company has done in the 3 ¾ years (through September 2015).

	IBM	**Amazon**
Total Revenue:	$352 billion	$295 billion
Total Earnings:	$54 billion	$108 million (yes, with an "m")
Total dividends paid to shareholders:	$15 billion	$0
Totals value of share repurchases:	$30 billion	$0.9 billion

So, which company has seen its true value, its *intrinsic* value, rise the most over the last three years and nine months? As of this writing, the Price/Earnings ratio for Amazon stock (AMZN) is roughly 900, whereas the P/E ratio for IBM is about 9. The market indicates that Amazon (the company) will grow roughly 100 times faster than IBM going forward. We believe these two stocks are great examples of the price of the stock not reflecting the value of the company – on the upside and on the downside.

And if the market is truly a scale in the long run, would we rather own the expensive stock or the cheap stock?

Price and Value Aren't the Same?
"The intelligent investor is a realist who sells to optimists and buys from pessimists"[4]

Investor sentiment is what causes stocks to be over-valued or under-valued. Everyone reads the same financial statements and news releases – it is simply a matter of what they believe to be true. As we have stated for years, the financial press (both print and electronic) does not exist to inform the investor, it exists to sell advertising. And, here's the important part, the press must fill up a 24-hour news cycle whether what they have to say is relevant and accurate, or not.

The last two years have provided a wonderful example of a stock becoming "unpopular" due to bad news from the company that was exaggerated by the media. However, intelligent investors finally winning out as the stock price rose to more accurately reflect the value, and future prospects, of the company.

For the last couple of years, McDonald's (which we own in many Paragon accounts) was pilloried by the financial media. Any sales or earnings report that failed to meet Wall Street's consensus expectation was roundly criticized and offered as proof that the company was doomed to be overtaken by its smarter, healthier, tastier competitors (Chipotle, Five Guys, Smashburger, etc.). Headlines and stories were written when same store sales failed to meet the previous year's sales by even a fraction of a percent.

Even though the company was the model of world-wide distribution efficiency, and earnings and dividend growth (which the company increases each and every year), the stock was not a market favorite. The stock went from low $70's to mid-$90's from 2011 through the end of 2013. Then the headlines really started. The stock traded in a range of low $90's through low $100's (below $110) from January 2014 until the middle of 2015.

However, for those investors who realized that the company was dealing with issues of competition, food safety, and international constraints in a proactive and professional way (not in a knee-jerk fashion), and trusted that management would find the correct answers, holding (or even buying more, does that sound familiar?) the stock worked out well. "Price is what you pay, value is what you get".[5] was never more true than it was for McDonald's during 2015. For the year, the stock returned almost 30% (including dividends) while the market struggled to show any positive return at all.

Where Are the Current Price-To-Value Discrepancies?
The markets are always full of securities that are mispriced. The keys to identifying and profiting from them are to be aware, to be intellectually honest, and to be patient. Although McDonald's recovered

rather quickly, as opposed to IBM which continues to languish three years after reaching its stock price high, McDonald's is the exception rather than the norm.

We believe that the most obvious discrepancy in the market today is the energy industry. From a high of roughly $140 a barrel in the summer of 2014, energy has been on a seemingly straight line down. Oil prices today are in the mid-$30's per barrel. How did this happen, and why didn't anyone see it coming?

First, in addition to supply and demand forces, oil prices are also influenced by speculators and legitimate hedgers. The price of $140 was probably too high for the supply/demand balance to support, but that's where the price got anyway. For those of us who can remember all the way back to 18 months ago, media headlines (there they are again) were telling us that gasoline was averaging $4 a gallon – as high as it had been since July 2008. There were even headlines touting industry studies that the U.S. might never see gasoline BELOW $3 a gallon ever again. As a counter balance, there are studies out this month that postulate the U.S. will never see gasoline ABOVE $3 a gallon again. "Never" was a long time in 2014, and "never" is a long time in 2016 also. We prefer to ignore pie in the sky, or doom and gloom, prognosticators and would rather let history be our guide – energy prices are very volatile and very cyclical.

When the commodity prices get so high, the producers of those commodities do whatever they can to pull them out of the ground and get them to market. That is what had been happening during 2013 and 2014. Finally, during 2014, the new production was coming online (especially from very expensive shale oil formations) just as the world economy was hitting another stretch of doldrums (thanks to China's slowing economic growth). The supply was going up at the same time demand was going down. As a result, oil and energy prices began to fall.

We attempted to take advantage of this in December 2014 when we purchased Devon Energy very widely across the Paragon portfolios. At that time, oil had fallen more than $25 a barrel in less than six months, and the Devon stock reflected that. The price of Devon stock had fallen about 30% from its high when we purchased it in December. Obviously, we were too early on our call that energy was "cheap" enough to buy Devon and for the other energy names we owned.

Last month, we sold some Devon for tax losses in appropriate accounts, but continued to hold it in some tax-exempt accounts. The savvy investor (and client) would ask us, why? And, many of you have asked that already.

"Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years."[6] Prices go up (for oil, stocks, food, etc.), and prices go down. We know that we will never buy a stock at its absolute low, nor will we sell it at its absolute high. So, after we've made a purchase the question isn't so much "what it has done in the past" as much as it is "what will it do in the future". The concept of converging price and value comes into play once again.

Since the peak of oil prices in July 2014, Devon has be very proactive in attempting to protect the value of the company for the downturn, as well as provide for the enhanced value of the company when the upturn in energy prices occurs. At Paragon, we are confident that energy prices will rebound, we just don't know when. So, in the meantime we are focusing on companies, like Devon, that are not simply waiting around for higher prices to "bail them out".

As energy prices were falling, but were still well above current levels, during 2014 Devon began selling properties they owned that were profitable, but higher cost to maintain and produce. Later in 2015, when energy prices were down substantially, the company began using the proceeds from those asset sales to purchase other properties that fit in better with its cost structure (whether geographic proximity to existing properties, or drilling similarities to current production). Although Devon is in the energy production business, and cannot simply quit drilling product out of the ground on a moment's notice, they did the next best thing and re-positioned their producing assets to better fit the near-term environment – while not ignoring the long-term prospects of the industry.

Looking out several years, we believe that Devon will benefit from more productive and profitable properties and that increases in energy prices, Devon's earnings and more normal valuations will reward patient shareholders.

Are There Other Mispriced Companies?
The interesting thing about investing is that it the market changes every day. The summary we just laid out for Devon Energy could be repeated for any company we've ever purchased for Paragon accounts. Every stock that we've ever owned, and our clients have profited from, has had down periods. Obviously, some downturns are longer and more harrowing than others but also some shorter and "easier to handle" than others. The markets, or the media, tend to over-buy and over-sell securities on a regular basis, and it is our job to try and discern fact from fiction. History and experience show that the best time to buy a stock is when no one else wants to own it. Many of the securities that we've had to explain, or defend, in the past have worked out very well for our clients – as the price of the stock has risen to more accurately reflect the value of the company.

We apologize for the length of this newsletter, but wanted to make sure that you understand our process and our diligence. We do not try to time the market, nor do we try to time economic twists and turns. As we've said so often in the past, we try to buy companies that will be able to grow their earnings meaningfully in both good and bad environments, and whose stock price is materially lower than what we think the company is worth.

We want to ensure that our clients are investors in quality companies and not just speculators in "scraps of paper, or electronic blips". We are happy to discuss any security that we own in your portfolio at any time, and we are confident in our ability to exhaustively explain what the company does, why we purchased it for you, and why we believe you will ultimately earn an acceptable return on that investment.

Finally, two last quotes that emphasize our belief that following the crowd is never the correct course of action:

> "The stock investor is neither right nor wrong because others agreed or disagreed with him; he is right because his facts and analysis are right."[7]
>
> "Invest only if you would be comfortable owning a stock even if you had no way of knowing its daily share price."[8]

Thank you for your confidence in Paragon Capital Management.

Craig, Howard, Elizabeth, Ward & Brian

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Footnotes: 1.) Benjamin Graham "The Intelligent Investor"; 2.) Benjamin Graham; 3.) Warren Buffett, "2012 Letter to Shareholders of Berkshire Hathaway, 4.) Benjamin Graham "The Intelligent Investor; 5.) Warren Buffett; 6.) Benjamin Graham; 7.) Benjamin Graham; 8.) Benjamin Graham, "The Intelligent Investor"