Aleph Investments September 2014 Letter

Stock Strategy

Let me tell you about the last three months. In September, we bought and sold three stocks:

Purchases

1. NOW, Inc. -- This is a new company spun out of National Oilwell Varco. It is one of two dominant companies that provides spare parts to the energy industry in the US, Canada, and globally. It has roughly a 20% market share. Their main competitor MRC Global has a 25% market share.

It is a little more expensive than the companies that I typically buy, at 1.8 times book, and 18 times forward earnings, but I think has good growth prospects. It has a lot of opportunities in foreign markets, in downstream and industrial markets, and in deepening client relationships.

2. Destination Maternity -- this company designs and sells maternity apparel. It is the largest company doing so in the United States. Have a little less than two times book, and 8.5 times forward earnings it seems inexpensive, and seems to have protective boundaries.

The company has only one analyst following it. It also has a strong balance sheet with no debt.

3. Navient Corporation -- this company specializes in student loans. It is a spinoff from Sallie Mae. They originate, acquire, finance and service student loans. They also help to keep education loans performing when former students attempt to walk away from them; they are the best at preventing default on student loans as measured by the US Department of Education. They are the largest private holder of student loans; their expertise gives their business protective boundaries that others do not have. They have room to expand this portfolio if the opportunities look good enough.

The growth potential of this company is not high, but trading at less than two times book, and 8.5 times forward earnings it seems to be attractive. A casual glance at the company makes it look like it has a lot of debt, but virtually all of the debt is nonrecourse, as it is a result of the securitizations that they did in the past. The company itself has very little debt.

Sales

1. Phillips 66 – this refiner made us a lot of money over the last two years. It reached a very fair valuation and so I sold it.

2. Olin Corporation – this company also appreciated from where we first bought it. Because it is relatively less attractive than other companies that I could buy, I sold it. As an aside, with the gun craze in the United States subsiding little bit because of the relative glut of guns, I expect that this company might underperform for a time.

3. Tesco plc – Tesco has a really good name, but it is been underperforming for some time. A large part of the problem seems to be trying to define its competitive position. It has not done that well, so it has been losing market share in its main market, the UK. This is a company that all of my clients, including me, have lost money on. I sold it partially as a way of generating a capital loss, but mostly because I lost faith in the management team; recent developments since the sale vet out that opinion, but I didn't expect anything that dramatic.

On Overall Stock Return Performance

For the last few months, June through September, my performance on the stock strategy has been pretty poor. June through August, I trailed the index by 2.2% (before fees). September (so far), trailed by another 2% before fees. There have been three reasons for the underperformance:

1. An overweight in energy stocks.
2. Foreign stocks have not been doing as well as US stocks over the last four months.
3. I have been playing too conservatively with respect to cash amid a market that keep reaching new highs.

Now, I think all of those factors are temporary. The valuations of the companies that we hold are cheap, and valuations in the US stock market are elevated to levels that are uncommonly seen in market history. That doesn't mean that everything will quickly change, but only that the odds are good that we could see relative outperformance in the future.

More than half of my net worth is invested here, and that is also more than 80% of my liquid net worth. I like the stocks that I own. If there are better ones, I will make trades, but not until then.

Bond Strategy

As for my bond strategy, I still call it "Fire and Ice." 20% Long Treasuries if the economy slumps, 20% Treasury Inflation Protected Securities as an inflation hedge, and 60% short-dated credit instruments if the economy picks up steam. These should balance each other, not do too badly in most scenarios, and produce a reasonable yield. Over the past ten months, it has underperformed the Lehman Aggregate by a little more than 1% (after fees). Almost all of that underperformance has come in the last four months, as longer credit spreads have tightened, and expected inflation has fallen.

At present, I am watching the economy for a wide variety of possibilities – inflation, deflation, and an uptick in corporate default rates. In principle, this portfolio is ready for all of them, which means it is unlikely to outperform by a lot. This is a confusing environment for bonds; it's difficult to find anything that is attractive, but I will keep looking.

Switch Strategy -- Discontinued

Partly because of a lack of client interest, partly to solve a small regulatory issue, and partly because I don't think I execute it well (I'm not sure anyone does), I am closing down the switch option. This will allow me to focus on what I do best, which is security selection.

Note on Valuations

Equity valuations remain high, yet not so high that I would hedge my taxable account at present. Equity valuations are a little higher than they were in 2007, yet not as high as they were 1997-2002, or late 1972, or the worst part of the Go-Go era in the 1960s.

Markets can fall for a number of reasons, but among the reasons are increased competition from bond yields, panic in the financial sector, war on your home soil, and a change in the economy that will constrain future profits. At present, I don't see any of those as realistic fears in the short-run. That doesn't mean that the market can't fall; valuations are high. It does mean the odds of it falling hard in the short run and staying there are low.

Closing

Recently my blog has started at a new publishing source – Yahoo Finance. I'm not sure what it will do for me in the long run, but it is nice to get the exposure there now that Seeking Alpha, Motley Fool, etc., no longer get to publish there. Briefly, it has led to a doubling of my blog traffic, and given me an increased number of inquiries about my business, which aids my long-term viability.

I thank you for using me as a manager of your assets. Feel free to contact me with any questions.

Sincerely,

David