



January 2014

## INVESTMENT PERSPECTIVES

### **Relatively Cautious, Absolutely Value Driven**<sup>1</sup>

2013 was a very good year for stocks, with the broader markets rallying nearly 32%, pushing total gains since the start of 2009 to approximately 130%. We suspect, however, that the rapid market advances have caused some anxiety. Many concerns often fall into one of the following categories:

- 1) I've been heavy in cash since the crisis and it appears the economy is improving so shouldn't I increase my stock exposure or at least rapidly put new cash to work?
- 2) Given the spectacular run-up in equity prices (and remembering the horrible experiences during 2008-2009) should I sell all/the majority of my portfolio and return to cash?

As we will attempt to detail, we think the prudent answer is far more nuanced than either of the above extreme views. Certainly, prices have risen and the scarcity of new investment ideas combined with pockets of excess in certain sectors make us more cautious as we enter the New Year. We think it is prudent for investors to plan for market corrections but to also understand that these do not necessarily signal the start of a great storm. Shorter-term caution can enable investors to take advantage of dislocations when they do occur and therefore clients should expect some sales of fully valued names and higher levels of cash as we search for new ideas. But we would note that despite the run-up, we still have found some attractive opportunities and expect more in the year ahead, particularly should a broader market pullback materialize. We believe investors who can relax, who can avoid snap judgments to either fully invest in equities or to fully allocate towards cash, and who can calmly adhere to a disciplined investment process can maximize their chances for longer-term investment success.

As we have noted in past letters, despite all the time and energy spent by prognosticators forecasting macro trends, interest rate fluctuations, or broader market movements, we think the success rate of these predictions is perilous (at best). For this reason, we spend the vast bulk of our time analyzing individual businesses. In our Third Quarter 2009 Investment Perspectives, we discussed investment legend Seth Klarman's writings about the importance of finding investments that were not just *relatively* attractive (those having more favorable valuation

---

<sup>1</sup> All market data taken from Bloomberg as of 01/03/2014

metrics than industry peers) but also *absolutely* attractive (versus historical valuation levels as well as relative to other investment options in varying industries). Given the market advances, finding investments that hit both criteria (we discuss specific examples later in this document) has become much more difficult and therefore the temptation to purchase securities that look attractive only on a relative basis has increased. But solely using relative analysis to guide investment decisions can lead to misleading conclusions.

By way of example, most readers are likely familiar with a Menlo Park company named Facebook. While we greatly admire the entrepreneurial spirit behind the company and we personally enjoy the convenience of keeping up with friends (even if we also are forced to hear their descriptions about what they ate for breakfast yesterday), we were never remotely tempted to purchase Facebook shares given the extensive list of unknowns with the company's future, including technology changes and mobile advertising uncertainties to name just a few. And of course, there was Facebook's excessive valuation. After the company's shares have risen by over 105% during 2013, our concerns are only magnified. Given the parade of cloud computing, 3D printing, and technology security Initial Public Offerings, however, some investors could argue (with varying degrees of seriousness) that Facebook is actually *relatively* undervalued compared with some of its other tech brethren, depending on the metric (assuming one exists – "NA" generally implies losses as the company lacks Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA), free cash flow, and/or earnings) examined. We show Facebook's valuation juxtaposed against a couple of other technology names:

		Market	Enterprise Value/ Sales	Enterprise Value/ EBITDA	Price Free Cash Flow	Price/ 2013E EPS
		Capitalization (\$ in bil)				
FACEBOOK INC-A	FB	\$138.6	18.9x	41.3x	61.2x	48.3x
TWITTER INC	TWTR	\$39.1	72.9x	NA	NA	NA
SALESFORCE.COM INC	CRM	\$33.2	8.9x	114.8x	53.4x	110.0x
NETSUITE INC	N	\$7.6	19.2x	392.4x	174.4x	364.9x
PANDORA MEDIA INC	P	\$5.4	8.1x	NA	NA	130.8x
YELP INC	YELP	\$4.8	23.0x	9037.9x	NA	122.4x

There are all sorts of ways investors can lose money in the stock market but we would submit that paying upwards of 20x+ trailing sales for stocks that have already doubled and tripled in value is a sound starting point. As a reference point, the S&P 500 trades at roughly 2x sales, 15-16x earnings, and 10-11x EBITDA and many of the companies that we purchase trade considerably below these broader market valuations. For those of us living on the West Coast, we can't help but hear stories about of newly minted millionaire tech workers aggressively bidding (According to *Sfist Daily*, one bedroom apartments in the SOMA area of San Francisco now rent for nearly \$3,500 per month<sup>2</sup>) for Bay Area real estate and wonder if this offers further evidence of excessive exuberance. Of course, the more things change, the more they remain the same. As we look at these valuations, we can almost close our eyes and remember investment pitches from the late 1990's where presenters would try to convince us of the merits of "dot.com" companies, arguing that their unlimited growth potential more than trumped such

---

<sup>2</sup> *Sfist.com* July 7, 2013

trivial details such as earnings, cash flow, and in some cases, revenue. Higher stock prices were used to justify the investment cases and this momentum led to even higher valuation and more momentum investors chasing performance. When it came to the 1990's tech world, relative attractiveness did not save investors – investors chasing Cisco at a “relatively attractive” 80x forward earnings may not have suffered the same damage as buyers of Global Crossing, Nortel Networks, or XO Communications, to name a few from an undistinguished list, but they still suffered permanent losses of capital.<sup>3</sup> By way of analogy, jumping off the top of a 3-story building, might be a relatively better decision than plummeting from the 9<sup>th</sup> floor but will still likely provide an absolutely unpleasant experience. Investors in the cloud/3D printing and other recent IPO growth story stocks will find it very difficult to make solid returns given high current valuations even assuming the companies continue to grow at breakneck paces.

Not every sector trades with such froth as some of the above mentioned technology names and we have found attractive ideas in a variety of industries, including names not only in the same industry but actually in the same geographical area. We would remind some of our non-West Coast readers that Intel's Santa Clara headquarters is actually located within 20-50 miles of several companies previously mentioned. Because many view the behemoth as a secularly challenged dinosaur, investors have chosen to value the company light years away from its technology brethren.

		Market	Enterprise Value/	Enterprise Value/	Price	Price/
		Capitalization (\$ in bil)	Sales	EBITDA	Free Cash Flow	2013E EPS
INTEL	INTC	\$128.2	2.2x	5.8x	12.2x	13.4x
FACEBOOK INC-A	FB	\$138.6	18.9x	41.3x	61.2x	48.3x
TWITTER INC	TWTR	\$39.1	72.9x	NA	NA	NA
SALESFORCE.COM INC	CRM	\$33.2	8.9x	114.8x	53.4x	110.0x
NETSUITE INC	N	\$7.6	19.2x	392.4x	174.4x	364.9x
PANDORA MEDIA INC	P	\$5.4	8.1x	NA	NA	130.8x
YELP INC	YELP	\$4.8	23.0x	9037.9x	NA	122.4x

Intel's stock will likely not triple in price from current levels nor will it likely generate double digit growth in top-line sales over the next 3-5 years. Additionally, the company clearly faces challenges in its traditional PC business. We believe, however, that the company (we provided a more detailed rationale for this purchase in our October position paper) has certain competitive advantages in its manufacturing process, a dramatically underappreciated Server chip business, and financial strength that can fund the company's entry into other markets. We attended the most recent Intel Analyst Day and spent extensive time speaking with the company's executives, including Diane Bryant (Intel's head of the Server Division). The interactions increased our confidence that a disconnect exists between the value of the Server business and the market value of the entire company. More importantly, we believe the company is acutely aware of this anomaly and actively debating whether possible actions could be warranted to highlight this apparent inefficiency. Relative to its past valuation and certainly relative to other technology names, Intel looks more attractively valued. More importantly, however, we believe that Intel's

<sup>3</sup> Cisco traded at over \$77 per share in March of 2000 versus \$21.76 today, implying losses of over 70% for those investors who purchased shares approximately 14 years ago and continue to hold them today.

current valuation is cheaper on a more absolute basis. If we error on several parts of the INTC story, the total downside we face is likely well contained given our entry point. Or in other words, a lot can go wrong with INTC and we can still realize a decent investment outcome – if a little goes right, we could do very well. Conversely, we would submit that investors in Facebook, Twitter, and others at current levels, need a lot to go right in order to make money and little to go wrong in order to avoid huge downside risk.

Clearly, there are lots of companies outside the technology industry, and as we previously noted, we continue to look for situations where we see solid relative and absolute opportunities but these are admittedly harder to find in the current market. The nearly 130% rise in markets since the start of 2009, the extensive use of margin debt to purchase stocks and the pockets of froth/incredible momentum all suggest investors should err on the side of caution as opposed to aggressiveness as we head into 2014.

So what should an investor do? As previously mentioned, we will likely look to sell fully valued or slightly overvalued names and build cash for better buying opportunities. We would stress, however, that we are certainly not burying our heads in the sand and calling for a major calamity. In fact, we continue to do extensive work on a variety of names, with the hope of making purchases at prices that we believe maximize our odds of investment success. Corporations, pension plans, and individuals continue to hold large amounts of cash and we suspect many will conclude that equity markets can produce higher returns than bonds, commodities, or other options. We, however, feel no pressure to immediately “put money to work” even though the market is rising. As long-term stewards of your hard earned capital, we believe holding excess cash and exercising caution can allow longer-term outperformance over a multi-year period, even if this leads to underperformance in a given calendar year.

In summary, we enter 2014 more cautious than in past years and remain wary of certain parts of the broader market. We believe some correction in the coming months is very possible and recognize that unexpected shocks are possible. But we do not believe investors should blindly sell entire equity positions. Despite the run-up, we have found attractive ideas and expect to uncover additional ones in the coming year. A disciplined investment process forces us to search for securities that are attractively valued on a relative and absolute basis while simultaneously selling those that trade above our value estimates. This discipline has been followed since the firm’s founding in 1995 and we think the process can help prepare clients for whatever transpires in 2014 and beyond.

PLEASE SEE IMPORTANT DISCLOSURES BELOW:

As of December 31, 2013, Hutchinson Capital Management (HCM) held:

367,207 shares of Intel (INTC)

0 shares of Facebook (FB)

0 shares of Twitter (TWTR)

0 shares of Salesforce.com (CRM)

0 shares of Netsuite (N)

0 shares of Pandora (P)

0 shares of Yelp (YELP)

As of December 31, 2013:

Intel closed at \$25.95

Facebook closed at \$54.65

Twitter closed at \$63.65

Salesforce.com closed \$55.19

Netsuite closed at \$103.02

Pandora closed at \$26.60

Yelp closed at \$68.95

As of December 31, 2013, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	12/31/13 Closing Price
JOHNSON CONTROLS INC	7.3%	\$51.30
GENERAL MOTORS CORP.	6.4%	\$40.87
MICROSOFT CORPORATION	5.8%	\$37.41
CVS CAREMARK CORPORATION	5.7%	\$71.57
WELLS FARGO & CO	5.5%	\$45.40
BANK OF NEW YORK CO (New)	5.2%	\$34.94
MARKEL CORP COM	5.1%	\$580.35
EMERSON ELECTRIC CO	4.7%	\$70.18
VALERO ENERGY CORP.	4.3%	\$50.40
CARNIVAL CORPORATION	4.0%	\$40.17

For a complete list of holdings, please see our most recent 13F filing on the following SEC website: <http://www.sec.gov/edgar/searchedgar/companysearch.html>

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

Past performance is not indicative of future results, which may vary. The value of investments and the income derived from investments can go down as well as up. It shall not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities mentioned here. While HCM seeks to design a portfolio which reflects appropriate risk and return features, portfolio characteristics may deviate from those of the benchmark.

Although HCM follows the same investment strategy for each advisory client with similar investment objectives and financial condition, differences in client holdings are dictated by variations in clients' investment guidelines and risk tolerances. HCM may continue to hold a certain security in one client account while selling it for another client account when client guidelines or risk tolerances mandate a sale for a particular client. In some cases, consistent with client objectives and risk, HCM may purchase a security for one client while selling it for another. Consistent with specific client objectives and risk tolerance, clients' trades may be executed at different times and at different prices. Each of these factors influence the overall performance of the investment strategies followed by the Firm.

Nothing herein should be construed as a solicitation or offer, or recommendation to buy or sell any security, or as an offer to provide advisory services in any jurisdiction in which such solicitation or offer would be unlawful under the securities laws of such jurisdiction. The material provided herein is for informational purposes only. Before engaging HCM, prospective clients are strongly urged to perform additional due diligence, to ask additional questions of HCM as they deem appropriate, and to discuss any prospective investment with their legal and tax advisers.