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ASSET MANAGEMENT

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*“At a flea market, I always head for the junk jewelry table first.”*

– Ethel Merman

Etsy is an online marketplace for handmade and vintage objects, and we have at least one jewelry-maker client who has had a fair amount of success marketing her handmade wares through the Etsy platform. Etsy’s business has grown at a rapid pace in recent years, and, as we are writing this letter, the company has offered its shares to the public market through an IPO. Etsy opened trading at \$31 per share, suggesting a valuation of \$3.4 billion.

Having generated \$196 million in revenues and nearly \$2 billion in gross merchandise sales during 2014, Etsy’s implied valuation represents a price/sales multiple of almost *eighteen* times, which is an eye-popping valuation multiple that is more than double that of established online marketplaces such as eBay and Amazon. We are not able to calculate Etsy’s price/earnings multiple, because the company has yet to produce any earnings. From biotech companies to still-unprofitable vintage jewelry websites, growth stocks are the current investment rage - value be damned! For Etsy’s venture capital investors, everything is coming up roses. For investors who bought Etsy shares at the IPO, we suspect a different outcome.<sup>1</sup>

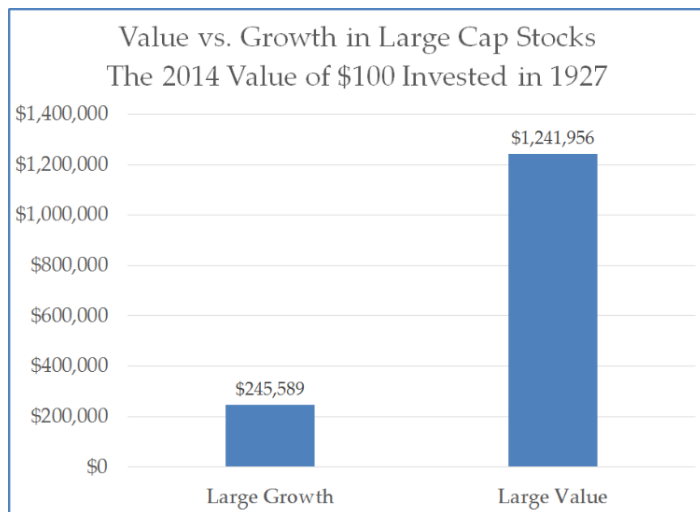
Last quarter, we discussed in this letter the principles of value investing at length, which correspond closely to the principles of our investing approach. In summary, they included the following: 1) focus on downside protection; 2) act contrarian; 3) watch leverage; 4) be patient; 5) seek a margin of safety; and 6) be wary of the expression, “This time is different.”

These value investing principles are the bedrock to long-term investors, including ourselves. Absent these, there is no telling what kind of imprudent capital allocation decisions will be made. Etsy is one, but another, higher profile story-oriented, “growth stock” investors have chased in recent years is Tesla, a company that produces all-electric automobiles. Tesla sells less than 40,000 unprofitable vehicles per year and is worth more than an established auto company such as Renault which sells more than 2,500,000 vehicles per year. In the short run, fashion matters to investors, and Tesla and Etsy are currently very fashionable. In the long run, however, the investment record suggests that value will out. Long-term, cash flows and earnings drive valuations – not eyeballs or fashion.

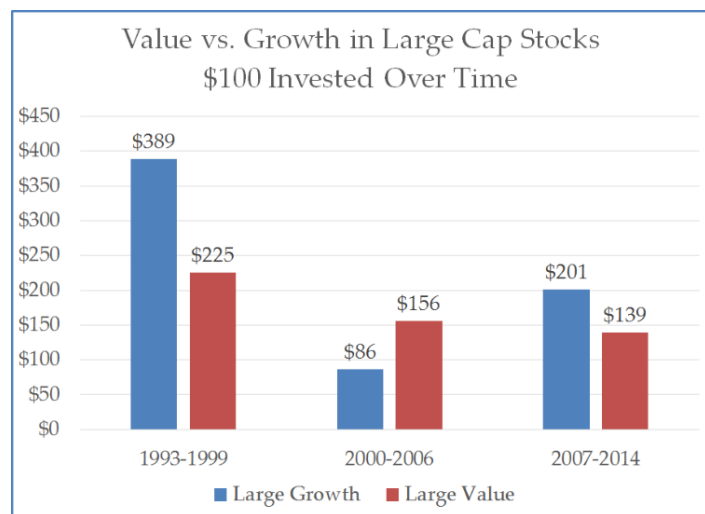
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<sup>1</sup> University of Florida Professor Jay Ritter has examined the returns of every U.S. IPO since 1970. Excluding the first-day returns, Ritter’s research has demonstrated that the total returns from IPO-ed companies have underperformed the total investment return of other firms of similar size by an average of 3.3% annually during their first five years of trading in the public markets.

Ibbotson Associates, an asset allocation research consultancy, provides historical data that demonstrates that value stocks have generated considerable outperformance over the long-term.<sup>2</sup> Between 1927 and 2014, large cap value stocks have outperformed large cap growth stocks by an average of 2.0% per annum, while small cap value stocks have outperformed small cap growth stocks by an average of 4.4% per annum.



While this difference in annual performance might seem to matter little at first glance, over long periods of time, the difference in performance between value and growth has compounded in a meaningful way, to the benefit of the value investor and to the detriment of the growth investor. Put simply, value investing rewards investors who stick to a value discipline over long periods of time. In the two charts to the left, we show the current value of \$100 invested beginning in 1927 using large cap value and large cap growth investment strategies. By 2014, the large cap value investor ends up nearly \$1 million better off than the large cap growth investor from just a \$100 initial investment! Clearly there is a compelling rationale for disciplined long-term investors to purchase their stocks from the value jewelry table.



Unfortunately for value investors, the tendency for value stocks to outperform growth stocks is not at all an every-year occurrence. There have been numerous multi-year periods of time since 1927 when Mr. Market has shown a far greater appreciation for fashionable growth stocks than for value stocks.

For example, during the tech bubble of 1993-

1999, technology investing was all the rage, and growth stocks far outperformed value stocks. A \$100 investment in 1993 would have appreciated by the end of 1999 to \$389 in large cap growth stocks, whereas that same investment would have appreciated to just \$225 in large cap value stocks. For value investors, 1993-1999 was a challenging era. Similarly, since 2007, growth stocks have taken the pole position once again, outperforming value stocks by an average of almost 5% per annum between 2007 and 2014. A sum of \$100 invested in 2007 appreciated to \$201 in large cap growth stocks by 2014, versus just \$139 in large cap value stocks.

Source: Ibbotson, Morningstar.

<sup>2</sup> "Value stocks" in the data are defined by stocks with low price/book ratios, while "growth stocks" are defined by stocks with high price/book ratios.

Two important takeaways jump out to us from this analysis. First, an investment portfolio of fashionable growth stocks can outperform for multi-year periods of time, as it has since 2007, trying value investors' patience, ourselves included. Yet, long-term investors are far better off investing in value stocks. Put simply and repetitively: a patient and disciplined value investment strategy works, but it requires patience and discipline.

### Bond Yields (Still) Declining

If being wary of the expression "this time is different" facilitates better investment decisions, what then does one make of recent, unprecedented developments in the bond markets?

Let's take a moment to review the current insanity in the fixed income markets. Bond yields have continued to decline (and bond prices have continued to climb), even to the point that more than 50% of sovereign bonds are currently yielding less than 1%, and more than 15% of the sovereign bonds outstanding are currently trading with a *negative* interest rate. Owning a bond with a negative interest rate means that an investor who buys a ten-year Swiss bond, for example, and then holds that bond to maturity, will generate a negative return on that investment! The yields depicted in the table to the right represent historic lows for most countries, despite high levels of indebtedness for most of them.

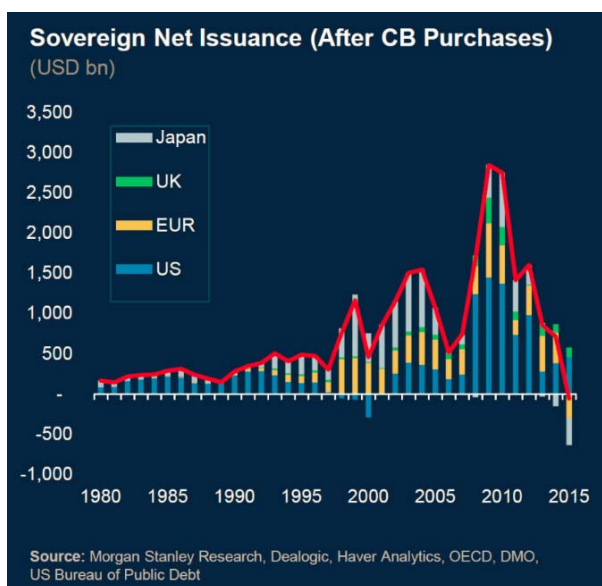
Other European countries besides Switzerland, such as Germany, France, and the Netherlands, also have bond issues that are trading at negative yields. Switzerland-domiciled Nestle recently offered a *corporate* bond issue due in 2016 at a negative interest rate, while Danish banks are offering *mortgages* with negative interest rates. With negative bond yields across much of Europe, it makes enormous sense (in hindsight) that the Euro has been declining in value as capital flees to the dollar seeking better returns.

One of the basic tenets of finance is that investors require a (positive) return on their investment as payment for giving up the use of their capital. The current bond market appears to be breaking this fundamental, time-tested tenet. What rational investor would purchase a Swiss ten-year bond that trades at a negative yield to maturity? Could long-term yields go negative in the United States?

### Sovereign Bond Yields

Country	Maturity		
	5-Year	10-Year	30-Year
USA	0.84%	1.88%	2.53%
UK	0.56%	1.58%	2.29%
France	-0.07%	0.36%	0.99%
Germany	-0.15%	0.11%	0.53%
Japan	0.08%	0.32%	1.34%
Switzerland	-0.44%	-0.14%	0.21%
Spain	0.54%	1.27%	2.14%
Italy	0.46%	1.24%	2.16%

Source: FactSet, 4/15/15.



Source: Morgan Stanley Research, Dealogic, Haver Analytics, OECD, DMO, US Bureau of Public Debt

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The answer is illustrated visually in the chart above and to the right. Beginning this year, central banks are purchasing sovereign bonds at a faster rate than countries can issue them. With demand by central bank buyers such as the Bank of Japan and the European Central Bank outstripping the supply provided by government bond issuers, bond prices have increased and yields have decreased, even to the point where bond yields in several countries have turned negative. In addition, captive investors such as banks and insurance companies are purchasing sovereign bonds to meet regulatory requirements, regardless of price and yield.

Needless to say, the combination of monetary stimulus and liquidity-promoting regulatory requirements has created enormous distortions in the bond and currency markets, and the unintended consequences from such unprecedented actions have yet to be fully seen. Furthermore, we expect that this low-to-negative-yielding environment will continue until central banks reverse course or until something breaks, whichever comes first. We are watching what is happening in the bond markets with trepidation. In this environment, it seems imprudent to do anything other than remain highly diversified across asset classes for most investors. It makes sense to have an allocation to undervalued stocks, because declining bond yields will continue to chase investors out of bonds and into stocks. It makes sense to own cash and low duration bonds (that generate a positive yield), because if and when central banks reverse course, it will be advantageous to have dry powder ready to put to work. And, it makes sense to own gold, silver, real estate, and other real assets, just in case something breaks amid the seemingly endless monetary experimentation on the part of central banks.

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We are as focused as we have ever been in helping our clients achieve their financial goals.

Sincerely,

***Pekin Singer Strauss Asset Management***

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