Q1 2013 Investor Letter

Shih Investments

http://shihinvestments.com kai@shihinvestments.com

[Summary]

- **Portfolios and markets hit all-time highs.**
- **Repositioning portfolio in anticipation of higher interest rates.**
- **New holdings of CSX and DVN.**

Fellow Investors,

Our portfolios had decent gains this quarter, with quarter-end balances reaching new all-time highs. Both the S&P and Dow indexes also hit all-time highs during the quarter, which is unsurprising as corporate profits have been setting new records since 2010.

On the horizon: rising interest rates

In the context of a generally growing economy and a rising stock market, it is prudent to think about situations that might cause the stock market to fall. My foremost concern: as the economy returns to health, interest rates are likely to rise.

Today, interest rates are very low, mostly as a result of various Federal Reserve policies. This is a deliberate move on their part to lower interest expenses and to encourage borrowing.

The Federal Reserve has begun hinting that it will allow interest rates to rise – not imminently, but in the foreseeable future. When that happens, a reversal of the current situation will happen: interest expenses will rise, individuals will be less likely (or less able) to buy goods on credit, and companies less likely to borrow money to fuel growth. I would expect higher interest rates to slow economic growth which in turn would cause the stock market to fall. Warren Buffett recently commented on the subject:

> "All over the world everybody that manages money is waiting to catch the signal that the Fed is going to reverse course. I think they're on a hair trigger. There are an awful lot of people who want to get out of a lot of assets if the Fed is going to tighten. Who knows how it will play out."

There are many unknowns to the situation: when will interest rates rise, and by how much? What will the economy be like by then? Will the Fed be able (as they claim) to balance interest rates with economic growth smoothly such that the economic shocks are minimal? And how will all of this impact our stocks?

If only I knew the precise answers to those questions– I would be wealthy indeed. Analysts estimate the Fed will allow long-term rates to increase early next year. I am starting to adjust our portfolios in anticipation of higher interest rates.

Portfolio changes this year

My current plan for 2013 is to let some cash accumulate in your accounts (a change from what we've done in the past). If the market continues to climb, I'll probably sell some stocks and increase our levels of cash.

Higher interest rates directly benefit banks, which will begin charging more for their loans. This is an over-simplification: higher rates also mean that more people will default on loans, and fewer people will want loans. But the banks seem to be eager for interest rates to rise and I expect higher profits then. Expect most of our bank holdings to stay put.

Many of our companies generate enough cash to fuel their operations and growth. They won't need to borrow for the next few years, and that means we can also hold their stocks without higher interest rates directly impacting them. Indeed a cash-rich position can form a competitive "moat" where new competitors cannot find enough capital to muscle in on our company's businesses.

When interest rates go up, bond prices are likely to go down. We own virtually no bonds today, and it's unlikely we'll start purchasing them for quite some time.

Summary

Our economy has enjoyed a few years of low interest rates, which have helped mend our economy and stock markets. In the next year or two, interest rates are likely to rise, and I am responding by repositioning our portfolios.

Sincerely,

Comments on Individual Holdings

This quarter, we bought two new holdings, CSX and DVN, and sold out of two European stocks, TOT and TSCDY.

- **CSX**. Buffett bought his railroad in 2009, and now we own one too (well, a small piece of one). Railroads have wide economic moats: for the densely populated areas that CSX serves, which is the eastern part of the United States, it is virtually impossible to buy the necessary strips of land to build a competitor railway.

  Railways are an extremely cost- and energy-efficient way of transporting goods. One gallon of diesel fuel moves one ton of goods 500 miles along a railway and they are getting more efficient over time (unlike trucks whose fuel efficiency has stagnated). Because they operate so efficiently, railroads have relatively stable business prospects in both good times and bad.

  CSX's earnings have recently been stagnant, and their stock price reflects that. However, I see a new source of growth in two years when the Panama Canal finishes an expansion that will allow much larger ships through the canal. Global shipping routes will change. Specifically, the economics of shipping between China and east coast ports will improve – and those east coast ports connect to CSX terminals. So, there will be a new flow of goods from Asia through CSX; and, in reverse, raw materials from the Midwest like timber, coal, corn, and wheat will travel through CSX back to Asia.

- **DVN**. I've long admired Devon, a domestic oil and gas company. They have a smart, conservative, disciplined team in an industry prone to bubbles and collapses. Devon declined steeply last year – around 35% - in what was generally a strong market. It finally got cheap enough that I wanted to buy it.

  Devon's investments in oil properties are going to produce more oil and thus profits. That alone has analysts predicting earnings to rise from $3.50/share this year to around $6/share in two years.

  The secondary reason to own the stock is a potential increase in natural gas prices. Devon has a lot of natural gas properties that will gain in value if and when natural gas prices increase. Sharp-eyed readers may remember that I've been wrong in this belief for quite a long-time (and I have the scars to prove it). Buffett made the same mistake. This time, it's not core to the investment decision but if natural gas prices do rise, Devon's stock will likely rise a great deal.

- **Sold TOT and TSCDY:** When the situation in Europe seemed fairly dire a year and a half ago, I used the opportunity to buy some large European companies. Today the crisis in Europe is mostly on the back-burner and I don't have a strong reason to prefer European stocks to U.S. stocks. In Q1, I sold off two of three European investments (TOT and TSCDY) and used them to buy CSX and DVN. I plan on selling the final European stock (VOD) by the end of the year.

- **Bank stress tests:** Last quarter, I mentioned that I had higher estimates on the stress tests than most market participants, and that I'd report back on how I did. I was too optimistic; my numbers were too high. But the market itself was too pessimistic and our two largest bank holdings in Bank of America and Citigroup were pronounced "the winners" of the stress test. Both banks gained strongly after the results were announced. The surprise loser was JP Morgan, our third bank holding, which is usually held as an exemplar of the industry.