# CAZ Investments

## Quarterly Letter

## “To Taper or not to Taper”

All eyes are focused on the Fed. Will they reduce their bond buying program or won’t they? That question grips the attention of market participants and will be the primary factor that drives stock prices in the short run. The market has become so addicted to the flood of liquidity provided by central banks that the very mention of the possibility that the Fed may begin to slow their rate of purchases strikes fear into market participants.

During times like this it is abundantly helpful to go back to some core basic principles that are irrefutable. All temporary influences matter, but these truisms are what determine valuations for stock prices. Ultimately, the valuation of all assets is based on the amount of cash flow that one can achieve from the ownership of the asset. After that calculation, one must determine the expected growth of that cash flow. Finally, the predictability of that expected growth must be ascertained in order to determine the “right” multiple of cash flow to pay. Based on the inputs, one can reasonably determine the “fair value” of that asset. None of this is new or creative, but that is what makes it so powerful. Most investors overcomplicate the investment decision making process.

The reason we mention these factors at this time is because this is where the market could face some real challenges over the next few quarters. We have benefitted greatly from “coming back from the brink”, and the market has marched higher on the basis that central banks will continue to flood liquidity into the system until the economy actually develops sustainable growth. The result is a market that is now fairly valued at best and expensive at worst. Can it go higher from here? Absolutely it can and very possibly may! That said, we see some very specific challenges based on the truisms we mentioned above.

The first of these potential headwinds is revenue growth. Bottom line, we are not seeing enough of it. In order for a company to grow cash flow for a sustainable period they must grow revenue. It is that simple. A company can cut expenses for a period of time, which is good business management, but that can only be done to a point. Eventually, a company must grow revenues if they want sustainable growth. This is a major challenge for companies right now. There is not enough worldwide “rising tide” to “lift all ships” so companies must create growth via new customers, larger volumes or raising prices. Revenue growth in the 1st quarter was flat to tepid, and we expect revenue growth in the 2nd quarter to be flat to slightly negative. Where is the growth of cash flow going to come from if revenue remains flat?

Profit margins are also a material concern in a period of flat revenues. Profit margins currently sit at historically unsustainable levels. Management teams are to be commended. They have done a wonderful job managing their business, but can they really keep margins at these lofty levels for the foreseeable future without growth in revenue? Even more challenging are the other looming increases in their costs from a variety of sources. Healthcare reform, global competition and rising wage costs are all factors that could put pressure on margins, which in turn puts pressure on cash flow with particular impact on the expected growth of those cash flows.

The final headwind that could begin to blow and further impact market growth is the slowdown in China. Economic growth there is slowing, and that trend accelerated in the 2nd quarter. China has been a major growth engine in worldwide demand, and it will continue to be in the future. However it appears that the growth rates there are going to moderate which could make it even more challenging for companies around the world to grow revenue. There are other headwinds, such as Europe, the Middle East, debt levels, etc., but those are well known so we will not elaborate.

The potential result of these headwinds could be pressure on valuations. The multiple an investor is willing to pay for an expected stream of cash flow is extremely fickle and based on emotional decisions. This is what we see as the greatest risk to the markets rise assuming no change in Federal Reserve policy. When one adds the growing likelihood that the easy money policies of the last few years will begin to be reduced, it creates a rather ominous potential outcome. This is why the markets were so volatile in June. The very hint by Chairman Bernanke that the Fed was going to taper sent shockwaves through markets around the world. If they actually begin to reduce their purchases the markets response may be quite dramatic.

In light of these factors we feel very comfortable with our "2" rating on the CAZ Scale. We have participated in the rally while not taking what we consider to be undue risks, and our security selection has been solid. We have been opportunistic during periods of volatility, and this has added value. From here we are going to continue with this approach until we see either a material improvement in valuations or a significant increase in expected revenue and cash flow growth.

Most of our clients know that we have experienced material growth in referrals from the families we work with, and this has led to growth as a firm. In response we are growing our team, and we added two outstanding individuals in the 2nd quarter. Jay Van Ert has joined us as Managing Director and will be leading our research effort in alternative investments, as well as joining our executive committee where he will be actively involved in the management of the organization. Jay has more than 25 years of investment management experience and has managed a multi-billion dollar portfolio of hedge fund investments. Vicki White joined us as Executive Assistant to the Chairman. Vicki has more than 20 years of experience and is a paralegal. We are extremely pleased to have both of them, and we look forward to the value that they are going to bring to the organization.

Please look for changes in the way we communicate and report to our clients. The feedback we received earlier this year was tremendous, and we are working hard to implement many of those suggestions. We have had an outstanding year thus far, and we look forward to the 2nd half with optimistic anticipation. Please let us know if there is anything we can do for you. Enjoy your summer, and we will see you soon.