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Jan. 23, 2015

OBSERVATIONS ON THE MARKET

No. 283

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Intrinsic value is an interesting concept. One explanation for intrinsic value as it relates to investments is: What would you pay for something if you could never sell it? That implies that at some point the investment has to pay you cash, because if you can never sell it, that is the only way you get your money back. In the world of finance, this principal gets clouded with holding periods that range from less than a second, to - forever. If you think about it, on any given day buyers of the same investment have different ideas of how long they plan to hold the investment. They have completely different intrinsic values on the same investment at the same moment in time. The person who plans to hold only to the end of the day really could care less about next year's dividend. They only care about what is being said on the financial news networks. The person who buys with a very long holding period, say several decades, knows that almost nothing said on the daily financial news network on any given day will change the intrinsic value of what they are buying. In short periods of a day, week, or even a year, the market really only cares about fear and greed. Intrinsic value is only concerned with forever. What is your holding period?

When most investors invest – they still perceive they have the cash, because at any time they know that they can convert their investment back to cash. This ability to convert to cash becomes the liquidity premium; it is what makes investors pay more than what would otherwise be a lower intrinsic value. In a market crash, that liquidity premium evaporates, and you get less for your investment. Here's the difference, if you bought it expecting to hold it forever, you don't care about market declines. You only care about your understanding of intrinsic value.

The problem we currently face is that certain parts of the market, hopefully, never get priced as they currently are ever again. Zero interest rates affect the cost of financing, and if an investment becomes more attractive solely because it is being compared to earning nothing, earning nothing may only be a short-term phenomenon. Therefore, you don't really want to own it forever, just while it is more attractive than the alternative of zero or 1%. This concept is really evident in two assets currently.

The first is Spanish 5-year debt. You may remember that only a few years ago, investors thought that in a few years they may not even get their money back because Spain was on the list of countries that might default. Not anymore. If you buy a 5-year Spanish government bond today you will get paid .73% for the next five years. U.S. 5-year debt currently pays 1.3%, and it seems that hardly anyone would argue that Spain is a higher risk than the U.S. How can Spain have a higher intrinsic value than the U.S.?

The second example is oil. The current collapse in oil prices has resulted in much lower prices for the companies in the oil sector. The Exxon's of the world have declined much less than the smaller independents, who may no longer have a 'forever' as a holding period. Operating losses and leverage do not go together forever. It has driven the bigger companies who will probably be around forever closer to intrinsic value. However, the smaller leveraged oil producers offer tremendous profit opportunities if they survive. Forever seems a little safer, but your definition of intrinsic value can really make a big difference in the oil sector currently.

We are in the sweet spot for financial markets; very low inflation with just enough growth to keep earnings growing. How long this will last is anybody's guess, and most people have been wrong for the last several years. My prediction for last year was for a market advance of 7%, the S&P 500 was up 13%. This year it will be up 6%. (Hint, never predict 10%, the long-term market average gain. It is almost always more or less thanks to fear and greed.) The Fed is hoping that the current state of zero unwinds itself very gradually, thus giving assets time to 'reprice' themselves in an orderly manner. The intrinsic value of an asset paying zero and 5% is a completely different number. We will see if the Fed can navigate back to forever in an orderly manner. (Disclaimer: The forever intrinsic value concept comes from Aswarth Damodaran, a finance professor at NYU.)