CAIRN INVESTMENT GROUP

**Newsletter and Quarterly Update** **June 2014**

### Inside This Edition:



### Important Reminders:

- **Annual Privacy Notice Enclosed**
- **ADV Material Changes**
- **NYSE Closed for Labor Day**


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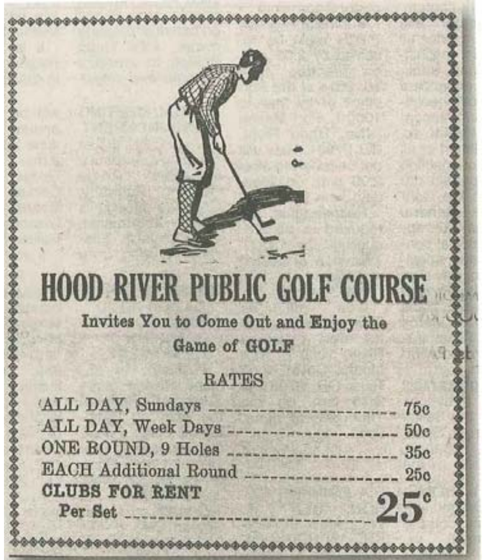
Greetings from the Northwest.

It is Saturday. The atmosphere has the feel of a hot day ahead, but only after the morning clouds burn off. If I time this right, I should be able to mow the lawn and wash the car before the sun pushes me into the shade of the forest edge where we live. While it's still cool, I am fueling up with a deep, rich cup of Portland's own Stumptown coffee. Portland has a few nicknames and "stumptown" refers to the look of the area back when the timber along the river and up to the steep slopes was ferociously harvested. Stumptown Coffee is also a great example of the hundreds of small businesses in Portland that are catching broad attention and are leading to growth, better paying jobs, and wealth for the founders. Right next to my scrumptious coffee are two newspapers. The Oregonian, which has evolved into a tabloid format and is a must read for me but I find it less satisfying as the changes evolve. The spectacular Wall Street Journal Saturday edition has become a terrific source of non-business goodies that, when coupled with the business content, makes it a valuable two-cup read.

The headlines of late have been dramatic and alarming. A story that is rapidly being eclipsed is pointing out that it's been 100 years since shots rang out in Sarajevo, and the beginning of World War I. The world changed on that day in 1914. In one of those wonderful history courses at the University of Oregon, I don't know if I was encouraged, or instructed, to read the book The Guns of August by Barbara Tuchman. It's a terrific book. If you haven't read it, I certainly recommend it, but this isn't about a book review, it's really about the fact that in 1962, when the book was first published, you could buy it for \$1.65. Today, it's hard to find anything worthwhile to buy for \$1.65, including a cup of coffee. This letter is really about inflation, one of the two things we as investors struggle with most…taxation and inflation. Having read The Guns of August, I had a keen interest in experiencing Sarajevo and had the opportunity to travel there during the spring of 1984, following the Winter Olympics. In particular, to the actual street




MAY 25, 1934: Hood River Public Golf Course rates.

corner where the 1914 shots rang out. At that time, it was right smack in the middle of Yugoslavia. My gosh, the lines have been redrawn since then.

That brings us to some of the noisy news being heard around the world. Energy volatility is currently being driven by a variety of events, including what have to be considered expanding hostilities in Iraq and neighboring countries. We are seeing oil prices move, but probably not as much as they would have moved a few years ago, prior to the opening up of a tremendous amount of energy production right here on the North American continent. I've written in previous letters about what it means to move crude oil around the country by rail or pipeline. Additionally, energy developing companies are lobbying the U.S. Government to allow them to export crude oil. Last month there was an announcement that one company was successful at exporting some of the condensates that are used as part of the refining process. It would appear that the fear of unstable oil supplies from Iraq and neighboring areas is being softened by the fact that we have created more oil supply here in North America, and that the U.S. and Chinese reserves are nearly at full capacity. So far, we have seen price jumpiness, but not enough to create major economic changes.

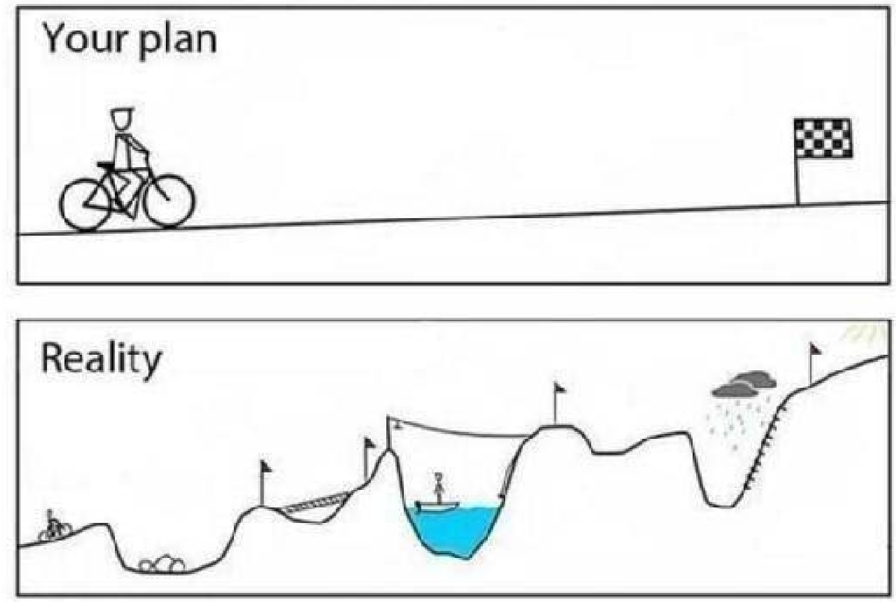
I'm not trying to paint over the really serious situation in Iraq and neighboring countries. No matter what happens near term in Iraq, whether we get involved with air strikes or other people come to assist, the violence there will inevitably go on for years, maybe decades. It's unfortunate, but religious friction means there will be constant turmoil in that region.

The reason I led off with inflation is that inflation is such a sneaky, slow, and consistent erosion of our buying power. As you're trying to create more wealth, it's important that you are getting ahead of not only taxation, but inflation.

We've found ourselves in an interesting situation during this economic recovery; it would appear to be an "asset-rich" but an "income-poor" recovery. What I mean by that is that the valuation of companies, and the valuation of products, goods and assets, have become more expensive, and more profitable respectively, while the income side of the economy (employment) has been rather poor. Yes, the statistics lately would lead us to believe that many jobs have been created. Last month, possibly 200,000 new jobs. That's wonderful, but oftentimes what's overlooked is that we have many more new young people looking for work. The United States is about 350 million souls with many working to an older age. The birth rate is such that the number of kids growing to the point where they'd like jobs is at a rate of about 4.5 million a year. So oftentimes, a country needs to be providing or developing jobs at a rate that will satisfy the expansion of the work force, and I don't think we're keeping up with that right now.

The stock market at "all-time highs" is the recent news headline often heard. Sometimes after an all-time high is reached there is a decrease, pull-back, correction or whatever you want to call it in the over-all stock market, but not always. A trend of higher-highs is a good friend to have. Right now the leading indicators - average work week, unemployment, new orders for goods and materials, building permits, credit, indexes, interest rate spread - have shown no sign of stress at this point.

We have seen change in the Fed's balance sheet, and even though they are now "tapering" (less bond buying) to support our economy, it is still a much ballooned balance sheet. By stimulating the economy the Fed hopes to have growth in the velocity of our economy, the "velocity of money," but it hasn't really worked that way. So again, with slow velocity, or money changing hands, and a slow employment growth rate, we have had an asset-rich recovery in an income-poor economy.




Another thing that has happened during this recovery is that bank deposits have grown significantly. There's a lot of money in bank savings accounts and money market funds. There is a lower growth rate in lending than there is in deposits. You would normally like to see deposits and lending run in tandem, but unfortunately, they have been diverging in the last few years. Recently bank loans have begun to surge, and, in particular, they have been surging at the small regional banks, not the large money center banks. The small banks look a little different from a traditional "buttoned down" bank. In fact, you might even find some Stumptown coffee being offered in the lobby of your local small bank.

One of the things that we watch rather carefully is the gap between government spending and tax receipts or tax revenue. That gap is narrowing, and that is positive. So while the government has shut down quite a bit of spending, slowing the economy for a time, we've also seen an increase in tax receipts due to the economy's expansion. This is a positive sign. High debt levels in our households and in the consumer area slow the economy. During the last couple of years we've seen decreasing debt levels on the balance sheets of individual households. This is a terrific thing; it means that people are less burdened with debt and have the ability to actually stimulate the economy with more purchasing.

The last few years have seen a lot of companies focusing on distribution of dividends as well as stock repurchase programs.  This is also positive.  I love to see it when companies buy back their own shares.  One of the things that we've seen most recently is the beginning of some CAPEX spending, or spending capital to replace generally tired equipment and aging physical plants.  This could be as simple as a piece of machinery in a factory that has reached the point where the company says, "It's done, we need to replace this."  So, if you are hearing news about companies spending money on capital projects, and possibly not engaging in their stock buyback programs, or not increasing dividends any further, that is probably a really good sign that companies are trying to do what we want them to do: grow the profits in excess of taxation and inflation.

As I mentioned earlier, household debt as a percentage of disposable personal income is trending downward.  The extraordinary housing bubble that we experienced leading into the last recession caused a temporary dislocation between household debt and the value of houses, and as a percentage of disposable income.  We are now seeing household debt as a percentage of personal income improving.

As I mentioned before, based on what we're seeing in the way of forward earnings projections, most companies are priced at a fair value.  Currently the S&P 500's forward price earnings ratio is 15.5.  This is not far from the stock market valuation highs of 2007, but it is a long way from the very high levels in 1999, and the disastrous technology bubble.

I know I've jumped around here a bit, but I want to get back to the main thesis, which is trying to beat taxation and inflation.  I thought I'd include an interesting clipping that appeared in the 1934 Hood River newspaper describing the golf course prices of that year.  Now, as many of you know, I'm not a golfer, so I can't know this for sure, but I think the prices have gone up since then.  If nothing else, hopefully you'll chuckle.

Additionally, I've put in a little sketch that sort of reflects on the reality of our lives, and how we think forward in such a nice linear way, and we expect things to move smoothly, but of course reality is different, and the little sketch shows the way our best efforts are all too often met with unexpected realities.

*Photo by: Jennifer E.*

As we continue to bump forward, sometimes making progress and sometimes not, I want to wish you all a very happy, sun-filled summer.  I look forward to seeing many of you in the next months.  As always, don't hesitate to call or stop in.  The coffee pot is on, and we are always delighted to see you.

Happy Trails,

Jim

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