investment intelligence

As seen in August 2010

Twin Cities BUSINESS

Fred Martin

Flight to Safety

Really? There are reasons to rethink that when it comes to bonds.

Since December 2007, mutual fund investors have voted their pocketbook in an incredibly consistent manner. According to the Investment Company Institute, a national association that represents investment companies on regulatory and policy issues, bond funds have gained share from stock funds in every month since then. This winning streak would dominate headline news for any sporting franchise.

Investors have been conditioned for decades to believe that investments in bonds are the safe bet. Prognosticators frequently call a rush to bonds, specifically U.S. Treasuries, a "flight to safety." And why not? Since 1982, bond yields have steadily declined, thus lifting their principal asset values in the secondary market. This happens because older bonds that pay higher interest become more attractive when newer bonds are issued that pay lower rates—bond prices and interest rates tend to move in opposite directions. So given an economy that continues to look weak, bonds still look like the rational, safe bet.

Until you look harder.

Bonds have a limited life span and limited potential upside for capital gains, while stocks are perpetual and have unlimited upside potential. It's also worth noting that lately we've seen a significant uptick in bond defaults (see chart at right)—and this is within the so-called "investment grade" category, the highest quality bonds available.

Given the level of economic uncertainty, it's not unreasonable to conclude that the risk for bond defaults will remain elevated, while the reward (yield-to-maturity) remains low. High risk, low return—that doesn't sound like a "flight to safety."

On the other hand, a lack of enthusiasm toward stocks improves their price/value relationship, and the financial collapse of 2008 is a major reason for optimism here. Since the financial meltdown, investors—not to mention a significantly weaker economy—have stopped funding bad businesses. Try now, for example, to put together a Pets.com and ask your banker or a Wall Street firm to back the idea. Companies with bad business models simply don't get capital. Weak economies weed out weak businesses.

Also at risk in such an environment are large companies. Most of them, faced with difficult times, prudently institute budget and hiring freezes. They also limit their focus to their core competencies. These measures often result in "opportunity costs" as companies forgo investing in potential market opportunities.

But creative and often smaller companies will still find a way to seize on a great opportunity in a tough economy, often in a more cost-effective manner than they might have during more prosperous times. And that can translate into a great investment opportunity for others.

A case in point is a local company, Stratasys (Nasdaq: SSYS), which has developed revolutionary technology in 3D printing that's as close to magic as I have seen. The company's 3D printers produce working prototypes of industrial or other parts using computer-aided-design (CAD) files. The printers heat and extrude plastics, applying them layer by layer as the design files indicate. The cost-saving potential is enormous, considering the alternative of metal fabrication that's needed for even simple prototypes.

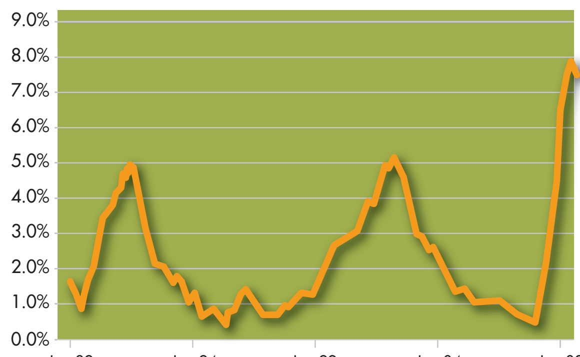
Stratasys ended 2009 having generated $98 million in revenue and produced nearly $25 million in free cash flow, further bolstering a company with $72 million in cash and no long-term debt. Prospects for growth were good, but Stratasys' market cap remained $350 million.

On January 19, along comes Hewlett-Packard, and the two companies announce a partnership in which HP begins to sell its own private-label Stratasys printers. This is a big deal, and perhaps also a sign of the times. Prior to the financial meltdown, HP would likely have purchased the entire company—probably at a nice 25 percent premium to the stock's trailing 30-day price. Instead, long-term holders of Stratasys stock will be awarded the value creation if the partnership is successful.

Investments like Stratasys are not unique. The market contains many such gems. If the "flight to safety" is debt-laden companies or countries, perhaps the road less traveled is a better idea. **TCB**

Investment Grade Bond Defaults

Twelve-month trailing default rate, CDX IG 10, 1/31/1989–12/31/2009



Source: Factset

on the WEB
tcbmag.com

Archives

For more "Investment Intelligence," go to "Ideas and Opinions" at **tcbmag.com**. There you'll also find the archives of other *Twin Cities Business* columns, including "Capital Beat" and "Portfolio Positions."

7/2010
SEEKING INCOME
It's still possible to generate it in an uncertain interest rate environment.

Fred Martin is chief investment officer at Disciplined Growth Investors. A 32-year veteran of the money management business, he oversees the firm's investment efforts and serves as senior analyst and portfolio manager.

fredm@dginv.com

REPRINTED WITH PERMISSION FROM TWIN CITIES BUSINESS • COPYRIGHT BY MSP COMMUNICATIONS

The securities identified do not represent all of the securities purchased, sold, or recommended for advisory clients. To obtain a list of all securities purchased, sold, or recommended, please contact Robert Buss at (612) 317-4107 or robertb@dginv.com.