# Mengis

CAPITAL MANAGEMENT INC.

# Mid-Quarter Newsletter

**November 15, 2011**

## From My Corner

*Jeff Mengis – President*

I recently attended conferences featuring speakers from Pimco, Charles Schwab, BlackRock and Goldman Sachs to hear their outlook on the fixed income and equity markets. Much of the discussion focused on the public and private debt levels of the developed world and its implications for investors. Bill Gross, a highly respected fixed income manager from Pimco, believes there are four ways to solve our debt problems: 1) economic growth 2) default 3) reflate or 4) financial repression. In his opinion, we appear to be heading down the path of financial repression similar to a period from 1943-79, where interest rates stay low for a prolonged period of time. A majority of the speakers believe that interest rates are in a bottoming process. While they feel we are near an inflection point for interest rates, they expect rates to stay historically low for some time due to the deleveraging process and increased demand from an aging demographic.

Fortunately, there appear to be areas of opportunity in the fixed income market that provide additional yield. As a result of recent market turmoil, the yield spread between high-yield bonds and the 10-year Treasury widened to a historically high level. When investing in the high-yield bond market, we typically purchase mutual funds rather than individual bonds because they diversify exposure across hundreds of corporate debt instruments, reducing company risk. In certain fixed income accounts, we have been adding to positions of the Goldman High-Yield bond fund (GSHIX), which offers a successful track record over the last decade and a half. Currently, the fund yields around 7.5% with an average maturity of about 6.5 years. Over the last three years, many lower rated companies have issued new debt, extending maturities, thereby reducing near-term default risk. We acknowledge that high-yield debt can be more volatile, however we believe this asset class offers relative value given the current interest rate environment.

## Investment Focus:

Over a year and a half has passed since an explosion on the Deepwater Horizon drilling platform in the Gulf of Mexico led to the worst oil spill in history. In the two months following that catastrophe, over $107 billion was removed from **BP's (ticker: BP)** market cap due to concerns that the company would not be able to pay the environmental and economic costs resulting from the spill. BP now estimates the total cost of the spill to be $40 billion. The company has taken significant steps to raise the funds necessary to cover costs resulting from the spill by divesting assets, temporarily halting the dividend and attempting to hold other parties in the disaster accountable. In our judgment, shares of BP have priced in uncertainty over liabilities from the spill and now offer an opportunity for investors.

Over the last fifteen years, the company has increased earnings per share by 3X, cash flow per share 2.4X and revenue per share 2.7X, yet the stock has *decreased* more than 30%. BP currently trades at about 6X current and future consensus earnings estimates while multinational oil companies on average trade at approximately 8X earnings. Most analysts forecast earnings upside over the next 3-5 years as production and oil prices gradually rise. The potential for earnings growth combined with a discounted earnings multiple provides an opportunity for the patient investor. Despite reinstating the dividend at half its previous amount, the stock currently yields approximately 4%.