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Down on the Farm

David and Jacob took advantage of a late planting season to spend a morning with Kevin Stoy of Stoy Farms. Kevin, along with his brothers Ken and Tom, runs a large operation that farms over 13,000 acres. Agriculture has been a hot topic in investing circles recently and we wanted to get a better understanding of the universe of opportunities.

Historically, farmland has been a solid investment. It carries certain inflation-hedging properties, has exhibited a low correlation with other investments and produces a necessary good. According to the National Council of Real Estate Investment Fiduciaries (NCREIF), farmland has returned 11.9% per annum over the past 20 years. Longer-term figures tell a similar story. Current bulls argue that with a rising global population and greater demand for crop-intensive food products like meat, the supply of arable land will not be able to meet demand and food prices will rise, pushing up farmland values in the process.

Figuring out the validity of such macro predictions is hard. After spending decades in the farming industry, Kevin is a bit skeptical of such claims. At its heart, farming is a commodity industry where high crop prices always seem to be ñcorrectedò via increased planting or improved technology. Consider that even after a strong run-up in prices the last several years, the inflation-adjusted prices for corn and soybeans are still approximately 10-15% below what they were in 1960.[1] In March of this year, analysts were forecasting that farmers would plant more acres of corn in 2013 than in any year since 1936.[2] And who knows if a breakthrough technology, such as a drought-resistant seed, could fundamentally alter the global food supply? The bulls might be right, but we donôt feel comfortable making such a prediction at this point.

Our primary concern, though, is that farmland values have raced to new heights that donôt appear to offer an adequate margin of safety for new investors. Institutional funds (i.e. monies from hedge funds, private equity funds and large endowments) have flooded the space. It isnôt unusual to see numerous ñsuitsò from New York bidding at farmland auctions that only included neighbors years ago.

According to data compiled by the Purdue Department of Agricultural Economics, the value of Indiana farmland has increased just north of 4% per annum since 1912.[3] This record has occurred in fits and starts; land prices tumbled during the Great Depression, rose sharply with inflation in the 1970ôs, crashed during the 1980ôs farm crisis and have taken off in the last ten years. (We note that current debt levels on farmland are nowhere near the highs from the 1980ôs, hopefully precluding any similar crisis.) Indiana farmland prices are up nearly 45% in just the past two years, despite the fact that they didnôt really recede during the Great Recession. More worrisome is that the cash yields earned on farmland, based on recent purchases, amount to around 3%, well below the average since the 1960ôs of 6-8%, despite the fact that crop prices are up 2-3x over the past five years.[4]

[1] *Farmdoc*, University of Illinois at Urbana-Champaign.
[2] ñRain of Grain,ò *Grant's Interest Rate Observer*, Vol. 31, No. 5b, March 8, 2013.
[3] The Index of Indiana Farm Real Estate Values, Department of Agricultural Economics at Purdue University.
[4] ñSoil for sale,ò *Grant's Interest Rate Observer*, Vol. 30, No. 22c, November 16, 2012; Purdue Agricultural Economics Report, August 2012, Department of Agricultural Economics at Purdue University.

We also had the chance to talk to Kevin about other parts of the farm economy, such as seed, fertilizer, capital equipment, distribution and transportation. We confirmed previously held concerns that any slowdown in the farm boom could bring a large cut to near-term capital expenditures. Farmers have used high income from recent years to expand their portfolio of machinery and tools and any slowdown in the industry could lead framers to drastically reduce expenditures on new goods. Kevin did give us some interesting thoughts to continue working on, though, particularly around distribution and transportation.

David checking out the equipment at Stoy's – he's always working!

Please don't misunderstand us, we aren't predicting calamity and can't shed much light on long-term bullish arguments concerning global food supply. We just get nervous when prices are high relative to fundamental cash flows and we would tread cautiously with new land purchases. Of course low cash yields aren't a phenomenon observed solely in farmland, but a ubiquitous sight in today's low interest rate environment.

West Coast Redux

Jacob took the opportunity during a recent trip to Los Angeles to visit with three different investment management teams, two of which currently serve as partners to AMI. The first fund management team focuses on international stocks, the second on global stocks and high yield bonds and the third on bonds, particularly mortgage-backed securities. As we have discussed previously, our meetings with partners and potential partners focus on several key due diligence topics:

- Is the fund's management team aligned with investors? For instance, what percentage of the fund manager's wealth is invested in the strategy? Does fund management own the management company, or are there outside owners that could pressure fund management to partake in behavior detrimental to clients? Does the fund have an appropriate amount of assets, or is the fund too big given the types of investment securities it hopes to buy?
- Does fund management share our views on how investment portfolios should be managed? Do they concentrate on their best ideas and target long-term holding periods? Do they have a conservative and intelligent approach to risk management?
- Does fund management employ an in-depth research process or some other unique capability that gives them a competitive advantage in selecting investments? How well do they know the investments in their portfolio?

As an example, the management team for the international stock fund has large personal investments in the strategy, manages less than $250 million, giving them a lot of investment flexibility, and insists on travelling to each country they invest in and meeting with management teams in person. Some of our due diligence analysis is a check-the-box type of task, but this just serves as a weeding-out tool; the important stuff is understanding the intangibles, which requires intense, ongoing dialogue and research into the manager's portfolio holdings, investment philosophies and personal characteristics. For example, while recently researching a private equity manager, we conducted thirteen due diligence calls and meetings with various references. We are passionate about finding managers who not only are intelligent, passionate and hard-working investors but also act with the utmost integrity in treating their clients as partners.

Jacob made time to visit the Wells Fargo museum while in L.A., a company we have long followed and respected. Here he is pictured with one of the original Concord stagecoaches.

Spring Meetings

David attended a couple of annual meetings for us in May. He had a chance to attend his first ever Berkshire Hathaway annual meeting, where Warren Buffett and longtime partner Charlie Munger field open, unscripted questions for over six hours. This is a rite of initiation for any serious value investor. Mike traveled to his first Berkshire meeting in the early 1990ôs when there were just 1,000 attendees; this year, over 35,000 attendees were expected. Topics included succession planning (Buffett is 82 years old and Munger 89), Buffettôs recent investment in Heinz, the competitive landscape in insurance, the status of the dollar as the worldôs reserve currency, the sustainability of corporate profit margins, the effect of interest rates on asset prices, Buffettôs investments in small market newspapers, the investability of the airline industry, Berkshireôs views on its recent investment in IBM and Buffett and Mungerôs general theories on investing. If you want a summary of any of these topics, please feel free to call us, we love to talk Buffett.

Unfortunately, this is the closest David was able to get to Buffett during the weekend. Maybe we can do better next year!

In a nearby auditorium, Berkshire showcased its large portfolio of products and encouraged visitors to spend on everything from Dairy Queen Dilly Bars and Fruit of the Loom underwear to Clayton pre-manufactured homes and Forest River RVs. David made sure to pick-up some famous Seeôs chocolate for his fiancé. Though David wasnôt able to secure a picture with Buffett as he had hoped, it was an awesome trip. In coming years we hope to continue to make the trek and become more involved in the ancillary events that surround the meeting, where talented, dedicated value investors come together to discuss ideas and strategies.

David also recently attended an annual meeting for another one of our portfolio companies headquartered in the Midwest. While annual meetings have become much less publicized than they were a couple decades ago, they represent a great opportunity, especially at smaller companies, to ask management specific questions and hear honest, unscripted answers. David had a chance to speak one-on-one with the CEO and CFO for a half-hour to go over some of our questions on the business, the industry and competitive risks. The company is a supplier in the commercial trucking industry, and David had just recently spent an entire morning with a large commercial truck retailer walking through industry risks and challenges. This ñscuttlebuttò research equipped David with some great questions to walk through with management.

In June and July we hope to make several more trips to visit with company management teams for both current and prospective stock investments as well as spend time with several fund management teams. We continue to believe that field research is an incredibly important and indeed indispensable complement to what we do at our desks.

We hope your summer gets off to a great start and look forward to updating you soon on our ongoing research activities. If you have any questions please donôt hesitate to contact us.

Sincerely,

Michael D. Axel, CFA
Jacob D. Benedict, CFA
David J. Manger, CFA