

**Title: Who is right: Buffet or Gross? & What about Tom?**

**Region: Global Date: 25th November 2009 No of Pages: 3**

On November 03<sup>rd</sup> this year, Warren Buffet, the Sage of Omaha, the smartest brains in the investment world, made the largest bet of his lifetime on the recovery of US economy. His investment firm, Berkshire Hathaway Inc agreed to buy a rail road company based in Texas, Burlington Northern Santa Fe Corp in a deal pegged at USD 26 bn for a 77.4% stake. He himself described the deal as “All-in wager on the economic future of US “. And more important, he bought the stake at a forward (2010) multiple of around 18.2 vis a vis the then prevailing S & P 500 index forward multiple of 13.4.

Very clearly Buffet must have had his numbers in place on the buoyant potential growth in US economy before paying a reasonable premium for the deal as against the markets. He does expect good days for the US economy. Just to put the size of the deal in Indian perspective: It’s around Rs 167,000 crs at current exchange rates. That’s equal to almost the expected annual current account deficit of India for the whole of FY 2009-10 or the balance of payment surplus for the same period.

Not far away from Nebraska, is Newport Beach, California, which houses PIMCO, the largest bond fund house in the world. Bill Gross, an eminent and influential bond fund manager, runs the USD 192.6 bn Total Return Fund, which invests in bonds across the world, including US treasuries. Gross increased his holdings in government and related debt to 63% of his holdings in the Total Return Fund in October 2009, from 48% in the month of September 2009. That’s an incremental bet of around USD 28 bn in that month, on the conviction that economies world over; including US won’t recover soon under the “New Normal” as he describes it. And media reports talked about major of this incremental holdings were in US government and related debt.

The New Normal being heightened Government Regulations, lower consumption, higher unemployment, lower interest rates and a shrinking role of US economy in the world. In other words it’s a USD 28 bn wager on the continuance of recessionary like situation in US. A bet on all the green shoots disappearing.

Now who will prove right? Buffet with his USD 26 bn wager or Bill Gross with his USD 28 bn one? Put together the size of the wagers is above USD 50 bn, the size of a very small economy.

Buffet’s bet is very simple: US economy will recover soon and trains stand to gain being more competitive than trucks, due to higher fuel price. Trains consume comparatively less fuel and are preferred to carry dry bulk commodities such iron ore. As fuel prices move higher the efficiency advantage of trains are expected to deliver. So does Buffet expect higher fuel prices? If Buffet is right, the recovery in US economy (higher GDP growth rate) will hopefully lead to more demand for credit as well as for movement of commodities. And combined with rising fuel

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prices this is likely dose the fire of inflation. If that's assumed to be the future, the natural consequence of it is higher interest rates driven by Fed in coming years.

And we were taught by Frank Fabozzi's books in business schools that rising interest rates lowers values of bonds and thus the net asset values of funds such as Bill Gross's Total Return Fund. In that case the New Normal would continue to be an Old Normal. And if the New Normal of Bill Gross as described earlier comes true, there will be lesser demand for rail as well as road freight. The wager of life time of Sage of Omaha in that case would turn terribly sour.

A stronger economic growth is good for corporate profits as it creates jobs and boosts consumption. And so it's good for the stock markets too, but the same stronger growth usually is a poison pill for bond holders as interest rates rise leading to fall in prices of bonds.

Both Buffet and Gross have large number of followers in form of global investors, who tail there investment strategies very closely. In fact the right to have a dinner with Buffet is auctioned annually at exorbitant price. But now who is right?

If learned and seasoned investors like Buffet & Gross are looking in opposite direction as far as investment strategy is concerned, what about the smaller investor? The dilemma would be multiplied for him/her due to lack of resources to understand or read the markets or the underlying economy.

The investors world over are confronted with such dilemmas since the world changed on March 09, 2009. Where to invest your money? Most of the asset classes have seen sharp recoveries from there lows and levels as well as valuations are looking scary for risk averse investors to create an entry point. The talk of liquidity driven asset bubbles and intervention by regulators are hampering the investor's calls on markets.

The developed and the emerging stock markets have rallied more than 65% from lows. Some of the emerging stock markets like India are more than 100% higher from the March lows. The corporate bonds in emerging as well developed markets have returned 25% to 50% from lows The sovereign bond yields across the world are much lower to be attractive, except for some high yielders but higher deficits/public debt remain the lurking threats for them to fall further.

Commodities, both hard and the soft ones, world over have jumped by more 50-100% and more in some cases. Crude Oil has more than doubled from lows. Garlic prices in China are up by more than 3.5 times since March 2009. Gold is up by 30% in the year 2009. And money market accounts are fetching a measly 0.5% pa. Real Estate remains sluggish though have recovered marginally. US Dollar has continued its slide. Some of the Asian and EM currencies have also benefited from the USD slide, taking them closer to there fair values.

Indian capital markets have not been isolated from the world. The year of 2009 saw foreign investors pumping in more than USD 15 bn in the stock markets as global confidence was back and risk aversion vanished. Thus taking the Indian stocks higher by more than 100% from March lows. The election outcome and India growth story added fuel to the fire. The PE multiples expanded more than 90% from lows. The stocks are now are hovering around the long term PE multiples of Indian stock markets. Gold prices in INR have also rallied by 26% in 2009, but for INR appreciation, the rise would have been more than 30%. Indian jewelery demand has already sunk substantially under the weight of high prices

Interest rates (GOI Bonds YTM) moved lower from the top making the risk reward ratio a little complicated. The RBIs exit strategy and higher inflationary expectations are impediments to a sharp rise in bond prices. Excess liquidity in banking system has forced the bank and corporate deposit rates (post tax) low enough to be uninspiring. Short term money market rates are touching new lows of 3-4%. INR vis a vis USD Dollar has appreciated in 2009 on back of strong FII flows. But if they reverse where will the INR go? An encore of 2008, when it depreciated sharply.

In line with global markets, commodities in INR have moved up, especially the Crude oil and Gold. Real estate markets are bogged down by higher supply and poor price rise expectations, especially on the non residential sector. RBI has also been cautious on the bank credit flows to the sector.

So the times will be challenging in India and elsewhere in the world for investors to generate sizeable returns. It's important to keep a balance of risk and return embedded in your investment strategy, especially the risk emanating from global events such as failure of a large bank or a country runs into trouble like Dubai or Greece or capital controls are back or developed economies expecting a "V" shaped recovery end up with a "W" shaped one. And India is not decoupled from such adverse developments, especially the sudden reversal of FII flows. 2008 is a classic instance of the myth of Indian decoupling with the world.

If Buffet and Bill are taking opposite bets, which way should the Tom's, Dick's Shahs, Singhs, Kulkarnis, Iyers of the world go? The only way both Bill & Buffet probably would be happy if US stages dramatic recovery without creating new jobs, or without inflation rising or without household balance sheets improving.

Welcome the year of 2010, the year of dilemmas.....

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***Delta Global Partners Research: The Cutting edge***

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