

The Hitchhiker's Guide to Modern Day Finance

Since the usage of "unprecedented" with regard to the current state of the global economy and finance seems to be tossed about in an otherworldly fashion, we will offer this quote from *The Hitchhiker's Guide to the Galaxy*: "A common mistake people make when trying to design something foolproof is to underestimate the ingenuity of complete fools."

To state the obvious, what has made life so difficult and volatile in the financial markets is the seismic intersection of what is political and what is economic in today's world. On the latter front, the historical method of reparation for the litany of mankind's financial follies is firmly at work despite the efforts of hard working men and women in the world's political capitals. Prices are coming down for many assets and as is the case with every material good on the planet and even including publically traded equities, lower prices are bringing out the buyers. Industrial entities are massively liquidating inventories and shutting down excess productive capacity to meet lowered demand. Overpriced assets in weak, overleveraged hands are beginning to move to stronger, better-capitalized hands. In other words, the free-market system, whether you like it or not, is slowly working to correct the giant and painful imbalances that we have collectively wrought upon ourselves and our financial system. Life can, should and will go on.

But there are clearly many who think this is a horribly unnatural state of affairs and something needs to be done about it, and as the table attests, something is being done in a size and scope that is truly...unprecedented.

Continuing with the participation of *Grant's Interest Rate Observer* in today's program, we offer its quotation of political columnist Frank Kent of *The Baltimore Sun*. "One project follows another so rapidly that they baffle the hardest mind...The whole business has become fantastic. The activities are on so many fronts, the experiments so numerous,

varied and vast that confusion reigns and many on the inside are as perplexed as those looking on." This was published by Mr. Kent in 1934.

As they did 75 years ago, these ongoing incursions into daily commercial life have complicated affairs in the short run. And since the collective works of economist John Maynard Keynes seem to be in steroidal vogue, we would concur that in the long run we are

all dead. But it remains a giant and counterproductive stretch to suggest that we should then all fall prey to the short run demagoguery of public opinion polls, vote buying, constituent pleasing television posturing and the emotional desire to open account statements and see stable values, which have for most of the last 18 months only been achieved via attachment to zero yielding treasury instruments.

What we have blessedly experienced over the past six weeks is recognition of one of the old saws of the value investor: good things happen to cheap assets. There is NO doubt in our

What government did—and didn't do

peak	trough	length (months)	decline in real GDP	—stimulus as % of GDP—		
				monetary	fiscal	combined
August-29	March-33	43	27.0%	3.4%	4.9%	8.3%
May-37	June-38	13	3.4	0.0	2.2	2.2
November-48	October-49	11	1.7	-2.2	5.5	3.3
July-53	May-54	10	2.7	0.0	-1.4	-1.4
August-57	April-58	8	3.2	0.0	3.2	3.2
April-60	February-61	10	1.0	0.7	1.0	1.7
December-69	November-70	11	0.2	0.3	2.4	2.7
November-73	March-75	16	3.1	0.9	3.1	4.0
January-80	July-80	6	2.2	0.4	1.1	1.5
July-81	November-82	16	2.6	0.3	3.5	2.8
July-90	March-91	8	1.3	1.0	1.8	2.8
March-01	November-01	8	0.2	1.3	5.9	7.2
December-07		15	1.8	18.0*	11.9*	29.9*

*estimated

Source: *Grant's Interest Rate Observer*, April 3, 2009

minds that buying real businesses with durable economic models at attractive to absurd discounts to intrinsic value has not changed as a rational and profitable course of action for an investor with a reasonable time horizon. As is always the case, minor movements in the economic pendulum from miserable toward less miserable are the basis for V-shaped rallies in stocks, as the resident geniuses of the day pontificate about the likelihood of an elongated U-shaped economic profits recovery. Financial assets almost always move with more pronounced velocity than what is actually happening on Main Street, and the effect works in both directions as many seemed to forget in the years that seemed to pass in the last six months.

What many also didn't acknowledge or understand is the overlay of an inventory cycle on top of merely poor economic activity. Our guess is that the day after Lehman Brothers was "allowed" to fail, the entire corporate world got the message that we were in an environment of economic hurt and proceeded to liquidate nearly every piece of inventory that could be sold. As this abates, we return to merely a lousy economy with credit issues, which again is an improvement from nearly exponential declines in order rates. Oh, and throwing \$900 billion at nearly any problem will also likely have some impact on reported economic activity.

It is another truism of investing that you never own enough of what is going up and we join in the collective muttering of wishing we had employed a bit more intestinal fortitude in the darkest of dark days and bought more aggressively, versus a continuing policy of simply leaning against the wind. But we have done okay, as we were not chased out of poor performing stocks whose businesses prospects and valuations did not change anything remotely like their stocks' prices and very often, what hurt in 2008 has rebounded strongly in 2009. As of this writing, we have put up numbers that are vacillating north of break-even for the year in our Large Cap, All Cap, and International strategies, which seems wonderfully acceptable given the environment and adds up to healthy relative performance. After a heartbreaking year in 2008, our Small Cap strategy is predictably killing it — up double digits. Michael Smith and Michelle Gosom at RCB marketing continue to welcome your call.

Getting back to our original thoughts, what will derail continuing, albeit slow, improvement in economic life as we know it remains meddling by Washington. As it is impossible to cover all the relevant issues, we will focus on two areas that systemically underpin all economic activity: monetary policy and financial regulation.

“Though an indispensable requirement for the functioning of an extensive order of cooperation of free people, money has almost from its first appearance been so shamelessly abused by governments that it has become the primary source of disturbance of all self-ordering processes in the

extended order of human cooperation. The history of government management of money, has, except for a few short exceptions, been one of incessant fraud and deception. In this respect, governments have proved far more immoral than any private agency.”

One might anticipate that some would find this quote by another deceased economist, Friedrich Hayek, a bit extreme, but in light of attempted policies by any number of branches of government not currently working in concert, it does not seem to be a stretch. While we often and correctly fallback on a bottom-up approach toward investing, there are occasionally extreme conditions that require attention. A Federal budget that is only 55% funded by taxes might qualify as one. The Federal Reserve moving toward zero short-term interest policies via “quantitative easing,” a lovely euphemism for the abandonment of fiscal responsibility and currency debasement, may be another. The spectacle of the Treasury Department issuing record amounts of Treasury bonds with the Federal Reserve directly buying hundreds of billions of dollars of them, a monetization of government spending that has delivered painful inflation in nearly every country in which it has been attempted, is another log on the fire.

Our recollection of financial history is that the Feds can do nearly anything they want to control short-term interest rates, but are generally powerless in controlling the level of long-term interest rates, which embed the inflation expectations of the market. We would suggest that current attempts to rule the entire interest rate universe is almost mathematically impossible. (And isn't holding down interest rates below market-setting levels the same course that got us into this mess?) As a point of fact, 10-year Treasury yields have risen six weeks in a row since the day the Federal Reserve announced quantitative easing.

We continue to disdain ownership of Treasury bonds, but have done well and expect to continue to do well in investment grade corporate bonds with short to intermediate maturities and Treasury Inflation Protection Notes (TIPS). On the equity side, while it seems “early,” we are looking carefully at rocks, trees, energy, commodities and operating businesses that may relatively prosper in a world that is distinctly different than the generally deflationary one in which we have lived for 30 years almost to the day. Stay tuned.

With regard to the “financial system” and its participants, we almost throw our hands up. We will assume everyone is up to speed on the “causes and headlines” and focus on the “what now” issues. Like it or not, we must get over how we got here and look to the future. You cannot fix and punish the banking industry at the same time; you must pick one.

Banks that should be able to survive can and will without federal assistance if there is not a continual series of proposals, rules and policies that are conflicting at best,

stupid at worst and if they might be effective, get zero time to play out and see their effect. Investors must have at least a remotely consistent regulatory policy that establishes a stable playing ground so that decisions can be made as to who will prosper and what securities to invest in to participate in that future prosperity. Stress test - are you kidding? The market conducts stress tests every single day. This intrusion into the markets so as to determine that a bank whose stock is down 90% and selling under \$5 per share is more likely to need more capital than JP Morgan and Wells Fargo is simply another instance of asinine policymaking that is only retarding capital building and investor confidence. Dare we ask, how many banking regulators and other financial supervisory folks have been on the taxpayer dole for years overseeing Fannie Mae & Freddie Mac, the structure of and fraud in subprime and mortgage exotica, leverage ratios across capital market players, etc.? And now they will have the answer? As is usually the case, no one worries when things are going well and everyone is making money, but suddenly there is a cry for stress tests once the barn has burned down and the animals are running wild in the meadow.

The consensus is that the stress test is essentially trying to solve the issue raised in the following earnings conference call exchange between long-time banking analyst Mike Mayo and the CEO of State Street Bank, Ron Logue:

Mayo: "The issue is we don't know what the rules are for capital and I would say that covering the industry for over two decades...what are the rules for capital...seems to vary bank to bank, regulator to rating agency...we don't know if its tangible common equity, we don't know if it's Tier 1, we don't know if it is leverage or is it case-by-case. How can we analyze the industry and why would anyone put private capital into the industry and how do you manage your business?"

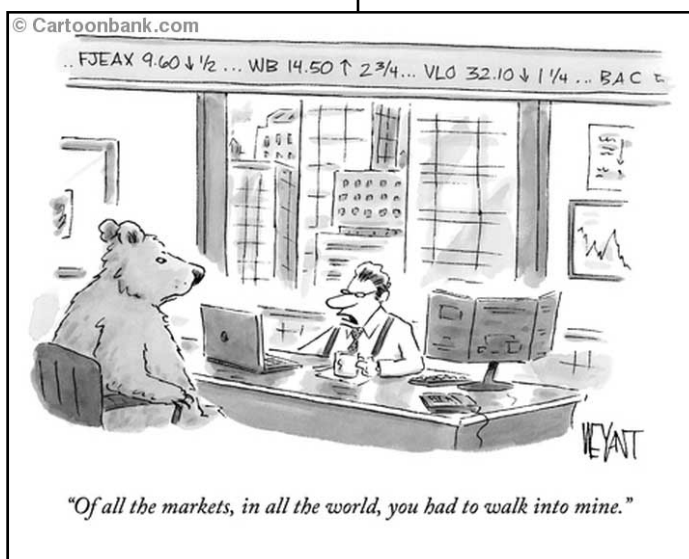
Logue: "I don't know, other than it is truly a balance and we are trying to find the balance in terms of the ratios between the regulators and the rating agencies."

Now, as you might imagine, that's not good. But what is also not good is a federally administered stress test that essentially presents an economic scenario and asks banks to submit reams of data to guesstimate how they would do in this environment. If it were that easy we would all be rich. The Feds are now in the process of telling the banks what they think is "right" and what they may or may not need to do about it. Yes, that's right, an open book test that you can

grade yourself. The measure du jour is "tangible equity capital" and what should or should not be the right level. On its own, that is a bedrock and conservative number, but if that is your only hammer, all banking issues look like nails and you begin to create elaborate forms of well-meaning nonsense. Let's start with the inconvenient issue that the Feds essentially coerced many banking institutions into taking TARP money in the form of preferred stock, which does not count in the new meaning of quality solvency. Secondly, tangible equity has nothing to do with whether you are making money or not. Would you rather own a bank with a 10% tangible equity ratio losing 2% of it a quarter or one with a 3% ratio that is minting money and could double it in two years? And which bank is more conservative, Bank A with a 3% ratio but another 5% in loan loss reserves prudently stashed away for potential troubles or Bank B with a 5% ratio and only 1% reserved for potential loan losses?

In addition, tangible equity capital ignores everything else, like say \$11 billion dollars of quarterly pre-loan provision earnings at Wells Fargo, which can pay for a variety of past sins. Yes, many banks need more capital, but for the Federal government to force banks to presumptuously raise equity in order to adhere to an incredibly narrow measure is no different than forcibly seizing property. This remains the single biggest risk in financial services investing.

There remains an enormous and compelling rationale to want to own well-capitalized banks and insurance companies that have been clobbered in the past 18 months, but it has been a hair-raising high stakes game of poker against players in Washington who clearly hold the ability to change the game on the fly, take self-determined pieces of the pot or simply throw you out of the game. (Our first ever RCB poker analogy.) Banking, insurance and capital market players (to a lesser degree) provide mission critical functions that someone has to do, and since there will clearly be less people doing it, there should conceptually be decent to excellent returns garnered by those who remain. We would suggest, however, that the vicious cycle of declining asset prices being ridiculously marked to market by automatons at big accounting firms causing the apparent need for regulatory capital can also work in reverse, a prospect which is just barely being discounted in the recent rally. Much of the same issues are present in property and casualty insurance companies. Within this specter of gloom, interference and some dilution risk, we own JP Morgan Chase, HSBC, Berkshire Hathaway, Alleghany, White Mountains Insurance Group and our newest bank, American Express, all of which



we think can be bought at current prices and will deliver excellent returns over the long run. We have more ideas on the horizon, but if there ever was a group that suggested it is better to be a month late than a month early, it would be the financials in this day and age.

The good news is that intelligent life does exist outside of financial services. In a recent client meeting, a question was raised about our apparent newfound love of diversification, as our strategies appear to be spread across more industries than in the past. Upon further analysis, the gentleman was conceptually correct. While we still run relatively concentrated portfolios, with the top ten holdings running 40% to 50% of our portfolios, the absolute disarray in the market has created opportunities to buy companies trading at 50% discounts across many different industries. All else being equal, enjoying the same discount in a more diversified fashion is a proverbial free snack in economic terms. We have purchased Total S.A. and Chesapeake Energy, as well as some service companies in the energy sector, falling under the triple threat of: they are cheap, there is conceptual inflation protection, and you pick up exposure to the prospect of an improving economy in our lifetime. We have inexpensive, cash-rich technology holdings in Cisco, Symantec and Accenture, an area in which we have also been generally unrepresented given valuation. We have “auto production returns to something closer to replacement level” holdings in Tyco Electronics and Autoliv. I think we mentioned financials.

While we would not argue that upward movement in stocks is any more a sign of intelligent life than downward movement, the fact that different sectors and asset classes are generating returns that are diverging from each other is an important sign that investors are showing signs of regaining control over their intellectual functions and differentiating between stocks, sectors and asset classes.

In closing, we would suggest that many of the issues that face the global economy are cyclical in nature and are being resolved on their own, despite the best efforts of governments across the globe to find elegant solutions to problems that can only be fixed by the sloppy mysteries of free markets and the passage of time unencumbered by election cycles. As journalist H. L. Mencken noted, “for every complex and difficult problem, there is an answer that is simple, easy, and wrong.”

The issue today is to balance the intermediate-term political risks with a portfolio of compelling values and not be chased away from profitable action, as the recent rally has brought many stocks from truly extraterrestrially cheap to merely inexpensive. We are in no way “out of the woods” or in a position to be cavalier about the global economy or political risks, but in the short run, it is easy to focus on headlines and grand statements and be swayed off a course that has proven durably profitable since the advent of investing. Intelligent

investing is quiet, focused and requires reflection and consistency, traits which are almost diametrically opposed to what passes for discourse in the political arena. It seems that 95% of the global investing population is putting 95% of its mental focus on what is happening between the close of trading today and the next three months, opening up truly wide and high quality opportunities for those with patience. We have seen any number of articles recently in what appear to be high quality financial papers suggesting that the process of what can only be called “daytrading” is now a superior method of investing. This naturally leads to the conclusion that since it is difficult enough to make a few good decisions involving asset allocation and manager and stock selection, an investor should try to improve his success ratio by making dozens and dozens of decisions every year.

We think otherwise.

*Jeffrey Bronchick, CFA
Principal & Chief Investment Officer
jbronchick@rcbinvest.com
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