

## The Rookie

Some interminable number of months ago; it was probably only nine, yet in today's world just seems like three years, we postulated that the most crucial yet mis-priced event in the financial market arena was the retirement of Alan Greenspan. Recent unhappiness in a whole host of what are now seemingly correlated asset classes has brought this point painfully home. As is usually the case in lousy markets, RCB clients have sailed through in fairly solid fashion, thus putting an end to four quarters of occupancy in performance wilderness.

In all fairness to our new Federal Reserve Chairman Ben Bernanke, following Alan Greenspan was a losing move and he had nearly zero chance to get off to a reasonable start, regardless of what he said or did. No matter if there is actually a Ben Bernanke puppet with Alan Greenspan pulling strings and moving his mouth circa the Conan O'Brien gag, he was going to be second-guessed to death and the global markets would gyrate in a fashion not seen in years.

Now let's put an end to the fairness preamble. Mr. Bernanke has introduced himself to the financial and political world with some completely boneheaded moves that have rightfully unnerved financial markets. Mistake one was his complete misreading of "the markets" when he appeared before Congress and in un-Greenspan-esque fashion clearly suggested the monetary tightening of the past two years may be over after a week of a sharply lower dollar and \$700 gold. He then gets sidetracked by CNBC correspondent Maria Bartiromo in her cocktail dress and is quoted as saying his comments in Washington were misunderstood by investors. This set up the inevitable whiplash as Bernanke adopted the "tough monetary love" posture in his next appearance before Congress.

All of which highlights two very obvious issues. Contrary to the formerly popular view of a predictable, low volatility world with which market participants have become enamored; the future remains decidedly uncertain. Second, the legacy of the inscrutable Greenspan is that he left little in terms of sustainable guidelines for his successors, because it is inconceivable that he ran arguably the world's most important institution by the intuitive seat of his pants. (Did we say that out loud?) Which means Bernanke must lead a team of well-meaning government officials attempting to actively divine and manage the future of the US and global economies, inflation, the value of the dollar, the employment rate, etc. As he does not get a hedge fund fee of 2% and 20%, the job lacks financial incentive and is obviously impossible and should be somehow abolished. In the meantime, we have lots of people in expensive custom-tailored suits saying in serious, client-ready voices that the new Fed policy is "transparent" and "data dependent." And this means what? The Fed will review new economic data as it comes in and make decisions on interest rate policy accordingly? Wow!

It follows that an investment process based upon Fed-guessing has returned to its fruitless and unhelpful state and we can get back to securities analysis and watching the weather channel (see below.) Again, contrary to popular thought, the Federal Reserve's policy under Greenspan was the most transparent in history: flood the system with money post-9/11 to insure we will not experience a financial meltdown, and then slowly raise short-term rates in a highly telegraphed fashion until some amorphous "neutral" position was reached and thus not produce a financial calamity, no matter what did or did not come out of his mouth. Bernanke speaks clearly, but frankly has no better idea as to what the future holds than anyone else, which is the position the

Fed has held throughout most of its 20th century life. For the sake of his sanity and that of our financial well-being, we suggest his first order of business is to redefine - *downward* - the concept of Federal Reserve Chairman as the source of all wisdom and move in some way that escapes our narrow sphere of competence to an institutionalization of neutral and non-personalized policy. What we have seen recently is the imposition of an “uncertainty premium” in the valuation of financial assets. The very basic math of discounting the two birds in the bush with a higher rate means lower present values for birds in general and a new appreciation of the bird in hand yielding 5%. This process has been particularly painful for a number of market participants in “riskier” asset classes given the enormous inflows into small cap investing, emerging markets and high yield bonds as recently as the first quarter of 2006. We argue it is possible the process of re-recognizing and re-pricing the concept of risk in financial markets is in its early stages and will present a solid headwind in the face of many financial assets.

We have argued much of this over the past four quarters, but as is said in places far from Los Angeles; that dog doesn't hunt anymore. While we have taken some scattered hits, by and large we have once again retained client capital in a tough market.

What crosses our mind at this juncture is the quandary of the investment management “business.” We bring this up because we have labored for the past year with single digit returns, which were “absolutely” reasonable for an off year but “relatively” mediocre versus some of our peers and relevant indices. As noted in our previous Strategy Letter (March 2006), this performance produced much consternation in certain circles that really should know better. We subsequently lost a slice of assets that resided with us on average less than two years in the time honored tradition of hiring managers on the basis of flaming hot trailing performance numbers and then firing them abruptly in order to make the same mistake again. Our timing on this issue is excellent as this “implementation shortfall” was neatly codified for us in the recent Financial Analyst's Journal, which has become surprisingly readable these days thanks to new editor Rob Arnott (who still owes this writer a bottle of 1982 First Growth Bordeaux for an untimely wager on Dow 5000). Arnott astutely describes this shortfall as the slippage between “the plan” and actual results. “This issue is exacerbated by certain agency effects, which encourage *comfortable*

*investing, not profitable investing* [our emphasis]. A portfolio manager who is underperforming will face pressure from a chief investment officer, who faces pressure from the client's chief investment officer, who in turn is pressed by the treasurer and CEO of the sponsor organization, all of whom are under pressure from the board of directors. Each step in this chain of agents creates an incentive to chase recently missed opportunities. Our industry is characterized by hiring managers and adopting asset classes and strategies when they've *recently* performed brilliantly and bailing out after serious damage has been inflicted.”

There is much truth that behind every good investment firm are great clients and their advisors who *think* about who they are hiring and why, and give their managers time to let ideas “mature” and allow the process a chance to work as it has in the past. Since we don't lock people up for years with break-up fees, we thank our rank and file client base and have sincere pride at having delivered our long-term track record to them.

Investing is not about commiserating about what should have been done three years ago (i.e. buy energy and commodities) but what should be done now to look great when looking back three and five years from now. Media and large-caps are values that are beginning to show signs of what we believe is a move with legs. In fact, our large and all cap portfolios are now fully invested for the first time in several years. How can that be, given the hesitation shown above? The answer remains consistent: as a fairly concentrated manager, we don't need 140 ideas; we need 25-ish and we have comfortably found them in large cap. We actually have more ideas than cash right now and will say something we have not said in some time: we could put a lot more money to work. Our target market, half joking, is every large cap growth stock circa 1999 that is still in business. The subtle positive of this shift in our portfolio over the last year is the portfolio's price-to-value ratio shrunk as values have increased while the stocks went essentially nowhere. We note, and have seen confirmed recently, that mega caps have increased the quality and defensive nature of our portfolio — characteristics which show up nicely in tougher markets.

Small cap investing remains slightly more challenging. While we have also picked up some performance ground after a horrendous first quarter, there are some bigger headwinds conceptually. As a firm that has been

running small cap portfolios for over twelve years, we have an extreme opinion that many small cap holders do not appreciate how small the exit door is in the small cap theatre. And thus, the “bid” underneath the small cap market that has helped support a six-year run of out-performance risks turning into an omnipresent “offer.” We also note the preponderance of “hedge fund” money that has gone into small and mid cap stocks and suggest their staying power to sit through a few tough quarters is lacking, which again brings into focus the prior statement. All of this is painful to go through, but we are internally gleeful. Long-term investors require occasional bouts of doom and gloom, as it creates the values that produce positive performance for the next few years. We expect to be fully invested in small cap shortly if the world continues to unravel at its current rate.

A number of ideas we find particularly interesting reside in the fascinating world of property and casualty insurance and reinsurance. These represent a significant allocation of our large concentration in the financial services industry. We cannot possibly cover all the issues that are at work here, and as our clients have far better things to do with their time (please call us for suggestions if you find this too interesting!), we will focus on a handful of key issues. Industry participants refer to “the insurance markets,” the implication of which is there are human buyers and sellers of the infinite varieties of insurance products. Where there are humans at work, there are high probabilities of short to intermediate term

inefficiencies that can and will create interesting opportunities for investors.

2005 was the second large catastrophe (“cat”) year in a row and the biggest on record in the world of hurricane damage. As you might imagine, this has had ripple effects in the insurance and reinsurance markets. “Freaking out” is one unscientific term that I overheard in a conversation between two insurance executives not long ago. Behavioral finance theory, or the study of how humans mess up neat economic theories based upon rational behavioral, suggests that insurance market participants are possibly extrapolating two years of data and hellish life-threatening losses into a new

world order relative to how much insurance and reinsurance is worth vis-à-vis the risks. This is compounded and reinforced by rating agencies like AM Best and Moody’s who are now requiring enormous capital reserve increases in order to write cat business. This further drives prices up and capital out. These requirements, plus newly

updated coastal real estate values, are dutifully plugged into industry models of “what would happen if” and voila, a vicious cycle of higher prices and better terms and conditions.

As of this writing, it is nearly impossible to secure reasonably priced reinsurance in cat exposed southeastern coastal areas. Reinsurance is the insurance that insurance companies buy for their own account, and is essential for their own ability to offer their clients’ cat related insurance. If you cannot lay off your



risk in the reinsurance market, you either don't take the risk, you raise more capital to carry more of your own risk or you may (or may not) become riskier as a corporate entity. And if the "the market" thinks you have become riskier, annoyingly you are priced accordingly. Now, we have no idea what the weather will be like this summer (nor does anyone else, no matter how large their computer or government grant.) We also have no idea if there is a high probability of secular global warming trends (nor does anyone else no matter how large their computer or government grant) that may or may not produce more hurricane activity. We do not know how many insurance investors will see Al Gore's movie multiple times. We will offer what is a minority opinion in that, as investment professionals we are very familiar with the process of torturing huge amounts of data into models to produce results that occasionally are so off base, we might as well have studied a bathroom stall wall for insight. Hurricane and weather prediction seem to be very close cousins to this process.

What we do know is if you are writing insurance policies at *twice to ten times* the premium with better terms and conditions, you are highly likely to have improved your profitability position vis-à-vis a year ago. All else being equal, buying insurance stocks that have either not moved or are down 50% over the same period also helps our margin of safety. Berkshire Hathaway, AIG, White Mountains Insurance, Alleghany, Montpelier Re and the always popular Fairfax Financial and Odyssey Re seem to fit this bill. The fun of insurance investing, as paraphrased by White Mountains Chairman Jack Byrne, is that it is never quite shooting fish in a barrel – because these fish can bite back! (White Mountains just lost 5% of its skin in a recent and embarrassing example of this.)

Our overall posture remains somewhat agnostic. The first quarter of 2006 was most likely the high water mark for economic growth for the foreseeable future and market participants tend not to like downward trends in growth, all else being equal. This is neatly offset with the emergence of value in a number of reasonably defensive stocks and thus we see "muddling" as the highest probability outcome for the balance of the year. If enough of the catalysts involved in some of our companies come to fruition this calendar year, we are positioned to put up fairly reasonable numbers absolutely and excellent on a relative basis.

On a closing note, we would like to announce a fond au

revoir to our Director of Marketing, Daryl Ann Weber, who retired after nearly forty years in the investment industry, including the last nine with RCB. Daryl was our first real "marketing and client service" person and thanks to her tutelage and badgering, we have come a long way in the institutional marketplace, with more than a five-fold increase in assets during her tenure. We will be realigning our "coverage" with our highly capable trio of Joel Schiffman, Michelle Gosom and Michael Adam Smith over the ensuing months to ensure a seamless transition with clients and their intermediaries.

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