

Now Comes the Hard Part

It would be nice to say that the financial markets have “normalized” and the debate over their future has neatly shifted to the disheveled morass of what now constitutes global economic activity. After all, the stock market is up, credit spreads have narrowed, tens of billions of dollars have been raised to ease any number of garden variety financial stresses and companies around the globe have become extraordinarily adept at using shades of green paint to construe earnings and revenue declines of 20% to 50% or more as “signs of a bottom.”

But a fair definition of “normalized” might consider some of these data points culled from the good folks at Bianco Research:

- The Federal Reserve is printing money to buy Treasuries, mortgages and agencies (over \$500 billion at last count).
- The FDIC is now guaranteeing almost \$350 billion of bank debt (TLGP).
- The Federal Reserve is the largest buyer of Commercial Paper (about \$250 billion at last count).
- The Treasury is now guaranteeing muni debt (“Build America” bonds).
- The Federal Reserve is providing financing for the purchase of securitization and has committed as much as \$1 trillion.
- The Department of Education is the largest buyer of securitized student loans, more than the private sector.

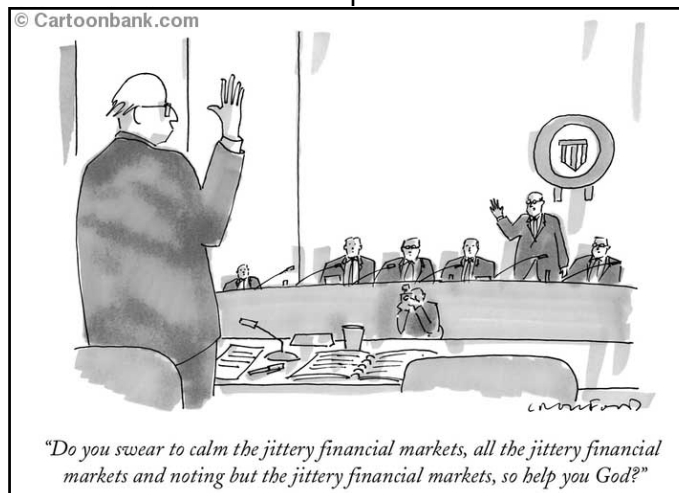
- Fannie and Freddie are buying over 60% of new securitized mortgages, more than the private sector.
- The Federal Reserve’s Term Auction Facility (TAF) has pumped \$500 billion into the LIBOR market. The market has been so overwhelmed by “Federal Reserve money” that some say it is no longer the reference rate for new short-term loans.
- 49.9% of the capital raised by banks has come from various governments (including Sovereign Wealth Funds), 50.1% from the private sector.

- Government spending for fiscal 2009 is projected to be 28% of GDP. Only 1944 and 1945 were higher in the last 150 years.

This cannot help but be troubling to even a casual observer of financial markets. We agree with Federal Reserve Chairman Ben Bernanke that he has all the tools to cede the world’s financial markets back to private investors over time. We just have thunderhead

size doubts as to whether he and his institution have the backbone to counter the enormous political influences that seem to grow day by day, much less the skill set to adeptly execute a withdrawal. History is not kind to his argument that he does.

We suggest that the overt display of political opportunism from the Federal Reserve, whether it is offensive or defensive, will be a massive and distinct long-term negative for the United States economy and the state of our finances and currency. Whether or not you approve of opaque, backroom mumbling and hazy indeterminate monetary and economic targets, this



model of a Fed Chairman is clearly superior to what seems to be emerging - a political appointee whose job clearly embeds the political economy of the day and whose battles are fought on the Op-Ed page of *The New York Times*. The Federal Reserve needs to be utterly walled off from the sausage factories of Washington and the demagoguery of the blogosphere to pursue what should be its only goal - "conduct the nation's monetary policy by influencing monetary and credit conditions in the economy in pursuit of stable prices." There is a bunch of other mumbo jumbo on the Fed's website involving its Mission Statement on "ensuring full employment," "supervising and regulating banking institutions," "maintaining the stability of the financial system" and "protecting the credit rights of consumers." We have to assume the website is out of date because no rational human being would claim to be in charge of all that over the past three years.

Anything that blurs the Federal Reserve's focus on maintaining stable pricing and all the good that comes from it weakens the institution's ability to pursue that very goal. New legislative proposals giving the Fed expanded regulatory powers are a quantum uptick in adhering the central bank to the political inanity of Washington and can only end badly. There are numerous acronyms in Washington fruitlessly spending money and interfering with the basic functions of commerce and finance and there is no reason why they are not perfectly capable of continuing to mangle the possibility of at least reasonably effective financial regulation without getting the Fed involved.

All of this, of course, leads the reader to the "where do you stand on inflation" discussion. One argument is that we are simply in the midst of cleaning up an enormous leverage problem which on its most basic level involves massive asset sales at lower and lower prices. Thus you are kidding yourself if you think anything the government is doing right now will have any material effect on inflation for years. (See websites of Annaly.com and Hoisingtonmgt.com for well-reasoned commentary on this line of thinking.) The other argument of course, is one we have been sketching above. We are running unprecedented experiments in monetary and fiscal policy and they are being managed by "people," regardless of how many may have worked for Goldman Sachs. People make mistakes, and these mistakes tend to be compounded when you are part of an enormous organization like the federal government that is not entirely motivated by economic results. While it is correct to presently say (thank you David Rosenberg) that "deflation is a fact

and inflation an opinion," we lean toward the argument that it will not take much for facts and opinions to change places.

In the meantime, the enormous move from the "generational" opportunities offered during the market lows in late 2008 and early 2009 (which we think will hold in case you wanted to pry a real opinion out of us) have made things a bit more difficult from here. In our view, the fat part of the probability curve as it relates to what happens now in financial markets remains bloodied and scarred by lagging economic and socio-political trends that cannot be solved by anything but the passage of time required to rebuild the actual and mental capital of the world's economic participants. (Although some argue mid-term elections might hasten this process.) While there are always company-specific ideas that have their own catalyst for valuation change and we spend much of our waking hours looking for them, many stock prices today require some semblance of at least a reasonably plodding economy to fundamentally justify our idea of an appropriate longer-term valuation.

A "growth cyclical" like say, Parker Hannifin or 3M, is arguably overvalued if your goal in life is to inanelly apply a multiple to the cash flow generation of either the last twelve or the next twelve months, and a disturbing amount of print and virtual space is devoted to this sort of drivel. But clearly Parker Hannifin is undervalued for the longer run if it approaches even an approximation of our estimate of \$5 to \$6 per share of earnings power. Achieving this will require a legitimate resumption of actual revenue growth. The longer we live without specific economic progress that is identifiable by a few line items on an income and cash flow statement, like say, the top line (sales), it will prove difficult to continue the fine and pleasing progress of the past four months.

That is the obvious and main point that can conveniently be reached by anyone - we need definitive economic growth from here in order for the equity markets to generate decent returns. It can also be definitively stated that our ability (and by "our" we mean you the reader as well) to answer that is as woefully inadequate as at nearly any other time in history.

So why should this be any different than any number of numerous historical instances in the past? The economy goes up and it goes down. Politicians come and go. Stock valuations get depressed and then giddy. Do the

work, buy well-researched value in companies with staying power, buy with conviction while the other guy is running for cover, be patient. Don't guess the immediate future, you will be wrong. As we have noted many times, the beauty of being a value investor is that if you can buy cheaply enough, you can leave the big thoughts to the other guys. We see very few headlines noting the acquisition of a \$40 million New York penthouse by anyone whose waking hours appear to be consumed by blogging on economic issues and being endlessly quoted by the financial media as to when the recession is going to end. "There is never a shortage of sticks if you really want to beat the economic dog," says Gloria Mae Smith, philosopher at large and mother of our own marketing maven, Michael Smith.

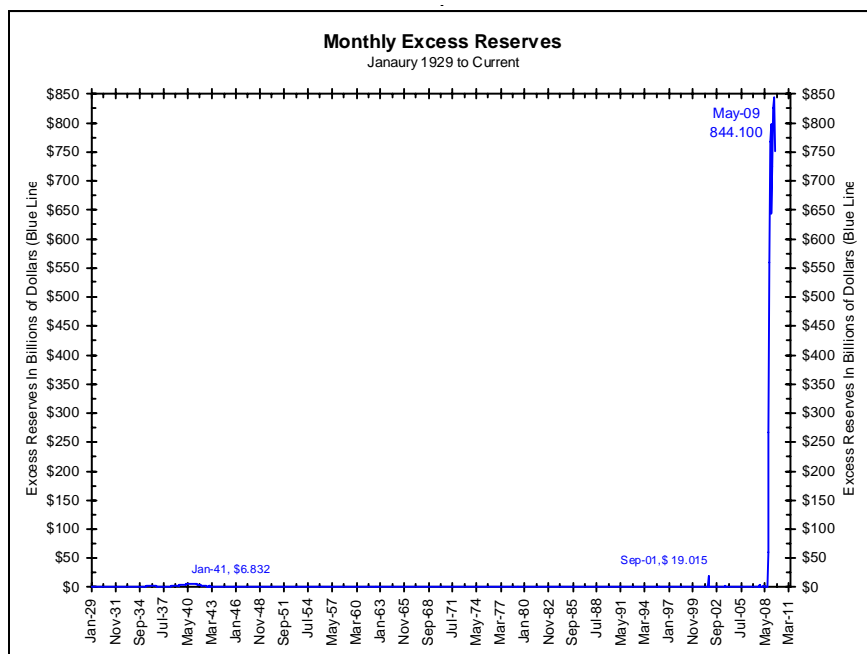
This is essentially our 1982-1984 scenario. Stocks reached generational lows after years of investor apathy driven by a series of global economic crises compounded by disastrous political and monetary decision making. Stocks rally sharply in the midst of miserable economic news and climb a steep wall of worry. The market then sits for a year and effectively waits for the economy to catch up – which it does. Life goes on irregularly up an 8%-ish grade. Thanks to the magic of Google, one can go back and pull some brilliant quotes from that day and age, referencing a litany of fears in regard to "budget deficits," "greed outdistancing fear," the "aging bull-market" and "fussiness over corporate profits." After all, the Dow just had a record run to 1200.

But while we are all in some ways victims of our circumstances, we do sense that bigger picture items seem to loom larger today than perhaps at anytime since the early 1980s, and while our tendency has always and correctly been to focus on the micro issues of business/value/people, there are a number of enormous "unprecedented" things going on the world that seem to want to impinge on our process. From

1982 through 2007, there was a global explosion of worldwide wealth no matter how you distribute it. The global backdrop trends were declining inflation and interest rates, increasing globalization, less taxation at both the business and personal level, less regulation and a sublimely low cost basis from which to begin a rally. It is now hard to argue that most of these trends have flat-lined at best, and raises negative thoughts that push decent economic activity past the time horizon of many investors. (Please insert timing joke here.)

We are staring at an enormous amount of "change" out of Washington and the natural reaction of any business

And Now for Something Completely Unprecedented



or individual who has a perceptible sense that someone is tugging on his wallet for a yet defined new obligation, is to clam up and wait. Why not wait to do nearly anything economic until you see exactly what it may cost you? In the meantime, most of the private sector is arguably in the middle innings of what effectively is a massive recapitalization that is transferring private irresponsibility to the public sector. And contrary to the sheer populist idiocy that

constituted the recent *Rolling Stone* piece on Goldman Sachs, memorable for a truly great quote suggesting that Goldman was "a great vampire squid wrapped around the face of humanity," the fact is that Goldman is merely a very, very successful middleman and the squid lies not in downtown New York, but hovers tirelessly over Capitol Hill (the analogy works much better with an *Alien* movie reference anyway). While we like to count ourselves as one of the last ten people on the planet to be forced onto the witness stand defending Goldman (11 interviews in 1984 and not one job offer?), the "other side" of a Goldman trade has the private ability to enter into what in retrospect may be a complete sham or an overpriced risk/reward. No such luck with the edicts from elected officials.

So representatives from the world's leading investment banks have had problems picking stocks and making

decisions that are in the best interest of its potential clients. (Shocking, simply shocking!) Are we going to be better off with the proposed Financial Services Oversight Council that would include the heads of the Treasury, Federal Reserve, Commodity Futures Trading Commission, Federal Deposit Insurance Corp., Securities and Exchange Commission and Federal Housing Finance Agency, and the directors of two new agencies the Obama administration wants to create: the Consumer Financial Protection Agency and the National Bank Supervisor? Are not these the same people asleep at the wheel during every angle of the financial excesses of the past decade? Aren't these the same people who are bemoaning the lack of credit available to "average Americans and small business" and yet pass a credit card reform bill that began to reduce credit to average Americans and small businesses before the ink even dried?

Maybe we should turn the whole thing over to Representative Barney Frank, who had this to say about Fannie and Freddie Mac: "I worry, frankly, that there's a tension here. The more people, in my judgment, exaggerate a threat of safety and soundness, the more people conjure up the possibility of serious financial losses to the Treasury, which I do not see. I think we see entities that are fundamentally sound financially and withstand some of the disaster scenarios." (*House Financial Services Committee hearing*, Sept. 25, 2003)

Or the thoughts of Sen. Christopher Dodd (D., Conn.) who just wanted to briefly say, "Mr. Chairman [Greenspan], obviously, like most of us here, this [Fannie and Freddie] is one of the great success stories of all time. (*Senate Banking Committee*, Feb. 24-25, 2004)

But we digress again. Contrary to fraying opinion, while Washington fiddles the marketplace does not burn; it finds solutions. The bankruptcy court managed to provide a forum that overcame Federal intervention and found a way to restructure a piece of the auto industry via Delphi and producing a great quote for the decades, "What's so special about Platinum (the federally mandated choice)? They're just guys in suits. Why can't the other guys in suits just pay more?" While one ill-thought out half-baked mortgage loan modification plan after another has been launched and flopped, lower prices, lower interest rates and the fledgling confidence of the greatly maligned American consumer has begun to hack at the inventory of unsold homes, putting in place the modest (very at this point) infrastructure for a

return to trend line housing growth. The personal saving rate has skyrocketed, putting many Americans in better financial shape. Corporate America continues to "lean" itself, and is able to refinance, thanks to the recognition by many banks that there has not been a better time in decades to dictate terms and put out money at terrific returns, even on a higher capital base.

Yes, we admit that the next 12 months are unusually uncertain even within the context of a perpetually uncertain future. There are giant looming monetary uncertainties that are particularly unusual to contemplate both in term of size and actual unprecedentedness. There is a significant amount of possibly awful and politically based economic changes that may be enacted. And yes, many stocks have come a long way in a hurry and have gotten ahead of themselves to use traditional Wall Street parlance.

But we just can't shake a stubborn belief (well supported by history) that buying a reasonably diversified mix of good businesses at cheap to reasonable prices remains the way to long-term wealth creation on an after-tax, after-possible inflation basis. We had a superb first half in all strategies on both an absolute and relative basis, which is a lot more fun to say when you are up double digits. Given some of the hesitations noted above, our portfolio is structured with a blend of offensive and defensive opportunities. If the economy takes four more years to get going versus something positive in 2010, then we will be sitting on our performance duffs for longer than desirable. At current prices most of our stocks have livable downside within the context of a longer time horizon, but material upside in a return to a decently growing economy. Your investments should be similar to what someone has said about marriage – start with low expectations, you won't be disappointed.

Jeffrey Bronchick, CFA
Principal & Chief Investment Officer
jbronchick@rcbinvest.com
August 2009

The opinions expressed herein are those of Reed Conner & Birdwell are subject to change without notice. Past performance is not a guarantee or indicator of future results. You should not consider the information in this letter a recommendation to buy or sell any particular security. These securities may not be in your account by the time you receive this report, or may have been repurchased for your account. These securities do not represent your entire account and may represent only a small percentage of your account. You should not assume that any of the securities discussed in this report are or will be profitable, or that recommendations we make in the future will be profitable or equal the performance.