REED CONNER BIRDWELL
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Markets Change, People Don't

We are delighted to get this to print as the daily nonsense of the Hewlett Packard circus and the imploding Amaranth "hedged on everything but natural gas" fund made it difficult to know when to stop and commit to a final product.

We enter the fourth quarter of 2006 with some surprisingly strong year-to-date absolute performance and some reasonable make-up on a relative basis. One of the sneaky reasons we waited a few weeks to put out this strategy letter was to get enough of the hurricane season behind us to crow a little about our deeper move into property & casualty and reinsurance stocks earlier this year, despite admonitions from Al Gore. Most of our holdings have ticked up nicely, but we have received some relative help thanks to the inevitable rollover in energy and commodity stocks. As our esteemed partner and colleague Victor Hawley noted during the summer, "there's nothing wrong with this firm that $55 oil won't fix" and voilà, he was directionally correct.

"I'm looking for a hedge against my hedge funds."

His point, stated another way, is that economic forces are cyclical in nature and "commodities" – however you define them and energy is thus defined – remain cyclicals on steroids. Despite what we may have learned from Major League Baseball, relying on steroids for performance is not as easy as it seems, as defeat can be quickly snatched from the jaws of victory when investing in cyclicals, and great performance ridden on one side of the wave can easily be lost in the white foam of its aftermath. (Southern California metaphor for those east of the Sierras.)

The official analysis of "cyclicality" relies on the simple premise that the two legged species presently dominant on the third planet from the sun responds miraculously well to PRICE MOVEMENT. Any variety of "100 Years of the Global Chinese Commodity Boom" and the temple-throbbing consistency of the "30 Year Oil Supply Decline," both of which may be directionally correct if your time horizon is the 21st century, appear to have run smack into our propensity to greedily create supply and change demand behavior causing all sorts of weird things to happen. "Mounting Steel Stockpiles, Weak Demand Fuels Fears of a Glut" is a headline which recently found its way into the Wall Street Journal. Surprise, surprise, the uptick in steel prices in 2004/05 combined with short-term supply constraints led buyers to panic and place orders for double or triple or ten-fold their actual need in order to be allocated what they really needed. This is an age old behavior which inevitably produces confusion on behalf of the seller who proceeds to create supply based upon overoptimistic forecasts of end-user demand. At some mysterious point, there is a "change" and all of sudden everyone and his brother is sitting upon a warehouse full of steel bought at high prices that cannot be sold. Not so oddly enough, the Chinese have been correctly identified as industrializing at such a rapid rate that they have turned into exporters of steel with the same zeal and pricing structure most people are so enamored of at Wal-Mart. So inventories are at their highest in two years, imports are up 40% and the stocks are down. You can substitute the word "steel" with any number of other commodities as well.

Also illustrative of "nothing is inevitable in investing," despite what you may read in the papers or is crammed into your head by Jim Cramer, is neatly summed up by the whole Amaranth saga, which in this environment of "further regulation of hedge funds" is very simply a case of someone being very wrong…on leverage. The resulting group of aggrieved orphans and widows - including folks involved with multi-billion dollar funds of funds and the crème de la crème of Wall Street who can't help but pay exorbitant fees in order to invest in highly levered and concentrated trading strategies of which they could not hope to know more than the barest facts - neatly deserve their fate.

While there is some merit in the case for the longer-term decline in oil and natural gas availability, that in no way relieves oil and gas assets from their commodity status. The magic of $12 natural gas and $75 oil last year worked its predictable magic on those with Texas dust and warm Gulf Water running through their veins. Just when you were ready to plunk down your hard-earned cash to convert your car into one that runs on Cheerios, a consortium led by Chevron announces it is on the verge of "readying" (which is a more accurate word in this case than "finding") a Gulf of Mexico oil field that is estimated to increase current US oil reserves by more than 50% thanks to the results of the Jack-2 well test. Onshore, meanwhile, the Barnett Shale in Texas continues to emerge as one of the largest US gas plays in decades. The Barnett story is particularly juicy since it was found by a host of small, independent players literally right under the corporate headquarters of one Exxon Mobil.

That a large increase in price motivates and harnesses all sorts of creativity to stimulate supply and make money, and thus counter and overwhelm prevailing trend orthodoxy, should barely make a hiccup in normal discourse as it ranks right up there with the oldest profession on a top ten list. Good investing ideas like oil and gas in 2003 are born in the loneliness of derision and exclusion, blossom in the multitude of Wall Street support, colleague and client backslapping, and frantic buying by hedge funds and exchange traded funds (ETFs), end unpleasantly as the "inevitability" of a long term trend is deemed too non-synchronous with monthly performance reviews, and then are rediscovered at values some tens of percentage points below peak prices.

All of which means to us, that having missed the home run in oil and natural gas investing that was reasonably available three years ago, we did not see the NEED to participate for the sake of participating in a sector that was at best fairly priced and still subject to the same commodity and cyclical forces which had and did have a more than fair likelihood of working in an opposite fashion. You don't have to compound a "miss" with a bad purchase. Much of the large cap oil and natural gas sector has only marginally retreated from the peak, which with the slowdown in the economy; we are likely to see further lackluster performance at best. Our thought is that the majority of oil and natural gas stocks at these prices are "market performers" which is a neat way of saying they do not appear to us to be cheap enough to make us hugely enthusiastic. We think it was famed investor John Templeton who once noted something along the lines of "never underestimate how long a formerly favored group of stocks will underperform once the glory days have passed." There has been much more pain in the small cap world which as you might imagine is subject to more gross violations of over-enthusiasm. In small cap, we actually did step into a energy services related company, Hanover Compressor, and a gas company, Rosetta Resources, each of which possess internal dynamics that make it an attractive investment somewhat apart from the price of the commodity.

Cyclical issues and their unintended counter-forces are also at the forefront of the other really interesting area for value investing – "housing and related" stocks. "And related" has been postulated to be 92% of the S&P 500 if one reads deeply in the gloom and doom forecast. (For a Halloween approved scary version of this argument, we suggest you go to annaly.com, the website of one of our small cap/all cap holdings, Annaly Capital.)

Since we will assume the reader has a pulse and therefore is probably sick of reading about it, we will move to the 18th green and ask the pertinent questions: is the real estate downturn going to completely obliterate the US economy as those most bullish have grossly underestimated just how dependent we have become on what has been the largest piggy bank in global history? Or is it simply a reasonably stiff headwind that will stifle the economy to sub-par growth for a few years and the real casualty besides the telemarketing community has been the horrendous felling of trees to support magazine covers suggesting eternal gloom and damnation? And are the "related" stocks down enough to represent value?

We profess no more ability than anyone else to divine the future, but we would note several issues in defense of a "muddle-through" outcome as opposed to an out-and-out disaster. The first is that Wall Street does a nice job of identifying sixteen of the next two disasters and thus an investor tends to benefit by being cognizant of, yet generally ignoring, the gloom and doom as much as he should ignore the hype. We would follow this by noting that there is not a single DATE at which every mortgage in the US resets upward from the introductory teaser rates, and thus "the consumer" will not experience a universally painful blow to his (and her) ability to buy stuff. This is clearly a headwind over the next two (plus?) years, but it wallows regionally and household by household, and the legend of the American consumer and his or her ability to manage seemingly on the brink of a leveraged disaster was built long before the last three years.

Realizing the weird yet intuitive way in which life tends to unfold, one can perform the mental exercise of imagining a severe real estate decline actually triggering a slowing of the economy (see oil, commodities, and 10-year interest rates), the Fed actually easing interest rates in 2007 and voilà, the mythical interest reset DATE does not materialize for many levered Americans. On an unconfirmed and personal note, the premature death of the American consumer has been eulogized periodically for at least as long as the 22 years this writer has been in the investment business and taking the other side of that argument has proved to be a consistently good way to make money.

With no conclusion in sight, what does all this really mean for the "housing and long list of related" stocks which are down 20% to 50% depending upon the instance and distance to the perceived fire? It's obviously a question that we and every value manager are considering. What concerns us is that when a stock is up 800% over five years riding the cusp of a real estate boom, it's not that clear that a 40% decline from its high creates a value. We would also note the glacial pace at which real estate "moves" and think there is serious time to ponder the stacks of annual reports piling on our desks despite the recent feline bounce.

In the meantime, after a fairly high degree of repositioning earlier this year, we have been content to let our bigger bets do their thing. Our largest positions in media (with the exception of the still beleaguered radio sector) and financials/insurance have done rather nicely with mistakes in large cap having been minimal.

In small cap, after what was truly a dismal four quarter run of relative performance, we have managed to put up some reasonable absolute numbers and claw back a minor bit of ground on a relative basis. The mathematics as well as the improved psyche which results from the takeover of two of your largest positions in a concentrated portfolio combined with a determination to stop making a few hellacious mistakes seems to have produced the desired results. We would also add that the small cap value world as denoted by the Russell 2000 Value index has displayed a remarkable resemblance to the S&P 500 circa 1999, producing another period of relative performance by this firm that, shall we say, got a little uncomfortable. Hot performance attracts hot money, and in small cap a little liquidity can go a long way. Several other issues are at play here. The advent of exchange traded funds that track small cap stocks exacerbate the trend du jour and injects a mindless buyer (and soon to be seller). Lastly, an awful lot of "activist hedge fund" money has been plowed into the small cap market and, as noted in some recent Wall Street Journal pieces, money invested at a 2% & 20% fee schedule does not have much staying power. If there is one thing to be learned in 13 years of small cap investing, it is that you do NOT want to be selling out of necessity because you will be eaten alive by the illiquidity. We look forward to taking advantage of the inevitable opportunities as historically our portfolio of 30-odd stocks has been able to side-step an index based headwind leading us to be confident in future performance.

We usually confine our comments on executive compensation and corporate governance to the spring for fear that we would touch on nothing else if we allowed this discourse to leak into every strategy letter. But two issues have been so over-headlined that we cannot help ourselves here. The least important specifically but the more important conceptually involves the Hewlett Packard remake of the Get Smart television series. Now that we have picked ourselves off the floor having finished laughing at the spectacle of Congress lecturing what's left of the Hewlett Packard board about corporate governance, our thoughts are that "we" have just seen the future of "the corporate governance movement" and it smells. Former Chairperson Ms. Patricia Dunn's mission was to move the board "from one that was more personality driven to one that is more process driven and capable of upholding today's highest standards of corporate governance." One can only conclude that means assembling a group diverse by every category known to man with allegiances to a variety of things that don't necessarily include what is crucial to driving shareholder value. Can you imagine a Congress of twelve people effectively assisting in the management of company? Take a look at proxy statements for the S&P 500 over the next few years if this continues.

Life is full of compromises and there are plenty of instances where there is successful middle ground between the dysfunction of a "perfect paper board" and the "my way or the highway" of Warren Buffett of Berkshire Hathaway or Hank Greenberg formerly of AIG. We would argue that great business successes lean much toward the latter than the former, so be very careful what you wish and vote for when it comes to reforming the corporate world. A roomful of lawyers never replaces common sense and integrity.

"Miss Dugan, will you send someone in here who can distinguish right from wrong?"

Contrary to being a black eye for corporate America, the Hewlett Packard saga actually takes the world's eye off a more egregiously widespread set of ethical breaches in regard to the practice of "backdating" the issuance of stock options to senior executives in order to lower the exercise price and thus create the possibility of instant wealth creation. It certainly takes a titanic amount of misdirection to remove your focus from the headline: "Cablevision Backdated Stock Options to a Dead Executive." But as is often the case, the unholy cabal of the financial press, Congress and a variety of Attorneys General are hard at work in out-indignant-ing each other and entirely missing the point in the process.

This point, which should be re-introduced at every mention of the word "stock option," is as follows: what constitutes a practical solution that symmetrically compensates and penalizes senior executives of public companies for their performance in the running of their companies? Stock options were introduced and grossly over-popularized as an inherently flawed solution for a number of reasons: they were a tax efficient means to get around inane new rules regarding the deductibility of executive cash compensation over one million dollars; they could be construed to avoid being run through the corporate income statement and thus were perceived to be a "free" way to achieve compensation goals; and they were not taxable at issuance to the recipient as long as the exercise price at which they were granted was the fair market value. These attributes were all positives in the universally desirable goal of getting management to think like a stockholder, which is what "we" want. (In other words, like most great financial engineering achievements, they were mostly motivated by an attempt to minimize the payment of taxes.)

The inherent flaw as a compensation scheme has simply been in the application. Excessively "giving" away stock options is like giving away anything - it tends to lose its value to the recipient. If you are given options annually at the then prevailing price, then the goal of working toward a higher price tends to lose its luster and most importantly, there is no direct penalty for failure. With nothing ventured, nothing lost, you get a new batch of options at the new lower price with which to roll the dice again. There is also the argument that "stock price" is not always the best indicator in the short-run of success, meaning that option plans should always be viewed as long run plans and combined with intermediate term, cash oriented bonus plans.

Which brings us to today's batch of weasels and scoundrels. To be fair, there are few documented and tried examples, despite the many ongoing investigations into deliberate acts of backdating the exercise price of stock option grants. It is ethically crucial that in this day and age of the Attorney General and Congressperson as judge, juror and press-leaker to differentiate between facts as disclosed in a court of law and a variety of ongoing investigations.

Despite the moral and legal ambiguity that appears to be tolerated in some circles, there are specific legal and ethical issues that arise with backdating options. First off, there is tax fraud, as you are essentially handing executives options that are "in the money" and not disclosing it as such to the IRS. In other words, if you can exercise an option that gives you the right to buy a stock at $35 when the stock is $40, you are giving someone $5, which neatly crosses the IRS taxable line that at the money options managed to stay below. "Ahhh," the excusers say, "but many executive options come with structures that prohibit their exercise for X amount of years, so no harm no foul." This argument runs neatly into another ugly buzzsaw of reality - in order to get around new accounting rules forcing companies to expense options that had been previously granted, many companies in one stroke declared all options to be immediately vested to take advantage of a loophole in the new rules, so back to square one.

The odd thing is that issuing "in-the-money options" is actually a terrific solution to the big dilemma: how to intelligently create incentive compensation programs? The executive puts up real cash to buy the options thus putting some skin in the game and creating shareholder friendly symmetry. But alas, the tax code is not nearly as friendly to in-the-money issuance either to the purchaser or the recipient, so its value as a compensation tool remains small.

And then there are these nasty little ethical issues. As noted in a recent Los Angeles Times article, financial executives at alleged serial-options-abuser Brocade promised a potential new employee that they would backdate options to ensure an immediate $2.5 million gain to induce the executive not to join a competitor.

But, "everyone was doing it, so what's the big deal," the Times piece quotes an untroubled (and 'unbiased') executive compensation lawyer in Palo Alto. "It's very different than WorldCom or Enron where it appeared the fraud was just to fleece investors." Might we inquire as to why taking $2.5 million from shareholders without disclosure is not fleecing investors? As importantly, if you are cheating at this, is anything sacred? How about the terrific espirit de corps you are creating at the senior level of management that neatly trickles down to the janitor stealing office supplies?

Some executives are using the "paperwork processing and administrative error" defenses as the Times quoted yet another Silicon Valley denizen as saying that "corporate officers might have decided to grant options sometime in the prior weeks, but couldn't remember exactly when." Our experience has been that most executives can tell you their exercise price to the third decimal and the annual issuance period is as closely observed as the box score in the middle of a Red Sox/ Yankees series in September.

We will assume the backdating era is officially over as all organisms behave differently when observed. We would simply conclude with a plea to the board's of public companies (particularly the ones we own) to really spend some quality time in seriously rethinking how they compensate the hired help.

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