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INVESTMENT MANAGEMENT

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The Investors Guide to Handling Sharp Objects

Since all roads currently run through some version of the global credit crisis, it seems silly to start any Strategy Letter without addressing it right off the bat.

We are likely somewhere in the middle innings of a long and drawn out hangover from many years of lax credit policies on a global and multi-asset class basis. The lack of prudence, diligence and "responsibility" extends across the board from global financial institutions who did the lending and structuring, to the largest private equity funds, to the smallest no-money down homeowners, to the largest pension funds, money managers and hedge funds who willingly bought more than their fair share of grossly overvalued if not worthless paper that few understood, to government entities whose tax, interest rate, and regulatory schemes, or lack thereof, enabled said players to create and then degrade asset value on a truly 21st century scale. Whew!

But aside from the explosive creation of new acronyms, the current crisis, while larger and scarier in many new ways (it should be said that any "current" crisis looms larger and scarier in collective conscious than any event in the past), is not depressingly different from its predecessors. We are not suggesting that serious problems do not exist in the world today, but recessions, financial panics, political changes, bank failures, currency debasement and inflation scares have periodically been legitimate issues with which investors have grappled and yet life in the western world has somehow moved forward. Now, having them all at once may represent a fairly serious challenge, but the task of the investor is unchanged: to seek value without undue risk, recognizing that the best investments are usually made in the most difficult environments.

We also note that if you simply look at the past ten years and the vicious rapidity at which conventional wisdom gets blown into tsunami-like proportions and priced into financial markets only to be proven utterly wrong in 18 months - the dotcom boom, the despair of the 2002 credit crunch and its rebound into the inevitability of private equity taking over the world – it is plausible that today's popular tomes involving either a doomsday credit scenario or the global commodities boom are not views of the future that are written in stone. To paraphrase investment thinker/ money manager Rob Arnott paraphrasing Kurt Vonnegut: history is merely a set of surprises; it can only prepare us to be surprised again.

While the word "subprime" is now burned into the collective global consciousness, the correct read is that we are in the midst of a loan-to-value crisis that is compounded by leverage. Golden West Financial became one of the largest savings and loans in California and hence the country by pioneering "affordability" loans – read subprime. In their heyday, their loss ratio in some of the worst regional recessions in the nation rarely exceeded 2%. How? Their loan-to-value ratios rarely exceeded 70%, so it would take a true 1930s depression before they ate into capital. (It should be noted that the founders sold Golden West in 2006 to Wachovia at the top of the housing market in one of the great "tells" in recent financial history. Wachovia just raised $7 billion to deal with its mortgage problems.) Extending credit to questionable people and ventures remains one of mankind's oldest professions, but most pawn shops are smart enough to only lend a few hundred dollars against a $2,000 Rolex. Lending people 95%-100% of an inflated value for a house or a private equity target leaves zero margin for error and, as we can personally attest, *everyone* makes mistakes.

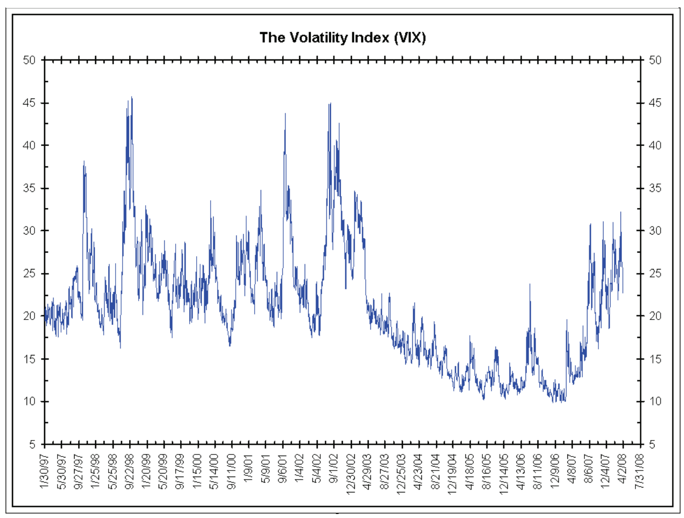
Mistakes are particularly difficult to live through if you are leveraged to the gills. A 5% down payment on a house means the home buyer is running an asset to equity ratio of 20 to 1. Bear Stearns and any number of well publicized blow-ups were/are running close to 30 to 1. What seems to be missing in the national debate is that it has NOT been the borrowers in most cases who have made the big mistake. In fact, ignoring character issues for a moment, it is entirely rational on an economic basis for a homeowner or a private equity buyer to put up as little money as possible and let some dimwit of a lender provide irresistibly lax terms. If the asset goes up, you get the upside and the lender gets his par value back. If it goes the other way, the buyer has lost little equity, but the lender is on the hook for the big dollars. This concept is obviously lost on the lenders writing down billions of dollars of zero equity loans and our elected officials who are desperately trying to keep people in homes when they are hopelessly under water. It is entirely rational for the homeowners to simply mail in the keys and go lick their modest economic wounds in a rental unit. Like it or not, since we have created a world in which mobility, flexibility and liquidity are valued, why is it not in the best interest of the borrower and our nation to let the lending institutions and their shareholders deal with it? Nearly every statistic screams that there is ample availability of places to live and rent, so the image of millions of destitute Americans sitting on doorsteps with their possessions looking for a place to pitch a tent is an outrageously erroneous view of what is really happening on the ground. The firm pricing in the rental market due to this phenomenon is also a sneaky foundation for a bottom in residential real estate at pricing somewhere above what is being implied in today's draconian forecasts.

And just as lower stock prices are a huge benefit for new investors or those with cash who have a chance to buy more reasonably priced stocks, why isn't exactly the same true for homebuyers? How many millions of rational Americans are out there who felt they couldn't afford to buy a home in the crazed environment of the past several years? They did the rational after-dinner-around-the-kitchen-table review of their finances and felt it was risky to put up only 3% and have payments that would soon balloon into 80% of their income. Since they weren't comfortable putting their name to a document that was potentially a big piece of fraud, they decided it was better to save and wait. Where is their March on Washington?

That brings us to the key issue - when is the "lending" world going to be earning or raising more money on a go forward basis than it is losing or writing off due to previous mistakes? At the core, it is this issue that plagues the financial markets, and getting *any* light at the end of this tunnel is a necessary pre-condition for an economic bottom, an event the financial markets will sniff out a year in advance.

Unfortunately, this light is obscured by the innate haziness of forecasting as well as some of our own doing.

Back to Normal



Source: Bianco Research, LLC

It is clear that the lending world has and continues to shrink, whether out of actual capital constraints or simply fear of being the next Bear Stearns. The "animal spirits" of homo economicus have clearly dissipated to that of a barely discernible "meow," and it matters not whether the economic powers-that-be declare a statistical recession or not. The economy stinks, to be blunt, and corporate profits are under pressure from lower spending across the board.

In response the Federal Reserve and its global counterparts, rightly or wrongly, are taking historically unprecedented measures to enormously enhance the earnings of those who essentially borrow money and lend or buy assets with the proceeds. This windfall of "net interest income" is being eaten by the litany of previous mistakes in the form of additions to loan loss reserves and write-downs or write-offs to balance sheet assets, but that won't go on forever.

It is absolutely clear that reserves and capital at many financial institutions are woefully inadequate to address prior mistakes by management, and it is the economy in general and the shareholder class specifically who will pay for those mistakes. There are two ways to right the credit crisis and both are at work. First, lending institutions must conserve capital i.e., earn money and not lend it or pay it out, a process which as noted above has been greatly enhanced by the actions of the Federal Reserve. The second process is to raise new capital. The recent equity infusion into Washington Mutual and Wachovia are classic examples. In WaMu's case, new equity representing 70% of the then current market capitalization was raised to keep the institution from going under. (And the CEO is keeping his job, how?) This process will roll through many of our lending institutions over the indefinite future, but there is a definitive time element at work that little out of Washington will effectively be able to speed up. But on the margin, the "market" is working.

Our specific take on this process is that the fourth quarter of 2008 is the first quarter in which many reported losses start cycling against the first big reported losses at many financial institutions. When investors begin to sniff the fact that loan loss provisions are only up 70% when the quarter before they were up 90%, confidence, and hence valuations, will start to improve as the gentle curve of a bottom is in sight.

What makes the process of getting a firm grip on the numbers even tougher is the confusion created by the new addition of "mark to market" accounting rules. The investment and accounting worlds have long clamored for transparency in notoriously difficult to read financial statements of financial institutions. In came new accounting rules that called for companies to mark all assets and liabilities to a fair market value. Like all accounting rules, there are lots of interpretations as to what this means in practice and it would not be an understatement to suggest that the practice is an utter mess. This topic would take a few hundred pages to go through, so we will highlight only a few of the fun issues.

FASB Rule 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants." Ok, stop laughing and answer question one: name an orderly market today? Just as the 10,000 or so publicly traded stocks all reflect different pricing based upon wildly different scenarios, the same is true on the tens of millions of different loans and the alphabetic cacophony of credit derivatives. But there is no New York Stock Exchange for this hodge-podge of credit. What there is today is a bunch of very desperate sellers and smaller set of skittish buyers who are showing little compulsion to be the first guy in to help make Rule 157 a reality. So in the unrelenting search for certainty and transparency, an auditing firm with Arthur Andersen-like existential fears must hang their hat on something more tangible than management assurance that an asset is "money-good". It is this desire to create markets that is behind an awful lot of investor confusion.

If financial Institution A has made a variety of blunders and desires to "put this behind them" by blowing out a block of difficult to value securities to a smart hedge fund at almost any price, is this price indicative of their true value? Should it be used by Institution B who technically has something similar to the assets but has actually done credit work and is convinced that these securities when held to maturity will show no or little loss? Let's say you are AIG and have written insurance policies on thousands of securities that have been specifically structured on a one at a time basis to be held on balance sheet. Is it appropriate to price this portfolio with a recently created credit index that measures only 20 credit default swaps on CDOs, trades with daily ten point swings, and is pretty much used as a speculative punching bag for credit punters? In the current world of fear and distrust, the answer of course is yes to the tune of an eleven billion dollar write-down which runs through AIG's income statement, even though some fairly draconian assumptions point to a worst case loss of less than one billion at maturity.

In a somewhat fascinating side-note, the world's major global investment banks are now declining to participate in efforts to create new credit indexes that measure things like auto loans, European mortgages and credit card loans for fear that these will simply represent new mark to market punching bags. "The dealers got caught in a vicious cycle," noted a Wachovia trader in an interview with Bloomberg. "They did a great job of selling the indexes. At the end of the day, they had to mark their own books to the prices of the indexes and fell victim to their own sales job."

This is the crux of the vicious cycle of credit fears that consumes the investment world. Is derivative pricing the tail wagging the dog as it reflects the fears of 30,000 Wall Streeters estimated to lose their jobs in the down-cycle, or does it represent legitimate marks to market and companies should stop whining? These issues are extraordinarily relevant for financial companies as "marks" count when determining capital levels and it would be fair to say that the market is not exactly friendly toward financial institutions that are in any way perceived to be in need of capital.

It is our own two cents that this auditor driven cycle has gone way out of whack and there is a world of economic difference between a write-down for accounting purposes and the eventual economics of many financial assets. In fact, the current scorecard indicates the world's largest banks have taken some $215 billion in write-downs and only $29 billion in write-offs. This is either indicative of the tyranny of the auditors or wishful thinking by management; reality is likely something in between. As life is settling down in financial markets, there is a reasonable likelihood that many written-down assets will prove to have been marked down to prices that were severe in retrospect, and the subsequent "write-up" numbers, while not likely symmetrical in size, will still be huge numbers that come back into the income statement and book value.

In AIG's case, which we would note has become one of our largest positions, investors' fear is grossly outweighed by the company's enormous capital base, which enables AIG to hold assets to maturity with de minimis funding issues and ride out the current panic state in financial stocks. This is not to say that the cycle does not get worse before it gets better, but our research suggests that the current stock price grossly discounts the current environment.

We have some support for our case from as unlikely a source as Omaha, Nebraska. In the latest Berkshire Hathaway annual report, famed loather of derivatives Warren Buffet discusses his recent increase in derivative positions by noting the difference in accounting between derivatives and investment portfolio accounting: "…thus our derivative positions will sometimes cause large swings in reported earnings, even through Charlie

(Munger) and I believe the intrinsic value of these positions has changed little. He and I will not be bothered by these swings – even though they could easily amount to $1 billion or more in a quarter and we hope you won't either….we are always ready to trade increased volatility in reported earnings in the short run for greater gains in net worth in the long run."

We share this minority viewpoint.

Through the mental clouds of regret and emotion, every investor should wake up and ask themselves this question each day: "What should I be doing today that will reap rewards several years hence?" Carefully choosing the financial companies that will not only survive but will take advantage of the current financial mess ranks near the top in our view.

One might also wonder about the sustainability of the companies benefiting from the enormous global boom in commodity pricing and conversely, the possible attractiveness of companies whose margins are being crushed by a boom that has not been seen in generations, if ever. As one farmer in the Midwest was quoted in the *Wall Street Journal*, "anyone who claims to have seen this before is a liar." We also note the enormous influx of new money into commodities as an asset class, which by some reckoning saw asset inflows in the first quarter of 2008 equal to the entire inflow in the year 2007. Under the heading of "Haven't We Seen This Before," aren't these the same institutions that poured money into venture capital in 2000? And the same that piled into private equity in 2006 and 2007?

The massive rise in commodities has also been aided and abetted by the nearly unprecedented decline in the dollar, which has been terrific for multinationals, but it has further crushed operating margins for many domestic businesses, smaller companies in particular, who in previous cycles were able to hold margins as their input costs declined in line with softer revenue. This has been a double whammy to which we can personally attest in some of our holdings, as there is no worse combination for a stock than soft revenue and declining margins.

While we respect the argument for consolidation in many mining industries and its conceptual benefit to stabilize pricing, as well as the endless Chinese demand story, we also note there is an extraordinary correlation since 2003 between lower credit spreads, the lower dollar, emerging market strength and commodity pricing. With credit spreads reverting back to historical averages and then some, and the US economy where it is, one can strongly argue for, at minimum, a settling down of commodity prices and an unwinding of the relative performance of commodity producers versus commodity users over the next few years.

Lastly, RCB performance has been reasonably solid in Large Cap, but simply dreadful in Small Cap, the latter of which has also taxed the performance of our All Cap strategy. In the past few quarters, the small cap sector has quickly turned from the favored institutional asset class to an exercise in evisceration as short-term liquidity and credit fears have disproportionate effects in lightly traded stocks. We see the current environment not unlike 2002/2003 with stupendous values being created, and have re-opened our Small Cap strategy to new investors for the first time in four years in light of the values we see and our ability to put new money to work. As David F. Swensen, head of Yale's endowment has noted, "there is no way to succeed in active management if you try to control for benchmark risk. You must be willing to deviate from the benchmark if you want to earn returns commensurate with the risk of owning equities. And you must be patient. These managers often lag, but they have done their homework and have no hesitation about hanging on." Despite the pain of the short-run, which has been material, we suggest that this is exactly the time one leans against the wind and puts money to work. Slowly. Carefully.

In other RCB news, we have raised some seed money for our International Value strategy led by new hire Sean Thorpe and co-portfolio manager Geoffrey Stewart, and they have done a terrific job in the short-run of putting up superb numbers in the face of a very tough environment. We welcome the opportunity to discuss our international thoughts with interested investors.

In closing, it rarely pays to make bold bets backed by bold global viewpoints, but rather pursue a strategy of looking at how the market is pricing securities and making specific investments as to whether a valuation is properly discounting the outstanding fears or questions. As noted by one Peter Briger, President of the publicly traded Fortress Investment Group, who in his last conference call made what we would suggest is an excellent recap of our current thinking: "A year ago, two years ago, in the markets for credit and assets, you had no perceived credit risk whatsoever and you had terrifying actual risks. Today we stand in a position where there is terrifying perceived risk and much lower actual risk…what about now? I would clearly make the argument that if you are catching a falling knife right now in making an investment, you're catching a butter knife as opposed to a sharpened steak knife a year ago."

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