

## A Stock and a Hard Place

The capital markets have produced so much that is wonderful over the past three months that it takes little effort to contain our enthusiasm for the near magical reappearance of double digit returns across the equity board. The facts are simple: at the end of a lousy March, we calculated that the companies in our large cap and small cap portfolios were trading in the public markets at a 40% discount to our estimate of their intrinsic value. Without the benefit of garden variety trimming, three months later the same portfolio was selling at a mid-teens discount. The usual suspects can be trotted out as to “why,” but we would point to the obvious elimination of the worst case scenarios in regard to the Iraq campaign and the less obvious and very simple fact that the fear of losing huge gobs of money gradually and then with great force has given way to the fear of missing a new bull market.

Despite some scattered complaints about “convoluted text,” most regular readers and clients know that we have argued for the last nine months that there were more than enough interesting opportunities to get us fairly fully invested in both stocks and short-to-intermediate corporate bonds

and that we were being well paid for the risk that hell would indeed freeze over. Don’t get us wrong, we would rather be scratching our heads now than holding our stomachs as we did in March. However, as value investors, we have difficulty in adjusting to good times, especially when they descend upon us as suddenly as a winning Lotto effort.

Contrary to much popular belief (Q2 had a net \$40 billion inflow into stock mutual funds compared to a \$27 billion outflow in March), the fact that the second quarter was wonderfully strong does not necessarily signal a trend or a new bull market as much as it may point to the opposite. Stock prices/valuations over nearly any longer term historical period tend more toward mean reversion (with an 8% upward bias) than to the identification of a predictable series of trends.

In other words, just as it was inevitable that the ridiculous valuations of the late 1990s would plummet back to earth, there has been an upward tailwind in many stocks to levitate from what in many cases seemed six feet under.

Of course, our current problem is “now what” as we have just earned two years worth of equity returns in



the past three months. Despite the illusion created by billions of shares traded every day, most of the time most stocks are fairly valued and that is as good a definition of where we stand today as any. The fall-out from this statement is that our ratio of selling to buying has rarely been higher; and at the same time, our pool of new ideas is better described as a puddle as of this writing. Thus, a growing position in our equity portfolios may now be that four-letter word – cash.

The fun part of being a concentrated manager is that we don't need twenty-four new ideas a year and with second quarter earnings in front of us, the likelihood of a variety of gross over-reactions to minor changes in perception could negate the comments in the previous paragraph in a hurry. However, for the moment, it seems likely that we will simply muddle along and wait for the anticipated economic recovery to actually show signs of a pick-up that is visible in the income and cash flow statements of corporate America.

Despite our predilection for ranking consistently good economic forecasting slightly north of our prowess at picking winners in the next reality TV show, an economic pick-up seems as nearly inevitable as we could imagine given the environment. In other words, Dorothy Parker's in particular, we suggest that a death-grip, Japan-like deflation scenario is an idea not to be taken lightly, but rather, it should be thrown out with great force. Conceptually speaking, deflation is the result of a sustained gap between our collective capacity to produce and our current level of production, which then so permeates the part of brain that controls our "animal spirits" that we put off today what we can buy/build more cheaply tomorrow. Is that where we find ourselves today? Let's pose some interesting questions.

How can one rationally discuss the likelihood of deflation and then follow it with a discussion of a bubble in housing prices? Aren't energy prices higher than they have been in decades and haven't there been decades of a determined effort to

increase the usage of the environmentally friendly energy source, natural gas, simultaneous with a determination to limit exploration, the net result of which is an explosive rise in raw material prices that is only beginning to work its way through the pricing chain? Isn't the Federal Reserve growing money supply at nearly double digit rates, cutting interest rates to their lowest levels in 45 years and allowing itself to be quoted to the effect that it is more than willing to adapt "unconventional methods" (throw dollars out of a helicopter?) in order to combat the specter of deflation? Didn't Treasury Secretary John Snow effectively announce in May that the Bush administration is abandoning a strategy of supporting the U.S. dollar exchange rate with a basket of currencies by recalibrating its definitional criteria of a "strong dollar" to include "such aspects of the dollar as the confidence it inspires in the public and its resistance to counterfeiting?" Didn't this produce a nearly immediate high single digit drop in the exchange, thus aligning almost the entire universe of hedge funds as "dollar shorts" and threatening the resolve of the rest of the world to foot our \$1 billion a day need for current account finance? Isn't the Federal budget going from a 1.4% surplus to an estimated 4.6% deficit and that's before possibly the single most irresponsibly expensive piece of legislation to come out of Washington (and that says a lot) in the form of a unfunded and irrationally constructed Medicare drug benefit that is the fiscal equivalent of fighting an ANNUAL war with Iraq? Wasn't a headline in the Wall Street Journal in June "Skyrocketing Healthcare Costs?" Haven't credit spreads collapsed in recent months, allowing an awful lot of walking wounded to refinance themselves, blowing away any fears of a credit crunch? Isn't the yield curve nearly vertical, which statistically has one of the best records of predicting higher economic activity eighteen months out? Aren't gold prices 50% higher than eighteen months ago?

If you closed your mind for five years and opened it to the facts of the preceding paragraph, would you position yourself for deflation or inflation? Yes, we

just brought up the “I-word”, which is entirely rational since even the most draconian, stripped-down measure of inflation (which excludes food, energy, housing, tuition, insurance, lattes, Ben and Jerry’s, and lift tickets) was up almost 1% in May. That’s “up” not “down” and we have a gut feel this could be the low print for the cycle. We also think the refrain of “overcapacity” is reaching its last legs in a number of areas. Would you hazard a guess on what would be the value of a piece of technology hardware grossly overproduced in 2000? How much of that has been written off as it approaches its last legs of utility or is simply unusable today? One of our personal favorite anecdotal interesting indicators that may or may not have any relevance is the Herman Miller “Aeron” chair phenomenon on eBay. This was the “chair of choice” for “Silicon Valley Masters of the Universe” wannabees during the tech boom and it was not too long ago that trains of them could be seen trailing out of office buildings (sometimes with tearful employees still in them) into repo trucks to find their way onto eBay. While researching Herman Miller a few years ago, this analyst dithered around on eBay and came up with nearly 400 listings for “Herman Miller Aeron.” Today’s number is 98, which conceptually is a small example of how “the market” assimilates and creates demand for the woes of over-supply and vice versa.

We draw two conclusions: investing is a process of weighing probabilities and therefore while we register the possibility of deflation, we just assign it a very low weighting. We would also reiterate that “change” is often imperceptible at the margin particularly when most of us are fighting not to drown in the same consensus cesspool of the financial press and Wall Street blather. The deflation and zero interest rate trade has been going on for a fairly long time and has intensified as if to go out in a blaze of glory, which unfortunately rarely inures to the last holder.

All of which means of course, that we simply do not see much attraction in most fixed income securities, which to throw in our de rigeur Grants Interest Rate

Observer quote, “offers the investor return-free risk.” We choose to be unpleasantly content with earning nearly nothing in short-term securities that will at least retain principal value, which can be reinvested later, rather than facing the specter of very possible double digit principal losses on the side of a balanced portfolio where we deem to avoid principal risk.

So to once again avoid the charge of obfuscation, the predicament is that many stocks have appreciated to or past our estimate of fair value, making it temporarily difficult to find compelling new ideas. In our opinion, the fixed income alternatives are even more unattractive. The answer, of course, is fiendishly simple: patience. While we are diligently working on a variety of new ideas, we are also content to diligently take pitches until we get the proverbial lob over the middle of the plate.

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*The opinions expressed herein are those of Reed, Conner & Birdwell and are subject to change without notice. Securities mentioned herein are not to be construed as a recommendation to buy or sell and are not guaranteed to be in the portfolio. Past performance is not an indication of future results.*

#### **Firm Update:**

We recently passed \$2 billion in managed assets thanks to this year’s performance and a stealthy recognition that stability, a commitment to absolute performance through thorough research, and integrity in putting client interests first are traits that contribute to mutually rewarding long-term relationships. We invite institutions to contact Daryl Ann Weber and individuals to contact Michael Adam Smith at 310-478-4005 to discuss these issues in further detail.

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