

INVESTMENT STRATEGY LETTER

Investment Management Since 1959

Volume 50, Issue 3 / July 2010

Cage Match

Let us assume that the economic future remains uncertain, which in some ways is the only “constant” in a world of variability. We follow from there a general belief in cyclicity or mean reversion, which practically applied, means that when things are presently awful, they tend to become better and when things are wonderful they tend to become less wonderful, the caveat of course being timing. Lastly, let us apply some behavioral finance to this mix, which suggests that investors tend to over-amplify these swings through economic history, over-pricing things that are doing well and under-pricing things that appear to be doing poorly.

It is our contention that this state of affairs is “normal” and our job is thus fiendishly simple: analyze businesses, value them, make a judgment on the people running them, cautiously put a finger in the air for the directional velocity of the economic wind, and then step to the plate as a buyer or seller when a reasonable sense of value gets materially divorced from the succinctness of the current price.

What we are not good at is handicapping the whims and wishes of a group of global homo reciprocans (elected and some un-elected officials), who are attempting to subjugate the normal ebb and flow of homo economicus (most of the rest of us) and given the recent volatility in financial markets, we would

suggest that our inabilities are widely shared investor traits.

Pick your global poison: regular intervention and manipulation in and of fixed income and foreign exchange markets; closed door politicking on massive proposals on every imaginable subject touching

almost every part of the global economy; overt and covert tax policy change – enacted or to be determined; the punitive targeting of specific industries; bypassing established contract law to directly intervene between private parties on a completely ad hoc basis; and not even remotely last, but possibly the highest on the outrageous scale, the near complete absolution of any self-analysis of government’s own behavior using

the rules of conduct that are being applied to third parties. And to be clear, you can repeat this paragraph in nearly any language you can think of – except maybe Canadian [*sic*].

These arguments can be viewed as either political or philosophical or both, and their points and counterpoints can be debated endlessly, but the facts on the ground are that literally trillions of dollars appear to be cowering in either fixed income instruments yielding zero to three percent, or in a non-yielding piece of yellow metal that has been



Source: The Cartoon Bank

perceived to be a store of value against political whims for centuries. Economic growth, which should be cyclically booming after cyclically cratering, is moseying ahead. Unemployment remains mired and more than one CEO has been in our offices attesting to the idea that “you have got to be crazy to think of hiring someone right now.” At the same time, dozens of large, stable, and global publicly traded companies can be had for historically low multiples of current or cyclically adjusted earnings and many have dividend yields that are well in excess of their supposedly risk-free competition. Those are pretty good signs that something is really wrong in the world. There is no mystery here, as Germany’s Prime Minister Angela Merkel threw the gauntlet down in her defense of the Euro: “Governments must regain supremacy. It is a fight against markets and I am determined to win this fight.”

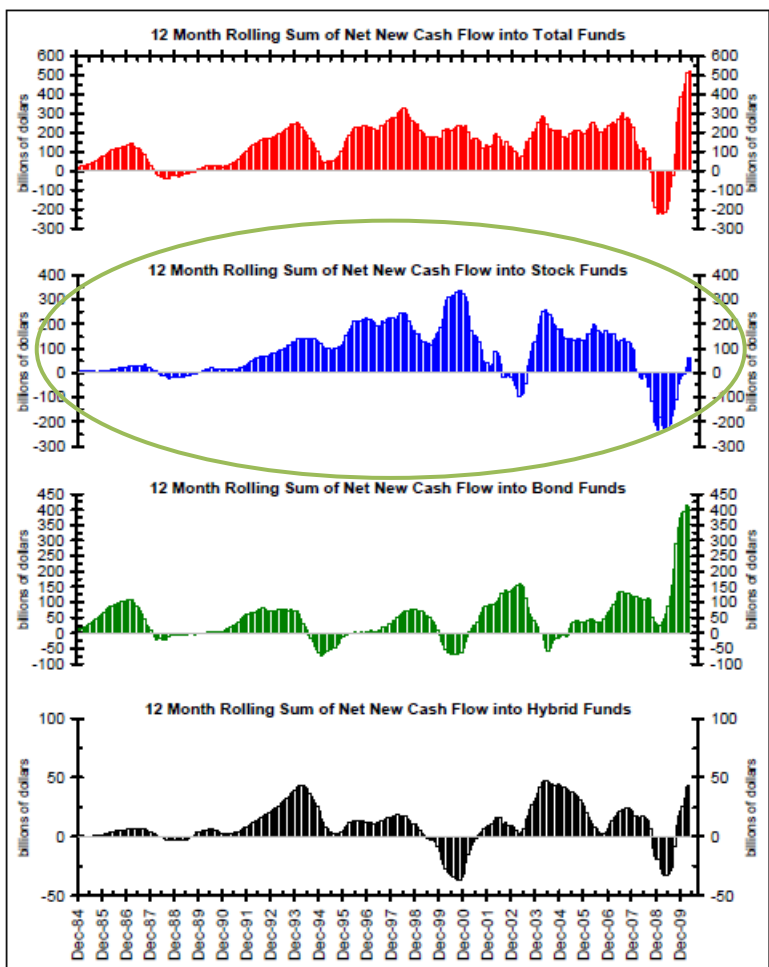
The good thing for all us is that there are still generally free elections and markets in a good chunk of the world, and somehow and somehow, we have managed to get through any variety of seemingly impregnable messes throughout the last few hundred years with these experiments on democracy and capitalism. And on that note, I would like to paraphrase some bits and pieces from a speech that Tom Gayner, a friend who runs the investments for Markel Insurance, gave to the Grant’s Investor conference this past spring. His core line that I simply love to re-quote is the old joke about Michelangelo. When he was asked how he created the statue of David, he replied “I took a big piece of marble and chipped away everything that didn’t look like David.” That in a nutshell, is a pretty decent argument for a pretty decent bunch of stocks.

Bonds at 3.1% for ten years? I’ve got ten superb businesses with fortress balance sheets yielding that much and that yield should grow in almost any environment but the Gulf of Mexico. If you are paying attention and do decent credit work, you can however pick-up odds and ends in what is left in the high yield markets as well some other yield driven securities.

Gold? It is the wiki-currency of our time as it represents the collective fears and nightmares of the world. What’s it worth? You don’t know either, huh? Warren Buffett on gold: “It gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head.” It has clearly been a fabulous intermediate term trade, and if one can argue that if it represents the outlet for a collective fear of global governments’ fiscal incompetence, then it might suggest we aren’t done yet. What also attracts the attention of many folks seemingly more clever than us is a sense of the following math: the household

and non-profit wealth of the United States alone is about \$54 trillion. If everyone joined the party and made an allocation of 2% of their portfolio to gold, that is roughly one trillion dollars of gold – which is 15 times the value of annual global production of gold, one thousand times the average daily volume of the gold exchange traded fund GLD, and simply a massive flow of funds into a relatively small market. That would be “pretty good” for the price of gold and gold mining companies, just as it was for the prices of oil and gas and the companies in the energy industry for a few years. (Note to self: sell at top this time.) We

I Ain’t Buying No Stinking Stocks



Source: Bianco Research, LLC

are not intellectually immune to the argument; we just tend to falter at the precipice of an investment whose key element is not our sense of a rationale estimate of value, but simply an estimate of what everyone else is about to think is an estimate of on a clearly inestimable value, which begins to put the investor on a slippery path of musical chairs.

And what about a trading strategy? A brief look at history suggests there is a very, very small group of investors who can claim a repeatable amount of success in this world. Since most clients would desire some degree of diversification among this select group, assuming you could identify the group, you would then have a high probability of running on the zero-sum game treadmill minus some truly fat fees. Simply not us and likely not you either.

China and emerging markets! On the former, it is likely the biggest source of instability and unpleasantness in the near-term as any ugly comment you can make about our political system, leverage and capital allocation you can put on steroids and inject directly into Beijing. Is there a high probability that a hybrid communist system with horrendous air pollution has managed to develop civil service cadets capable of divining economic and financial tea leaves and succeed on a global scale where generations of Harvard Business School graduates have lined intellectual graves before them? It is likely the biggest non-elected headwind an investor is facing today in our opinion. And on the latter, yes it is entirely possible to find good values and good businesses run by smart people with non-U.S. addresses. Call us about our International strategy which is about to hit three years of terrific performance.

While we are not arguing that the current state of the investable world is the financial equivalent of one of the greatest works of art ever created (that was March 2009), our research suggests that a reasonably concentrated strategy of very reasonably valued equity-oriented investments strikes us as pretty good risk reward for the long run. The secret sauce in this simplicity is that the management of every company we own (even Aubrey McClendon of Chesapeake) wakes up every day reading the same newspapers we do, talks to their troops around the globe about business conditions, opportunities and risks, and plans accordingly. They move, feint and deke around competition, regulation, raw material increases, inflation and deflation, Chinese demand and global

changes. When we buy a stock, we are buying a piece of a business run by real people whom we are likely to be slightly over-paying in order to be our eyes and ears and to adapt to the uncertainty of tomorrow. It is the intangible *more* that you get if you can chose well at the right price. That is a huge and mostly positive difference between buying a piece of metal or a piece of contractual math (bonds), which like a robot, can only respond to an unexpected change in the future with a very clearly delineated set of DNA.

As is always the case, there are plenty of other things that can go wrong than merely pointing out the very visible foot of government stepping on the invisible hand of the free market, but as we read daily the convolutions of the Financial Services "Reform" bill, we wouldn't underplay it. We do think our biggest risk as an investor today is time, not necessarily price, as nearly every attempt of civilized society to "fix" very real economic problems merely delays or dilutes the reckoning. As an example, real estate problems should be nearing a very practical and cyclical end, but we seem to have the inability in this country to let people and institutions fail and get on with their lives, and so we stare ominously at a fat pipeline of potential foreclosures or the living dead of financial institutions instead of new money picking at their remains.

We worry about China and the "end" of its success of economic stimulation and thus how much of a downward tug that could be on our more cyclical companies. We are very lightly exposed to commodity producers for the same reason with the exception of oil and gas, which have a decent probability of a changing supply/demand focus thanks to our friends at BP. We do not take lightly the mathematics of debt repayment, on either a personal, corporate or government level. Repaying, subtly repudiating or simply defaulting on debt is not a trifling matter for either the debtor or the lender, and despite the urgency of the past spring's headlines, Europe is still a geographic region with 400mm people in some form of semi-employment going about their business, limping along as they have done in much of the last forty economic years. But once again, time is involved in either the proper fix of cutting spending *and* raising taxes and regulatory red tape or the wrong fix of pretending to cut spending and raise taxes.

That all said, we will use a new top ten position for RCB in our Large Cap and All Cap strategies, Baxter

International, to highlight some of our thoughts. Baxter has a \$24 billion market cap, does north of \$12 billion in very diversified and global sales with 23% operating margins, generates impressive free cash flow and regularly returns 25% in a full counting of invested capital, and yields 3% at its current price of \$40 per share. It is earning somewhere between \$3.75 and \$4 per share as we calculate it, valuing the company on an earnings basis of about 10x. On low single digit future cash flow growth, we can value the stock in the low \$60s and we expect that growth to be higher. CEO Robert Parkinson, Jr. came to Baxter in 2004 and has done an exemplary job in re-orienting management and strategy. Yes, there are headwinds in global healthcare in general, and they have some interim competitive issues in their plasma business and yes, they are having a tiff with the FDA in the pump division, but at current valuation levels, we see very little downside and we are getting paid fixed income plus to wait. The company is not dependent on any one blockbuster product or drug, and is not that mega-large that it needs a miracle drug or product to move the revenue needle. We find it difficult to see how this will not outperform the 1.8% return offered by a five year Treasury bond.

Stepping back from the forest of Baxters we have collected through our bottom-up process, we see portfolios that continue to be a mix of economically offensive and defensive names. The volatility and decline in May and June have created individual stock valuation that is attractive, but we are not being paid that well in any specific sector to truly load the boat with conviction. We are having a decent year in our Large Cap strategy, excellent years in Small Cap and International, and something in the middle for All Cap.

Unlike the current investment flavor of the month, which seems to involve waking up, eating breakfast, reading blogs and determining whether one should be "risk on" or "risk off," we continue to execute an investment process that has proven highly correlated with success over decades: value orientation, long-term focus, and a discipline that involves research and specificity. Contrary to a fair amount of public opinion, there is enormous opportunity for an investor today to focus on the business and valuation details of a particular investment while everyone else is running around trying to tie the world together into some neatly gift-wrapped strategy that can be easily quantified and traded by computer algorithm. Yes, it

can be frustrating when *everything* seems to go down on a day when the market goes down, but no one said this is easy. And when it gets that easy, you should be selling into it.

We hope that you enjoy a wonderful summer.

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

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RCB Investment Management's Distinctive Strengths

Global, Innovative Research Boutique

The purpose of our research is to uncover securities that are trading at substantial discounts to our estimate of their true value. We believe the best way to accomplish this is through multi-dimensional, hands-on research, shared freely throughout the firm. A consistent, fundamental and research-oriented approach to investing produces the best investment results over the long term for all of our clients - large institutions, private clients and individual mutual fund investors.

Disciplined, Principled Investment Processes

Our portfolio construction techniques reflect our commitment to disciplined, principled investment processes. A disciplined process is one that methodically seeks to uncover the best investment opportunities in any asset class and construct focused portfolios with 25 to 35 securities. We seek to mitigate risk through a disciplined sale process.

Investment Strategies Geared to Client Needs

Our primary goal is to help our clients with solutions to asset allocation modeling. In seeking this objective, we are committed to offering investors *investment solutions* for their complex financial obligations and needs. Accordingly, we have designed a broad range of investment products and strategies that are diversified across asset classes, styles and markets that include: Large Cap Value Equity, Small Cap Value Equity, All Cap Value Equity, International Equity, and Global Equity.

Delivered by Our Most Important Asset: Our People