Active Value Investing

making money in *this* economy

PRIVATE PORTFOLIO
IMA
MANAGEMENT

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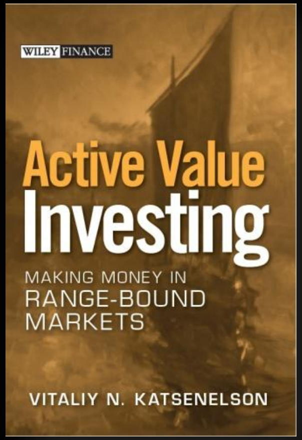

Value investment approach needs to be adjusted for *this* very different economy

On the surface, the vital signs of our economy are improving:

- Employment is declining at a slower rate
- GDP's stopped declining and started growing

But what you see on the surface is very deceiving. Here is how we view our economy:

- Like a marathon runner who runs too hard and hurts himself. But now he has another race to run. So he's injected with some serious, industrial-quality steroids, and away he goes. He's up and running, so he must be ok. What we don't see is what is behind this athlete's terrific performance – the steroids.

Serious steroid intake comes at a cost:

- It exaggerates true performance
- Steroids are addictive; once we get used to their effects it is hard to give them up
- The longer we take them the less effective they are
- They damage the athlete’s body

Our economy suffered severe injuries last year and now there is a giant IV hooked up to the veins of the economy, through which billions of dollars are constantly being pumped in.

The stimulus is everywhere:

Auto industry

- To help the auto industry taxpayers were subsidizing the price of autos and thus were creating artificial demand.
- GMAC is to receive a third government bailout. So far taxpayers have pumped $13.5 billion into GMAC.

The housing market

- On one side there is a buyer (used to be just first-buyer, now it is any buyer) tax credit.
- Interest rates are kept artificially low by the Fed's quantitative easing, fancy econ-speak for the Federal Reserve buying long-term bonds.
- Fannie and Freddie - (now) defunct government-controlled, which *are the mortgage market* of our economy, they account for the bulk of new mortgages originated today.

Banking sector

- Banks are the conduits through which the government pumps stimulus into the economy. The aforementioned government involvement in the housing market helps them generate enormous fees.

- Profitability is boosted (at the expense of savers) by almost zero short-term interest rates, again thanks to the friendly Fed. They earn a healthy interest-rate spread.

Infrastructure projects - giant, multi-hundred-billion-dollar infrastructure projects that are coming on line as you read this.

Yes, steroided we are!

Now let's look at the side effects

- Our economy's true, unsteroided, unstimulated performance is a lot lower than the one we observe.

- Government can spend money at a high rate for longer than one would rationally expect. Stimuli are finite, come with heavy price tag, financed with higher future taxes and rising government debt thus a higher future interest rates.

Steroids and stimulus are both addictive and have consequences

- Once we're used to them it's hard to give them up as the short-term consequences bring pain. The $8,000 tax credit started as a temporary measure. The program was extended and supersized by providing tax credit to anyone with the patriotic ambition to buy a house.

- The longer we stimulate the economy the less effective stimuli become. Japan was on a zero-interest-rate policy since 1990s. Now it is a prisoner of zero interest rates, as its economy is geared that way. Now, even a small increase in interest rates (say, from 1% to 2%) would be devastating for Japan's economy.

- Not a viable long-term solution. Japan was on the stimulus bandwagon since 1990 and has nothing to show for it except government debt-to-GDP tripling,.

- Stimulus just rewinds future sales to an earlier date, at the taxpayer's expense. After Cash for Clunkers ran its course, demand for autos fell into the abyss. The same will be the fate of industries exposed to infrastructure projects.

Consequences

- Postpone our problems into the future. Results in higher debt and higher taxes.

- Stimuli cause bubbles. The fix for the 2002 recession involved interest rates staying at extremely low levels for a long time, and resulted in the housing/liquidity bubbles we're paying for today. The present stimuli will leave us with even more serious damage, somewhere down the line.

- Stimulus creates an appearance of stability and growth, but a lot of it is teetering on a very weak foundation of government intervention.

- The hopes that we'll painlessly transition from government steroiding back to an economy running on its own are overoptimistic; there is just too much stimulus in the economy for that to happen. The detox process from the massive consumption of steroids will not be smooth and painless.

Process adjustments for *this* economy

Stock selection, stock selection, stock selection. It is paramount to distinguish between what is real and what is not.

- Will not buy marginal stocks for the sake of diversification. Investment success will not only depend on what stocks you own but also on the ones you don't. We won't subject the portfolio to unattractive risk/reward scenarios for the sake of diversification.

Defensive posture in stock selection. The portfolio is positioned for subdued economic recovery. We ask ourselves a question: what is the company's true earnings power after stimulus runs its course?

- Earnings power of our stocks should remain intact in the absence of recovery or post-stimulus.

- Economic recovery should benefit our stocks. However, if the pace of recovery is off the charts our stocks will lag (junky) cyclical stocks. We'd rather make less money than lose money. In other words, we'd rather give up a low-probability / high return opportunity than lose money.

- Cyclical stocks are priced as if the go-go days of 2002-2007 global growth, which was predicated on several bubbles colliding, will come back after $3.5 trillion in global stimulus is out of the system post-2010. Though governments will try, act II of 2002-2007 bubble will be hard to do (at least not this soon, the wounds are too fresh).

We err on the side of quality

- Pricing power. We don't know when or if we'll have inflation, but in case of inflation we want to own companies with pricing power.

- Strong balance sheets. We are assuming that interest rates will rise in the future (with or without inflation). We want low debt levels or the ability to pay off debt in a few years from very stable cash flows.

- Quality stocks should outperform low-quality stocks in a low-growth or deflationary environment. According to GMO, quality stocks have outperformed low-quality stocks in Japan during its multi-decade debacle. (Our explanation for this: Deflation causes risk premiums to skyrocket, high quality is rewarded.)

  The US is not Japan, but economic growth rate will likely be lower over the next decade than in the past (deleveraging is a lengthy process).

Thank You!

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