

New York & San Francisco

Spring/Summer 2009



Overview

Your intrepid investment managers have been on the road again, endeavouring to find meaning and direction in today's troubled global economy; this time we ventured to the eye of the storm - the land of the free, and the home of the brave... Along the way, we also found several new compelling investment propositions on both East Coast and West Coast.

Meltdown 101 - Just how bad can it get?

On a cold, crisp morning in NYC, as I walked towards midtown, I prepared myself for a full day of meetings. Ten blocks later and still not a single yellow cab available. You'd be forgiven for thinking that the big apple hadn't gone rotten at all and that business was booming. However, as wispy snow came down I had time to reflect on the global economic situation, gaze at the skyscrapers and wonder; which institution would be next to fail, which global titan would have to remove its name from one of the shining metal edifices, and behind which corner would the next skulking fraudster be exposed. These days the home of the brave is feeling a bit like the home of the battered and bruised.

The devil is in the detail

We know that markets lead economies (they lead the fall, and lead the recovery), but the key pieces of data seem to be getting worse, not stabilising. Business and consumer confidence, corporate profits, personal indebtedness, unemployment rates, house prices, government deficits, you've seen the headlines, and I'm not going to depress you further by reproducing the stats here. Regular readers of our monthly missive will have the key data at their fingertips.



However, despite the poor numbers, the market has since rallied on the back of the US Federal Reserve's big Treasury purchase plan. Can this rally be sustained? After all, the market has seen more bear rallies than goldilocks on trial for breaking and entering. Whatever the market does, the likelihood of an extended period of low growth in the economy seems ever closer to becoming a reality.

Prophets lose profits too

Several of the managers that I met with in NYC and San Francisco insisted that they saw this economic storm this coming. Included in that group are a long only manager and a hedge fund manager operating in the technology sector. It is worth considering how they have performed, to understand better the characteristic of the downturn.

The equities manager

As a firm SCD&Co embrace the value approach to investment. When assets are cheap, value managers buy undervalued assets, when assets become expensive, value managers sell. This is as distinct from growth managers who identify fast growing companies with less concern about whether the stock is cheap. Our approach to equities follows the Graham & Dodd approach, the founding fathers of investment, which also mentored Warren Buffett. We adopt a value mentality to whatever asset class we are invested in. The US smaller companies fund managers I met that day are true value managers and self confessed 'Buffett groupies', investing in companies that are out of favour, with strong balance sheets, and a strong return on capital. So how did they perform in 2008? In a typical bear market, the fund expects to fall around half of the drop in the Russell 2000 (the smaller companies index in the US). However, in this downturn the outperformance was only 7%. For us and them, whilst beating the index is one goal, the overall result is disappointing. The manager points out that he had the right idea, but admits to being wrong-footed by the a) the extent of leverage that hedge funds had created in certain sectors, and b) not expecting the government to make the decisions it did. His overall view of the economy has not changed in 3 years. It is worth noting that this fund this is one of only a handful of equity funds we own for our clients.

The technology hedge fund

Here I'm not talking about the kind of highly-leveraged low-conviction hedge fund who will have undoubtedly experienced trouble recently. I'm referring to talented managers operating with independent thought in tough markets (markets driven more than ever by motivation rather than valuation). The hedge fund is a long short hedge fund operating the technology sector.



These guys started making significant changes to portfolios in January of 2008, and unusually for a hedge fund manager, they have made money on their short positions in almost every year since launch in 2004 (except 2006). In 2008 they managed a positive return: +1.31% (a great performance in our view). We saw this as vindication of their style, exercising a 'true' balance of long positions and short positions: i.e. not just using short positions to dampen volatility. Instead balance is sought across sectors and positions. The managers admit on reflection that they could have been more aggressive with their short positions.

Justification, anyone?

Some of the more common reasons/excuses (I think they're valid, but you decide) highlighted by managers for their inability to predict the market movements despite expecting the economic challenges are as follows.

Leverage: Give me a place to stand and I will move the earth (Archimedes)

The first unexpected element is the sheer size of the leverage employed by hedge funds applied in a blanket fashion across sectors rather than targeted to specific companies. These positions had to be unwound at any price – leading to indiscriminate selling. The impact is straightforward. Good companies were bundled up with bad and sold en masse in the market. An example of this was the previously fashionable 'buy smaller companies, sell large companies' hedge fund 'herd instinct' trade, the subsequent unwinding of which was brutal and indiscriminate on smaller companies. Another example was the sheer weight of funds leveraged into sectors such as agriculture. Hedge funds are still deleveraging now...

What a State we're in!

Another unpredictable element highlighted is the 'government' wildcard. History will show that governments on both sides of the Atlantic played their part in exacerbating the extent of the woes we are witnessing now. Probably the greatest example concerns Lehman Brothers, being the biggest bankruptcy in US history. It is now widely accepted that Lehman should not have been allowed to implode. The resultant costs have massively outweighed the perceived benefit of protecting against moral hazard (i.e. Lehman was made the scapegoat to force the banks to take note and do their level best to sure-up their businesses). Lehman was sacrificed at the altar of moral hazard, but the impact shook the foundations of the entire western economic church. The cost of rescuing Lehman would have been a fraction of the costs the government and taxpayers are facing now after widespread wealth destruction.

These meetings caused me to reflect on our approach to investment, and what it had meant in 2008, and what it is likely to mean through the second half of 2009.



Diversification and 2008

Diversification is the only free lunch in finance, so said Markowitz, the father of modern finance. However, we have also always been wary of the adage that the only thing that goes up in a bear market is...correlation. That old adage was never so true as in this recent downturn. Regular readers of our commentary will know that we share investment philosophies with the Yale endowment fund. It is worth repeating a paragraph from their latest report, which reminds us to hold true to our principles:

...In the Crash of 1987 and LTCM crisis in 1998, flights to quality led to temporary market disruptions that caused diversification to lose its power. After the panics subsided, diversification once again mattered, as fundamental drivers of return determined results, not the overriding concern with safety. The crisis of 2008 differs from the crises of 1987 and 1998 in breadth, depth and intensity. Yet, after the current crisis passes, prudent investors will reap the benefits of a well-diversified portfolio. (Page 3, the Yale Endowment, Endowment Update 2008)

It is times like this when critiques of our approach will claim that our interpretation of diversification has not helped protect capital beyond a standard equity model. This simply isn't true.

The Mosaic approach has achieved significantly better performance numbers than the typical investment model, and our risk adjusted return would be even more encouraging: when normal conditions return, we will have taken far less risk than the average equity portfolio to achieve the level of return we achieve. If we are in for an extended deflationary period, and the equity model is broken for many years yet, we will still be striving to achieve positive returns.

Caught in the stampede?

For sure, this downturn has taken out a lot of dead wood in many industries, which needed to go. However, in the storm, a good many perfectly talented and able managers have also been taken down. This is for several reasons:

Lehman Brothers

Lehman must be mentioned here again. Many well run institutions lost assets held at Lehman Brothers. We struggle to blame those institutions for assuming that Lehman was too large and too important to be allowed to go bust. After all, Bear Sterns had recently been saved, and the government couldn't possibly save one bank and not another...



However you view the world, it should be fair to assume that governments will do the right thing, for the good of the nation. Yes, capitalism is messy at times, but it's the 'least worst' system we have – the best of a flawed bunch of economic systems. Hedge fund managers are often smart individuals, but they are also straightforward and pragmatic thinkers. It's always been a percentage game - you will make some errors, but you trust that your winning trades outweigh your losing trades.

Liquidity

Good, profitable funds have been punished in various quarters of the world. Asset managers everywhere have needed to liquidate positions and have been restricted due to lock-ups, gates, and exit fees. When investors have needed to sell, they have often been restricted from selling the worst funds or worst assets, which have gone into lock-up. What happens next in this scenario? The asset manager keeps searching up the quality list (i.e. from the lowest quality upwards) until he or she finds a security that can be sold. Given the stress on so many funds, that asset manager will have needed to go quite far up that list to find liquidity. Hence selling has been indiscriminate and in some respects, counter to logic and justice. Good firms and funds have faced redemptions and some have had to close.

Trimming the hedge

Hedge funds may have a tarnished name at the moment, but the ability to 'short stocks' in this market has been vital. Indeed we have been able to use market index shorts (that inversely mirror the performance of the market concerned) to provide a dampening of the volatility and protect against market falls at times.

Unfashionable shorts

It is worth reviewing the attitude to short selling. In itself, a short trade is not evil. The concept of a ban on short selling in a bear market makes me question why there isn't a ban on buying overvalued stocks in a bull market. Which is riskier: driving a share price up to massively unrealistic levels or driving a share price below fair value? Many of the banks which have faced problems recently were indeed worth nothing, or rather less than nothing. A share price can only be sold down to zero, but it can be bid up to many times its fair value.

Hence the danger of a 'run on the bank' when the bank's share price is depressed should be balanced across the cycle by the danger of pushing a bank's share price up to unsustainable levels in a bull market, encouraging its management to engage in an ill advised acquisition, such as that of ABN Amro by RBS.



Mistakes and the domino effect

Forget trying to find someone, institution or sector for this downturn. Governments have made mistakes before and after this crisis broke. Banks made mistakes, investors made mistakes and homeowners and consumers made mistakes. Hell even Warren Buffett admits he got it wrong this year.

The shape of things to come:

So which assets should we be investing in now? There are two scenarios of how the world will move forward from here: Scenario A – a V-shaped recession, which expects the world economy to bounce back in the next year or so. Perhaps. Scenario B – an L shaped recession or even depression - says we could be facing many bear rallies in a long period of deflation. Scenario A suggests we should be moving assets aggressively back into equities some time soon. Scenario B suggests we should look elsewhere for returns. Which assets should we consider? As ever, it's all assets...! And as diverse as possible.

Its niche, capiche?

As I walked down Madison Avenue, I wondered, if we are destined for low growth over the next few years, what asset classes will thrive? Clearly one of the main problems at the moment is the availability of credit. As Warren Buffett said, over a decade ago “Creditworthiness is like oxygen; you don't notice it when it's around” One of the key beneficiaries of this constraint should be the niche lending sector. Hence I next met with a fund manager specialising in Asset Backed Lending (ABL). An interesting dynamic is being played out in this fast growing sector. In a stable business environment, ABL, when done well, involves lending to highly creditworthy businesses for a greatly enhanced yield, with the lender having the security of significant underlying assets should the borrower default.

Give me some credit

In today's environment, in one respect demand for ABL has never been greater – the contraction in available credit is causing many small and medium size businesses significant stress. This provides a massive opportunity for those who have money to loan. However, ABL fund managers need credit themselves, and many of the banks which traditionally enable asset backed lenders, are pulling out of the sector, causing a further downward spiral in the availability of credit. In addition ABL has had its share of fraud, which we all know is being exposed in many sectors at the moment. In sum, this will continue to be a key area for investment in the next few years, but it is currently experiencing some tough times.

So what other assets are sitting in the box, waiting to be added to the Mosaic? Let me start you with three: Currencies, Life Settlements and vulture funds in the commercial property market.



Trading currencies: Greenback, fall back

At SCD&Co we have always searched for a currency fund with a demonstrable process and stable returns. We may have found it. The foreign exchange market didn't really exist before the late 1970s. In those nascent times, this group of managers started a company providing research on currency movements. Before long an institution asked them to start running currency overlays, which then evolved into a fund. They now run over \$10bn. They note that their skill is not necessarily in having a better set of models than another firm, but rather how the investments are put together. For us, this has always been potentially another source of uncorrelated returns. It demands further research.

So what of the US dollar? It has had a strong run before weakening to more realistic levels in recent weeks. Essentially, massive deleveraging has been taking place across the world increasing the demand for dollars on a global scale. Everyone needs dollars to pay back creditors. When this process is finished, the world will be awash with dollars. And at that point, the mighty greenback will almost certainly go a little yellow bellied, particularly when the full cost of the bailout plan starts to hit home.

Life Settlements: The death of drawdown's

As I headed through the Holland Tunnel under the Hudson River to New Jersey, I wondered about the Life Settlements industry. Individuals sell their life policies to investors, who commit to paying the premiums until death. The investor's return is dependent on how much they paid for the policy and how long the individual survives after the policy is bought. However, recently two elements have caused most investors problems. Firstly, with the credit crunch, the market for life policies has dried considerably, making it hard to sell a policy on, which as ever affects the implied value. Secondly, the leading publishers of mortality tables for the over 65, extended their projections in late 2008. This inherently reduces the value life policies if you view the industry as a whole.

Niche Redux

However, niche players can often avoid almost all the woes facing an industry. So it was with a certain degree of anticipation that I headed up to the HQ of a company which has put its own brand of management onto a hit or miss industry. After some 3 hours of diligence, going through the documents and even speaking to the nurses, I felt even more confident that the company had a firm grasp on its own situation. In contrast with most investors, the firm focuses on patients with terminal illness. The patients are monitored regularly, and the manager works hard to understand the life expectancy and factor in significant safety margins. What allows the manager to win policies over competitors, despite often paying less for a policy, is the speed and reliability of the payment.

In ethical terms, the patient gets the money quickly, and therefore can get on with making the most out of the rest of their lives. In business terms, the broker knows he/she will get the commission quickly and that the manager will not back out of a deal.

Only two things are certain in life

The reaction I get to mentioning life settlements as an investment to clients is often polar. It's either 'I can understand that, it is clearly valuable for a dying person to be able to access cash and do what they need to do' or it is 'I can't believe you profit from this'. For me there is one aspect that clinches it. When an employee is diagnosed with a terminal disease in the US, they then go on to disability pay. This is at 66.67% of normal pay, and therefore the person may struggle to pay the premiums to maintain the life insurance. The insurance that was there to protect the family is then at threat because of the very event that the policyholder was trying to insure against!

Go West

It was time to head to the airport for the flight to San Francisco and whilst I waited in the terminal, Martin Wolf was being interviewed on TV. The government is not doing anywhere near enough he said. Clearly still a bumpy ride ahead...



All that glistens...

San Francisco is no stranger to risk or reward. Built on a fault line, the City by the Bay is also the home of the gold rush which attracted hundreds of thousands but benefitted just a few. Most importantly for us, it is also the origin of the famous investment philosophy "In a gold rush, buy companies selling picks and shovels rather than the gold miners" – a concept known to economists as derived demand. It is one of our favourite philosophies and we apply it to every trend we identify. An example is the approach we have taken to investing in China over the last few years. Instead of investing directly, we preferred to benefit from the growth via investments such as commodities and Asian beachfront land.



I had planned for a few days of meetings and a few of R&R, but by day two, the meetings that I had with fresh contacts had spawned a multitude of extra contacts, causing me to reorganise my week. It just goes to show that there is no substitute for on the ground research and getting in front of people. The networking was working.

The legacy of Silicon Valley

My first meeting was with the manager of a private equity fund. We already own an East Coast biotech private equity fund. What is our approach to the sector? We don't invest in the big private equity firms well known for reorganising mega companies. This is about niche industries, with high barriers to entry via knowledge and innovation. Limited partners (fund managers) in this arena must have in depth understanding of the industry with the right network.

Wild West Pioneers

After the meeting I hurried through the rain to get to the ferry across to Sausalito – a small coastal village near the Golden Gate Bridge. Harbour Drive houses some real hedge fund investment pioneers. These guys run emerging markets funds, and have found themselves invested alongside Soros more than once. They find inefficiencies in emerging markets and then try to work out the socio-political risks to their investment not coming right. Amongst other topics, China was discussed...

China still coupled up

Last year's decoupling argument was clearly premature. China could not come to save the day when the West embarrassed itself. However, another is more likely. China and the Far East will come out of this downturn faster and stronger. Many factors are going to help China and hinder the US, apart from the difference in the US deficits vs. the Chinese surplus. What happens when a global business sees that the US is a harsh place to do business, and HK is holding the flag out for deregulated markets and low tax systems? What happens to the talented young CEO who finds his salary and bonus is being capped? The crystal blue waters of the Pacific beckon.

Use the force...

My last meeting was in the Presidio in San Francisco - George Lucas's part of town, and an homage to Star Wars. The macro hedge fund's offices I was visiting are in a complex that houses full size mannequins of Darth Vader and Boba Fett, and even a fountain with Yoda sitting on top in the courtyard. Anyway, the manager's fee structure is based on taking 25% of any upside they produce for clients in any one calendar year. Last year, they were up 50% mid way through the year but then lost it all and ended the year down 5%. The fund is over \$2bn in size, so it doesn't take a mathematician to know there where hundreds of millions of dollars potentially made and then lost by the firm. Where is Yoda when you need him?

What's worse is that they can also demonstrate that they predicted the downturn, but were caught out by some of the sizes of the moves. However, these days you will struggle to find anyone taking pity on hedge fund managers, and they have returned 368% since inception at the end of 2002. Indeed they strike me as one of the most original thinkers I have ever encountered. True thought leadership in investment. Unfortunately, what they have to say about the future is difficult to hear. It's not a new theory, but the last 90 years can be divided into periods of expansion and contraction. In simple terms, if we are in a contraction phase, it is not useful to consider the long term averages as benchmarks for expected returns over the next few years – statistics solely from the contraction phases must be used instead. In addition, we know equity markets always overshoot on the upside and the downside. Hence equity markets could still fall much further.

After all this talk of difficult times ahead, it was time for some R&R.

Set the brakes

After exhausting myself running over the hills of the city in the rain earlier in the week, it was time to chill out and take the tram. It's difficult not to be awestruck by the steepness of the hills and you wonder how many accidents there have been with runaway vehicles. (This in a city built on a fault line...) On many hills, there are road signs which read "Prevent runaways – curb wheels, park in gear, set brake" If only investors would take the same precautions when investing. "Prevent losses – diversify properly, review funds often, protect capital". Perhaps then fewer investors would feel the full impact of market crashes...



The Rock

Walking around Alcatraz I mused at the picture of Al Capone, and almost expected to see a picture of Bernard Madoff. How much wealth has Bernie destroyed and how many lives wrecked? Far more devastation than Al could ever have hoped to achieve. How many more frauds was this downturn likely to unearth? This wasn't helping my mood. I decided to head up to the wine country for a day and tried to find the answers at the bottom of a bottle of Napa's finest.

My crystal ball is more broken than usual

I am a strong believer that at times like this, more than ever, no one knows what is going to happen, or more importantly, when. Not Warren Buffett, not Nouriel Roubini, not Peter Schiff, no soothsayer, no crystal ball gazer, no one. Sure statistically, a small number of prophets will be right for what seems like a superhuman amount of time. These people get more and more dangerous as their success grows. One correct prediction after another correct prediction, their reputation and confidence grows, until they are willing to bet their mother on the next flip of a coin. Don't believe it. If you do your homework, and you are bright enough, you can observe trends and even warn of bubbles, but even the most intelligent man in the world could not understand the complexities of the global financial and socio-political system to the point of useful prediction of when and how the credit crunch was going to blow. Therefore, if you expected the credit crunch, you could have been protecting against it for 5-10 years. What do you do in that scenario? Pack your bags and move to Alaska?

One thing is for sure, we need some better sentiment. On my last day in the city, I walked around the Saturday fair down at the ferry building. San Francisco is a great place to be in the sunshine on a Saturday. Music, colour, wonderful aromas, smiling faces and the sun on your back. As I walked around one stall had a pirate theme, in keeping with San Fran's heritage as a historic port. One flag read, "The beatings will continue until morale improves". As I finish this paper we appear to have just about worn out the sellers with some blue sky following on behind them...



We welcome your views. Please email me at paul.denley@scdavies.com



The Small Print.

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