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It is my pleasure to welcome you to another installment of investment philosophy, courtesy of Tidd Capital.

Intrinsic Value

Fundamental to our investing philosophy is the concept of intrinsic value. This is the value of a business based on its financial condition and prospects, independent of its market value. One way to think about intrinsic value is the price that the business should fetch if sold in a private transaction, a price that is fair to both buyer and seller, which might be determined by an informed third party.

Intrinsic value is by necessity an estimate, since it takes into account various judgment calls about the company's current and future prospects, which are not 100% knowable. It is best expressed as a range of values, based on varying assumptions, with probabilities assigned to each value. Even though it is not a precise figure, it is still a useful measure. As Warren Buffett said, "you need not know a man's precise age to know that he is old enough to vote, nor know his exact weight to recognize his need to diet".

Businesses represented in the public markets also have a "market value", based on the current market price of their stock. Thus, each business really has two values, its "intrinsic value" and "market value". Most of the time, a company's market value is fairly close to its intrinsic value. The stock usually trades at a price that is within the range of probable intrinsic values, given reasonable assumptions by an informed observer.

Occasionally, however, there is a significant disparity between market and intrinsic value. This can happen in either direction – market value may be significantly higher or lower than intrinsic value. If you hold the security and are interested in selling it, you can take advantage of an unreasonably high price to make an outsized gain. Similarly, if you are a buyer, you can take advantage of an unreasonably low price to get a bargain.

The concept of intrinsic value and its relationship to market value describes the yardstick by which we make our investment decisions. First off, we identify high quality companies within our circle of competence with honest management. But price is just as important as quality. **We seek to buy into companies <u>only</u> at a substantial discount to intrinsic value**. By "substantial", I mean something like 25-50%. This allows for errors in judgment, unexpected events, and other risk factors.

This in my opinion is the only approach that can simultaneously limit downside while maximizing upside. If our appraisal is close to correct, and we buy at a discount, our potential loss should be limited, because even if the business prospects decline suddenly by 25-50% we should be able to exit at break-even. On the other hand, if the business does well, we should win twice – once when the market price increases to intrinsic value, and again as intrinsic value increases.

Why do these disparities occur? There is no single explanation. In some cases, the entire market goes through a period of euphoria (such as the dot com bubble) or malaise (the period after). Warren Buffett has commented that the market seems to overshoot in both directions – high and low –

as greed and fear alternately dominate the markets. During these times, market values may have little bearing on intrinsic values.

Other disparities are specific to a situation. A scandal may be discovered in a company, and all similar companies decline in price, even if no scandal is present. Sometimes a market segment becomes unpopular as people with a short-term mindset flock to the hot topic du jour, and perfectly attractive investments collect dust in the unlit rooms of the market.

The true reasons are really unknowable, because they have to do with the psychology of the thousands of other market participants. But my view of this uncertainty is expressed by the beer advertisement – "why ask why?" It doesn't really matter why these disparities occur, what is important is that we recognize a few of them, and when we do, we need to act.

In our experience, the attentive market observer who sticks to a well-trodden circle of competence will occasionally be rewarded with opportunities to buy into businesses that are good to great at prices that are good to great. We wait and watch for just these opportunities.

Cheap, Safe, and Good

In terms of quantitative analysis, a prospective investment must meet three criteria:

1. Cheap
2. Safe
3. Good (i.e. solid prospects for well above average returns)

It is common to find opportunities that meet one of these criteria. Most distressed companies are statistically cheap, and might trade at a discount to their asset values. However, a truly distressed company is not safe, since its value may well end up at zero. On the other hand, companies that can generally be expected to provide above average returns are usually expensive. Excellent companies usually command a premium price.

Paying a low price for a below average company and paying an above average price for an above average company will often yield the same result – average returns (or worse). It is only when buying into an investment at a price that is obviously "too low" that we should expect to achieve better-than-average results.

Occasionally, we do find an opportunity that threads the needle and meets all three of these criteria. As you might imagine, this is rare, so when we do find such an opportunity, we get pretty excited about it. This partially explains why we hold a limited number of investments at once.

A Specific Situation

I thought I would go into some detail about a specific investment situation that I think provides a tangible example of these concepts.

Brascan Corporation is a Canadian conglomerate run by CEO Bruce Flatt. Brascan has a long history of managing various classes of assets, including real estate, power generation, mineral mining, and timberlands. Brascan is not simply a real estate company, or a power generation company, or a mining company, but is what Marty Whitman calls a "wealth creation company". That is, their business is generating capital and then redeploying that capital into new attractive investments. The type of investments may change over time, but the goal does not. In this way they are similar to other investment-oriented conglomerates such as Warren Buffett's Berkshire Hathaway.

While Brascan has many moving parts and a long history (one business unit goes back more than 100 years), the organization is run with a single purpose – to generate sustainable, low-risk cash flows and increase shareholder value. This vision statement certainly gets my attention. Few companies can actually generate low-risk recurring cash flows, and fewer still are run for the good of the shareholders. An analysis of Brascan's deal history shows a value-oriented approach to buying and selling their investment – they bought low and sold high. They have the expertise to value and manage investments for the long term, and have been able to finance their acquisitions on very favorable terms.

Brascan used to own a hodge-podge of dissimilar assets, many of which were not of the best quality. Over the past 5 years, under excellent leadership from Bruce Flatt, they have transformed this into a collection of "best in class" assets.

For example Brascan now owns One and Two World Financial Center (the buildings adjacent to Ground Zero in lower Manhattan, which were remarkably unscathed), and recently closed a deal for 635,000 acres of timberland in British Colombia, considered to be the best in North America. They have also been acquiring hydroelectric power stations in the northeastern US and Canada over the past 3 years, with a current installed capacity of 2600 megawatts. All of these assets are high quality and provide sustainable, reliable cash flows for many years to come.

The result is several diverse streams of free cash flow. These assets were acquired at prices ranging from fair to good, and their quality ranges from good to excellent. These high quality assets will increase in value over time while requiring a minimum of additional capital expenditure, the canonical "cash cows".

Brascan finances these purchases with a combination of debt and equity. The debt is generally at very low, fixed rates, with long maturities, and Brascan's very low cost of borrowing is a key advantage. While maintaining a strong balance sheet, the debt financing allows Brascan to deliver excellent returns on equity with a minimum of risk.

Annual free cash flow – the all-important "owner earnings" – have been $510M, $582M, $710M, and $805M in 2001 through 2004, compounded growth of about 16%. These cash flows have been used to pay an increasing dividend, buy back a large number of shares (about 10% authorized in 2004), and make new investments, all of which substantially increase shareholder value.

So far, I have described a decent investment opportunity, though I have not mentioned price. An informed observer would expect Brascan to trade in the markets at a high price that would only deliver average performance to shareholders. However, that is the best part of this story.

When I first started buying shares of Brascan in late 2002, they were available at a 40-50% discount to fair value. There was no good reason for this discount, except perhaps that Brascan is not widely followed, or was misunderstood as a cyclical mining company. But “why ask why?” The result so far is a 280% increase in the value of these shares (from the original purchase prices), through the "win-win" combination of an appreciation from a discount value to fair value, and a substantial increase in fair value.

If only these opportunities were available more often, my job would be a whole lot easier.

Outlook

2004 was a difficult year for finding new investments, with the market generally rising slowly throughout the year. Valuations of specific companies were generally accurate, which means we had very few buying opportunities (in this activity, market inaccuracy is our ally). The buying opportunities that did occur were very fleeting, in some cases just lasting a few days, requiring us to be very quick on our feet, and making it difficult to build full sized positions. Generally, those stocks that we held did well, though we weren't able to add to many positions.

There were numerous corporate "disasterbacles" in 2004, including those at Merck, Krispy Kreme, and Marsh & McLennan. In every case that I examined, the huge fall in share price was entirely justified (and in some cases expected), so the sharply falling share price was not an opportunity, but rather something to avoid. No Tidd Capital portfolios were the victims of any of these disasters.

The period from the election to the end of the year was a surprise (albeit a pleasant one), as virtually everything I was observing rose dramatically, and our picks generally outpaced even the market's brisk pace. As a result, Tidd Capital portfolios posted excellent numbers in Q4, on both a relative and absolute basis.

The first quarter of 2005 has so far provided us with the yin and yang of investment opportunities – there was a sharp market decline, which hurt our near term results, but provided many investment opportunities. This time, I found the market to be far less discriminating – many good companies were discounted, which provided us with many opportunities. I have been filling our basket this quarter with investments that I expect to perform well in the future. Remember, what matters most is not what the market as a whole does, but how our carefully selected investments perform.

Thank you once again for entrusting your assets to Tidd Capital. If you have any questions or concerns, please feel free to contact me by phone or e-mail at any time.

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