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Second Quarter 2005

The red-hot market of the fourth quarter of 2004 turned cold in the first four months of 2005, followed by a strong rally in mid-May. Tidd Capital portfolios are generally slightly ahead of the market, which is close to flat year-to-date. In this difficult environment, I am pleased to not be lagging the market. In any case, 4-5 months is not a strong indicator of the long term picture.

Our primary goal as investors is to significantly beat the market, specifically the S&P 500 index. Over certain periods, this can mean declining in value, but declining less than the market. Short term, I would be just as happy if our portfolios fell by 10% while the market fell by 20%, as if our portfolios gained 20% while the market gained 10%. Short term outperformance is important regardless of the absolute returns in the market. Over longer periods, I expect the market to provide positive returns, and our outperformance will translate to above average gains.

Chicken Pie

A country song goes like this:

The hardest work I ever done,
Was plow a field of rye,
The easiest work I ever done,
Was to eat a little chicken pie.

The ever-changing market provides attentive investors with both "field of rye" and "chicken pie" periods in terms of finding new investments. Over the years, sometimes it is difficult to find a comfortable place to commit money, and other times it is easy. Unfortunately, the hard times are far more common, and the easy times are all too fleeting.

The current market environment resembles a field of rye much more than a chicken pie, which has been true for about the past 6 quarters. The market is facing significant head winds, including rising interest rates, and market valuations are generally fair to high. I'll discuss both issues in a moment.

I am finding what I believe are excellent opportunities, by being both energetic and creative in my research, and I am satisfied that the positions in our portfolios meet my criteria for risk-adjusted reward potential. If there were any doubt, I would not be making any commitments at all – making no investment is much better than making a bad investment. However, I need to caution clients to keep expectations reasonable, because a difficult environment usually translates into returns that are less than spectacular. My goal remains to substantially outperform the S&P 500 over time.

Interest Rates

Macroeconomic trends are notoriously difficult to predict. As the old saw goes, economists have predicted 9 of the last 5 recessions. That said, I generally agree with certain investors and analysts (including Warren Buffett) that there is mounting evidence that interest rates are likely to rise over the next few years, perhaps sharply at times.

Rising interest rates act like increasing gravity on equity prices for two reasons. First, they increase the cost of corporate funds, which impacts the profitability of companies that require outside capital. Second, and perhaps most significantly, increasing rates means an increasing risk-free rate, which decreases the risk-adjusted value of all securities, including equities.

The current long term interest rate is often referred to as the "risk-free rate" because an investor can achieve that return without meaningful risk by buying long-term US Treasury bonds. A projected 10% return from an equity looks pretty good when the risk-free rate is at 3%, but a lot less good when the risk-free rate is 5% or 7%. A period of steadily rising interest rates means the same equity would steadily become less valuable.

Even though we are likely to go through a challenging environment for equities, it will probably be even more challenging for bonds, and current yields on cash are fairly low. While we don't object to owning bonds or other instruments, equities are still the horse we prefer to ride, and as long as the market serves up opportunities for us to buy them at a big discount to their fair value with minimal risk, we'll remain busy. If we are unable to find attractive investments, rest assured that we will make no investments – there are times when the best thing to do is stand and watch.

35 Year Old Hedge Fund Managers

As Warren Buffett has said, investing is a competitive activity. Anyone participating in the markets seeking above average returns must compete with other market participants who are trying to do the same thing. This is not Lake Woebegone – all investors are NOT above average.

For this reason, when it is hard to find a good investment, a common cause is that there are too many blankets on the beach, so to speak – too many investors with too much capital are chasing too few ideas. The current market environment is characterized by valuations that are fair to high, investors making commitments without sufficient attention paid to risk, and very low market volatility. These are all signs that the market is simply too crowded.

Some interesting anecdotes along these lines recently came out of the annual meetings of Berkshire Hathaway and Leucadia National Corporation, two of the best investment institutions of our time. For instance, Warren Buffett had this to say:

> **"There's far more money today looking at deals, and that will pay up for good-but-mundane businesses, than five years ago. The situation has eased somewhat recently, but people were lined up to buy just about anything."**

Ian Cumming and Joseph Steinberg, the gentlemen that run the Leucadia corporation, commented:

> **"Competition for investment opportunities… [has] roared back in the form of 35-year old hedge fund managers—private equity firms who have never known a bear market—and other investors willing to invest at high prices in risky assets with seemingly cheap money."**

Despite this, the market is a big place, and I believe that the creative and energetic investor can usually find some opportunities. I'd like to discuss one area where we have been finding some gold.

Business Development Companies

Many investors are familiar with REIT's (Real Estate Investment Trusts). These are companies with a special charter that requires them to invest their funds in real estate, and to pay out at least 90% of their earnings as a dividend. Because most of their earnings are paid out, these stocks typically become high yield stocks, with yields usually around 6-12% or more.

A lesser known but similar structure is a BDC, or Business Development Company. These are companies created with the express purpose of investing in other companies. Like REIT's, they pay most or all of their earnings to shareholders as a dividend. Successful BDC's, like successful REIT's, usually become high yield stocks.

BDC's are not new, as the structure has been around since 1940 and has been in regular use for decades. For example, one stalwart in the industry, Allied Capital Corporation based in Washington DC, has been operating as a BDC since 1961. However, in the late 90's, the structure experienced sudden popularity, and a number of new BDC's have emerged since then.

BDC's generally invest in small private businesses, and structure their investments as both debt and equity. The investments are typically more sophisticated than typical commercial lending, for example the BDC may help a small company recapitalize, make an acquisition or expand into new markets, buy out a previous owner or ESOP plan, manage a liquidity crisis, emerge from bankruptcy, etc. The investments often take the form of more than one security, for example a combination of senior debt, junior debt, and equity. The BDC might be represented on the board of the investee, and otherwise exert more control than a banker would.

The returns that BDC's can achieve from this kind of investing are usually well above average. Compounded returns from a successful investment in the 15-25% range are not uncommon. There is also substantially more risk in each investment. However, the beauty of the BDC structure is that the BDC can put together a diversified portfolio of investments, and an investor in the BDC experiences the diversification of the full portfolio while also experiencing most of the outsized returns (not all of the returns, of course, since management has to pay themselves something, and it is usually a percentage of the portfolio returns). In a sense, BDC's bring the high returns available in private equity investments to the public stock market.

We have found some excellent investment opportunities in the BDCs for several years running. In 1999-2002, BDC's had very easy access to cheap capital through both debt and equity offerings, the cost of both of which was very low. During a soft economy, they were able to make excellent investments with this cheap money that eventually delivered great shareholder returns when the economy solidified. By carefully choosing our investments among BDC's in terms of both quality and price, we also did quite well.

More recently, as new BDC's have entered the market, we have been quartering the hog a different way. When a BDC goes public, it usually raises a fixed amount of money from the public market, and the stock usually trades at a discount to this cash, usually 10-20%. This discount reflects the initial frictional costs and management incentives, and the uncertainty that the cash will be put to good use. It usually stays in this range until the BDC starts to invest that money, and typically within 12-18 months, the funds are invested.

A fully invested BDC with a good deal pipeline will commonly trade at a 1.25-1.75 multiple to book value. This is because the invested funds are usually earning well above average returns, and the stock is priced based on its dividend yield and expected future returns rather than its asset value.

Thus it has been possible to buy into BDC stocks at 0.80-0.90 of book value, and, if the BDC executes its plan well, see it rise to about 1.25-1.75 of book within 12-18 months, which can lead to compounded returns initially of 25-55%, which is exceptional. If the BDC continues to execute, it will begin to pay a dividend of about 6-12% on top of that, which is icing on a rather large cake.

While this sounds simple, it is far from easy, because there are numerous pitfalls with this strategy. The new BDC's are typically brand new companies with no established track record, thus the execution of their investing plans is far from certain. Private equity investing is a murky world because the companies are, by definition, private, which means that detailed financials on them are often not available. BDC management has considerable influence over the fair value of each private company, and management is paid based on the portfolio performance, so of course they are incentivized to be more optimistic than an impartial observer would be.

Despite these drawbacks, I believe there are many factors that work in our favor. First, buying into a BDC at 80% the value of newly raised cash does not carry a lot of downside, unless management fritters away or embezzels the money. So, even if the BDC does not mature as we hope, there is a limited chance of loss.

Additionally, the first few commitments for a BDC tend to be the showcase investments. A BDC is usually formed when the principals find mouth-watering investments and go to the public markets seeking capital, so the initial harvest tends to be quite sweet. The level of disclosure for these investments is also typically above average, because management knows they are in the spotlight.

All of that said, the private equity space is now becoming quite crowded, as I mentioned earlier. New players in this market both private and public seem to be springing up like weeds. Good investing is best done without competing crowds, and the BDC beach is nearly full of beach umbrellas. We are getting more and more selective in our choice of BDC investments, and exiting most of what we have already bought. We may well be witnessing the end of a 10 year heyday for BDC's. We expect to get returns that are at least acceptable from our current selection of BDC's, though additional commitments in this space in the future are unlikey.

Closing

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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