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Introduction

Stocks have generally been flat throughout 2005, with some ups and downs, with a rally over the past few weeks. The S&P 500 is about +5% as I write this in early December.

Our portfolio selections have been extremely volatile, some moving up and down 10-20% over several days, or in some cases in a single day. It is remarkable to see some stocks up 20-40% in a few months, with other stocks down 20-40%. Overall our gains have been greater than our losses, and I expect most of the losses to be temporary.

As long-term investors, these day-to-day movements should not concern us, in fact they are best ignored. To paraphrase Charlie Munger, a life spent watching stock prices wiggling around it not much of a life. Our primary concern is the mid to long term prospects of these businesses, which are defined by the business fundamentals, not today's market price. If the business does well, the stock price will eventually follow.

A New Image

When you have a minute, please check out our new web site at http://www.tiddcapital.com. I welcome your feedback!

Declines vs. Impairments

You may have noticed my use of the terms "decline" and "impairment" when discussing our portfolios. I thought I'd distinguish between the two terms.

A market price decline just refers to a lower quotation for a given stock, and can happen for many reasons. There could be a specific event perceived to be negative, or a sudden change in the perception of the business on no news. Stock prices move up and down day-to-day for a myriad of reasons that are impossible to predict.

An impairment, on the other hand, refers to other-than-temporary damage sustained to the business itself, or an other-than-minor error on the part of the investment analyst.

At Tidd Capital, our philosophy is to "analyze the business, not the stock". Our attention is focused squarely on analyzing the fundamentals of the business. So day to day stock movements don't concern us, while we take impairments very seriously.

Though certain stocks in our portfolios have had a lot of ups and downs over the past quarter, with one exception that I'll mention, I don't consider the declines to be impairments. It can be tough to see a stock fall, in some cases precipitously, when you own it. But when the stock price moves, we can remember Ben Graham:

"You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right."

The only way to evaluate an investment is based on data and cool-headed reasoning. As seductive as the ever-present market quotations can be, they are the tail, not the dog.

The First Marblehead Roller Coaster

First Marblehead is a financial services company in the private student loan sector, and is a significant holding of ours. Incidentally, the name comes from the town in Massachusetts where the company was founded (I get asked that a lot). The stock has seen sharp declines in the past few months, which raises the question of whether these were just declines, or if the business saw an impairment.

The stock started falling initially over general concerns of Marblehead's business and competitive position, particularly their relationship with their large customers. Then, the CEO, Dan Meyers, was caught giving a $32,000 gift to the contract manager at a large client (Bank of America). The manager was fired by Bank of America, and Meyers was subsequently fired by First Marblehead's board. The stock fell about 15% on the news.

Meyers helped found the business and was instrumental in creating their business model and forming key business relationships, so I did view his departure as an impairment. However, the 14 year old company is more than a one-man show, and I thought they still retained important advantages, including good relationships with Bank of America and their other large clients. Having the founder of a company leave on bad terms is undoubtedly disruptive, however in this case I believe the company will continue and prosper. So I view the impairment as modest.

Later, the company announced that Bank of America sought to renegotiate part of their contract with the company, which is perhaps not surprising considering the nature of the scandal. The stock fell about 20%. Based on my analysis, the worst case scenario from the loss of this business was a 6-7% impact to revenues. Given this, I believe the 20% decline in the stock was way overblown.

So there were three sharp declines in the stock amounting to about 45%, while I estimated that the underlying impact to the business was about 6-7%. The departure of Meyers is difficult to quantify immediately, but I do not think it made the business 38-39% less valuable. In short, I believe the stock fell far more than was justified by the business changes.

In the midst of these declines, the company announced that they were buying back about 8% of their stock. This is good news for shareholders, and the stock rallied about 13%. Shortly after the Bank of America news, the company announced that JP Morgan Chase, now their largest customer, renewed their contract to 2010. The stock rallied about 20% on this news. Later, Bank of America renewed a different part of their contract through 2006. The stock continued to rally.

These sharp down and up movements created a stock chart that looks like a ride at Six Flags. The stock started at about $40, fell as low as $22, and is currently at around $34. An observer looking only at the stock movements would probably lose sleep worrying about it. However, the business fundamentals have remained sound throughout this period and had not changed nearly as much as the stock.

So what does it all mean? First Marblehead continues to provide a very valuable and unique service to their lending partners that is profitable for both Marblehead and the lenders. They have a solid franchise which is growing. The demographics of the private student lending business are excellent, as college enrollment is increasing, the price of college is rising much faster than inflation, and federal student loan programs are not keeping pace with demand. Marblehead's business produces a lot of cash, which Marblehead is using for the benefit of shareholders, through buybacks and dividends.

The price of the stock was cheap when I was first buying it at around $40, and despite the small impairment from the departure of Meyers, the stock is still cheap at $34. I believe the stock offers a compelling investment opportunity, and I intend to stick with it for the long term.

Financial Stocks

We own other financial stocks that are going through a difficult period for totally unrelated reasons. Novastar (NYSE: NFI) and Friedman, Billings, and Ramsey (NYSE: FBR) are financial stocks involved in subprime mortgage lending. The past few quarters have been a very difficult period for this business, as it is coming off of a cyclical peak a couple of years ago. The flattening yield curve has been squeezing their margins, while booming home values provide their borrowers with easy access to alternate forms of financing. There are also concerns brewing over subprime default rates.

Novastar has proven to be far more resilient than their peers in this difficult environment. Their business is better hedged against interest rate changes, and they continue to add new loans to their portfolio at a rate that offsets other weaknesses in the business. I don't think the rough times are quite over for this sector, but we are being paid a fat dividend while we wait for things to pick up. Novastar pays a dividend of about 20% from today's market price, and I think this dividend is very secure. Last quarter, the portfolio generated about $2.04 per share of income, while the company paid $1.40 per share in dividends.

FBR recently jumped into the subprime mortgage business with their acquisition of NLC, a private company with a business model very similar to NFI. They are also reallocating parts of their mortgage portfolio into subprime. They were not as well hedged against the weakness in this sector, and are seeing other problems related to movements in interest rates. However, FBR has other business units including underwriting and asset management that are very strong businesses in their own right. Over time, I believe the subprime problems will wane, and FBR will recover and prosper.

Montpelier Re

Montpelier Re (NYSE: MRH) is a "reinsurance" company, which is an insurer for insurers. Sort of like "risk wholesalers", they provide insurance to other insurance companies and handle huge, multi-billion dollar policies. A reinsurer can in turn have reinsurance, also known as retrocessional coverage. Most reinsurers do so, choosing to accept certain risks and passing the rest on to another party.

Montpelier Re, however, does not carry much reinsurance. The buck, and the risk, stops with them. They accept large, concentrated risks, and earn huge underwriting profits while accepting the brunt of any losses that do occur. This is a strategy that produces high highs and low lows, since the profits can be very high in good years but the losses can be severe in bad years.

I started buying MRH soon after hurricane Katrina hit, at a time when I thought that Montpelier's losses from that event were not going to be severe. Unfortunately, I was wrong in a big way. While initial estimates of Montpelier's exposure to Katrina were fairly minor, after the flooding and other related damages, they ended up taking a huge loss, currently estimated at about 40-45% of their equity capital. They took additional losses from hurricanes Rita and Wilma.

Montpelier has a very impressive pedigree (related to Berkshire Hathaway and White Mountains), and well-heeled financial backers, and were able to immediately raise more capital to shore up their balance sheet. However, the damage was done, both to their financial position and insurance ratings. While the company may eventually recover and prosper, I feel that there had been a significant impairment.

While the extent of the damage from Katrina was difficult for anyone to predict, Montpelier took losses far out of proportion with their peers. Obviously they were writing business and were not appropriately compensated for the risks they were taking. Their strategy is to be ready to write new business after a catastrophe when rates are higher, but in this case they took such a large loss that their ability to do that was significantly impaired. They have since changed their financial structure and underwriting models, though these changes have yet to be tested.

Unfortunately, I exited our position in MRH soon after buying it at a significant loss, and I don't expect the stock to provide an attractive opportunity for reinvestment for the forseeable future.

What's in a Name?

Two of our stocks underwent name and symbol changes over the past few months. Brascan Corporation, long a favorite holding of mine, changed its name to "Brookfield Asset Management", and the symbol changed from BNN to BAM. Separately, MFC Bancorp changed its name to the somewhat less mellifluous KHD Humboldt Wedag, and the symbol changed from MXBIF to KHDH.

In both cases, the change reflects a relatively minor and expected change in the company's image, and does not change the investment thesis or business. There should be no tax implications of this change in taxable accounts, it is in a sense only cosmetic. If you have any questions about this and how it is reported in your statements, please give me a call.

Welcome Stalwarts

Famed investor Peter Lynch popularized the term "stalwart" to describe large, well-established companies that provide steady but perhaps unspectacular returns. Such companies are of above-average quality but tend to trade at above-average prices. Paying too much for a company can negate its quality. On the other hand, getting a great price for such a company can change your investment returns from good to great.

In the past quarter, I had the opportunity to buy three stalwarts that I have long coveted but have not owned. These stocks are Berkshire Hathaway, WalMart, and Anheuser-Busch. These are stocks that any investor should long to own -- at the right price. I have been following these stocks for a long time, waiting for an opportunity -- in the case of WalMart, since at least 1995. Fortunately, the right price arrived over the past few months, and I jumped on it.

"Harvesting" Tax Losses

At this time of year, many investors start to think about taxes. Capital gains taxes are based on what stocks were sold during that year (but only in taxable accounts, not IRA's). If a stock is sold at a gain, the shareholder will probably owe capital gains taxes on that stock. If a stock is sold at a loss, the shareholder may have a tax loss. A tax loss can be used to offset capital gains or income in the same year. It can also be "carried forward" to future years.

I always keep taxes in mind when managing taxable accounts, because my portfolio activities deliver tax consequences to clients. I do my best to manage taxable portfolios in a way that is tax-efficient. I strive for long term capital gains, which are taxed at a lower rate than short term gains, and I look for other ways to manage taxes.

One strategy I employ is to "harvest" tax losses on portfolio positions that are currently at a loss but that I expect to later recover. In order to capture a tax loss, the stock can't be repurchased until 31 days after it was sold.

This can be tricky though. First and foremost, the investing dog should wag the tax tail, and not the other way around. Investments should be bought and sold primarily based on their investment merits, not the tax consequences. If you sell a stock and have to wait 31 days to buy it back, a lot can happen during those 31 days. The stock may appreciate, and you may miss out on that appreciation in the name of saving taxes.

With these caveats in mind, I did do some tax loss harvesting in our portfolios. One stock was First Marblehead, which as I noted saw a sharp decline followed by a sharp increase. This is the ideal circumstance for tax loss harvesting.

I will be in touch with each client who has taxable accounts soon after the end of the year.

Closing

I hope that this letter has given you a better understanding of my investment process and some of our positions. Thank you once again for your continuing trust you have placed in my company to manage your assets. 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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