

First Quarter 2006

Introduction

The S&P 500 has increased by a little more than 4% since the end of the year, after gaining about 6% in 2005.

Many of our portfolio stocks have roared back to life after a weak 2005, primarily certain financial stocks. The star performer of the past 6 months is none other than First Marblehead, a frequent topic of this newsletter, which is back on solid footing and has nearly doubled from its lows in October 2005. Almost all of our stocks have posted solid gains over the past 6 months.

In some cases our portfolio has benefited from stock prices moving from a discount to fair value. In other cases, the "fair value" has increased, as businesses have continued their above-average performance. By buying into above average companies at below average prices, we should hope to get some of both.

When to hold 'em, and when to fold 'em

There is a Charles Schwab advertisement where an investor is lamenting some stocks he has in his portfolio that fell, but never went back up. But he isn't sure if he should sell them, in case they do recover. He jokes that he wishes he had a "dog detector" to help him find the stocks that will never recover.

The question of whether or not to sell a declining stock is an important one. As a value investor, I often buy into declining stocks, and it is rare to have a stock immediately reverse direction once I buy it (don't I wish that happened). So almost every stock is held at a loss for some period of time. In some cases, the business changes fundamentally for the worse after I buy, and I need to assess the damage.

First Marblehead fit both categories. After purchasing it, the stock fell due to a change in general sentiment surrounding the company. Then, a scandal leading to the abrupt departure of the co-founder and CEO occurred. At one point the stock was down nearly 50%. After losing some sleep, I checked and re-checked my analysis.

Despite the scandal and a negative sentiment surrounding the stock, I thought the fundamentals were still sound. The stock had fallen to a price that only made sense if a "worst case" scenario would occur, and I was not convinced that it would happen. Meanwhile, the company had many compelling advantages that I thought could lead to a stronger and broader business, despite the scandal. I maintained our investment in First Marblehead as the storm raged.

So far, it looks like I was right. Shortly after these dark days, First Marblehead extended their contract with one of their largest customers (JP Morgan / Chase) through 2010, which was one thing analysts were worrying about. Not only that, but the terms of the new deal appear to be just as good as the old terms, which stanch another concern. Since the departure of the ex-CEO, they have taken

steps to broaden their business, which would decrease their customer focus -- addressing another concern.

The last item makes me wonder if there was a silver lining on the cloud surrounding the CEO's departure. Sometimes a founder leaving a business can be a good thing, since founders tend to run their businesses in an autocratic fashion. The departure of such a figure sometimes allows initiatives to gain traction and improve the business.

First Marblehead is still not without concerns. They still have a significant client concentration, and we have not yet heard from Bank of America, one of their largest customers who were involved in the scandal. However, the stock is developing well and I look forward to seeing how they perform in 2006.

Probabilistic Investing

Each moment in a stock's history provides the investor with an opportunity to make a risk/reward assessment. We can choose to act, or not to act. Fortunately there is nothing that forces us to act, so we can wait until we are given a "pitch" that we like.

When a situation changes rapidly, it is tempting to look at the past to guide our future. Perhaps the most compelling distraction is the stock's recent history. A rapidly rising or falling price can deliver a compelling, if misleading, message. Investors are best served to ignore this. Another mistake is to let your original cost basis stick in your head as a milestone, even though the circumstances surrounding the stock were totally different when you established your position.

A disciplined investor must screen out all of this noise, and repeatedly reassess the risk/reward potential given the present business fundamentals. The stock market tends to overshoot in both directions, and a rapid stock movement is likely to be inaccurate.

When the events surrounding a company are coming fast and furious, an investor must keep a cool head. Each change in the situation requires a reassessment of the business fundamentals that include the new information, and a risk/reward assessment can be made, independent of all other assessments.

This approach was particularly useful with First Marblehead, which went through significant "events" in rapid succession over a period of about 6 months. The manic-depressive nature of the market meant that the impacts to the business were not nearly as severe as the stock action suggested. In fact, at times there were new opportunities that were even better than the original one, which allowed us to benefit from the volatility.

Intended Holding Period of 2-3 Years

The experience with First Marblehead also reinforces a point I often reiterate -- our intended holding period for investments is 2-3 years, and portfolios should be evaluated over a similar period of time. As we saw, during a 6-month period, a stock can drop by 50% and then fully recover. If an investor had a 6-month holding period, or if they claim to have a 2-3 year holding period, but then lose their nerve at the first downturn, they can sell out at the bottom. "Buy high and sell low" is not a formula for success.

A Tale of Two Investors

Bill Miller is a fund manager at Legg Mason who manages the well-regarded Legg Mason Value Trust as well as the newer Legg Mason Opportunity Trust. He has put together an unusually good track record, beating the S&P 500 in every single year of his tenure. He has a reputation for making unusual investments that are decried at the time but end up doing fabulously well. A recent example is his investment in Google, which has increased about 350% in less than 18 months.

Miller is an eternal optimist, and is known for making universally bullish commentary on the markets. His comments in a recent interview were no different. Miller predicts that oil prices have hit a peak, and that many businesses are in cyclical troughs.

They say that "Main Street drives Wall Street", and Miller says that the American consumer is doing just fine. He says that the low level of savings among consumers is appropriate given high home values. He suggests that if you combine savings and home equity together, then over the past several decades, consumer "saving" follows a recognizable trend line. This diffuses much of the talk about consumer indebtedness and credit risk, which is one major concern of the markets.

Not surprisingly, Miller is optimistic about the US dollar, the US consumer, and the US stock markets. He expects financial and technology stocks to do particularly well in 2006. The prediction of financial stocks, if true, would be a boon for us, since we have a significant weighting in financials, as I've mentioned before.

On the other hand is Warren Buffett, the famed chairman of Berkshire Hathaway (one of our holdings), and the second richest man in the world. He also has one of the best long-term (i.e. 50+ year) investing track records that have been recorded, which is the exclusive source of his incredible wealth.

Buffett, however, is no optimist. He has had a decidedly gloomy opinion of the markets. For years he has maintained the view that the US stock markets will return around 6-8% per year for the next decade or more, a far cry from the performance of the past decade. He has been negative on the US dollar, primarily because of the US trade deficit, and has been engaging in huge hedging and foreign currency transactions in his investment company.

Buffett's pessimism extends from the markets to its participants. He blasts corporate executives for being overpaid and not behaving in the best interests of their investors. He also believes that fund managers are overpaid and do not experience the risk of their investments, which encourages them to take significant risks. (It behooves me to mention that I am invested in the very same investments as my clients, so this is not true of me!). These people, he believes, are behaving in ways that make the markets irrational and unstable.

Not only that, but Buffett has been suggesting for years that there will be a large-scale financial catastrophe, what he calls a "dislocation". He has given a few specific ideas about this disaster. He has been a very outspoken critic of derivatives, which are sophisticated financial instruments that are used to hedge and spread risk. A few years ago he seemed almost certain that a disaster was imminent, yet despite wide swings in commodity prices, there has been no disaster.

Buffett, perhaps more than any investor, puts his money where his mouth is. Over 99% of his wealth is in Berkshire Hathaway, and his company's holdings are currently dominated by cash and liquid investments. He holds an incredible \$115 billion of cash, bonds, and equities, which include foreign investments and hedges. He has, by any measure, battened down the hatches and is waiting for a 100-year storm.

It is hard to imagine that both of these famed investors can be correct in their predictions, considering their diametrically opposed viewpoints. However it would probably be foolish to disagree with them, considering their track records. It will certainly be interesting to see what transpires in the next few years.

My approach in the face of this uncertainty is the same as my approach in other times -- look for a small number of carefully researched investments, which each offer a compelling risk-reward potential, and create a portfolio with enough of them to achieve adequate diversification. It is important to remember that we are not invested in "the market" as a whole -- we are invested in 10-20 individual investments, which may or may not be correlated with broad market trends. And my money is invested alongside yours, so you can be sure that I'll experience the same ups and downs that you do.

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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