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Introduction

The stock market as expressed by the S&P 500 and Dow Jones indexes approached all-time highs at the end of April, before reversing course in mid-May. The "sell-off" in the markets has been abrupt, but as is almost always the case, there was no specific event that triggered the change. The declines have continued until the time of this newsletter in mid-June.

Market observers mention energy prices, inflation, interest rates, the war in Iraq, the level of consumer debt, and other macroeconomic factors as cause for concern. However, these same concerns have been present for months or years, even as the markets have been rising. But one morning, market participants changed their mind, and suddenly equities started to decline in value in a broad sell-off which continues today in mid-June. The selling has been in international markets as well. The Bombay stock exchange was even halted for an hour after a sudden 10% decline on May 22.

These events, while dramatic, probably have very little bearing on the long-term prospects of our investments. But this manic-depressive behavior serves to highlight the short-term risks of the equity markets. Stocks or entire indexes can change in value by 10-20% or more abrutply with no warning and with no specific reason. However, over longer periods of time, the market performance is driven by economics. As Ben Graham famously said, in the short term the market is a voting machine, and over the long term it is a weighing machine.

Just a few days before the reversal, The Wall Street Journal described the economic environment as a "good old fashioned economic expansion". Despite recent stock market activity, this may still be true. The business fundamentals of many businesses are sound, and the economy and the consumer appear to be doing well.

Correlation With the Market

My goal is to outperform the market over the long term. The two ways to maintain an edge over the market are to gain more than the market when it gains, and to lose less than the market when it falls. In the short term, I would be just as happy to gain 15% while the market gains 10%, as I would to lose 10% when the market loses 15%. This stance makes sense because, as Warren Buffett repeatedly says, good relative results will lead to good absolute results.

One way to achieve this goal is to make investments that are not correlated (or, more precisely, negatively correlated) with the market. That is, investments that perform according to variables other than broad economic factors and general corporate performance.

One pattern that I employ frequently is buying into companies at a price that is below their tangible net worth, and looking for gains as the stock trades up to a premium to book value. I look for situations where there is something "wrong" with the stock causing it to trade below book value. This may include an unresolved lawsuit, a surplus of capital which leads to poor performance metrics, a limited operating history, and other factors.

I look for situations where I believe the concerns are overblown or fixable, or both. This requires careful study of the facts and some judgement calls, but there are many situations where the price of the stock overemphasizes the possible negative outcomes. But most importantly, I only consider situations where management has shown clear interest in improving the value of the stock, through buybacks, insider ownership, and financing that benefits equity holders.

The value of these companies is usually driven by a few specific events, such as the resolution of a lawsuit, a small number of investment transactions, or a business plan reaching the "rubber hits the road" stage. These investments are much less affected by economic factors such as interest rates, inflation, and stock market activity. This negative correlation with the broad economy is desirable, since it provides our portfolios with some protection against potentially adverse economic conditions.

Performance

This past quarter I have started reporting the performance of each client account, both an an absolute basis and relative to the S&P 500. Shortly, I will start reporting composite performance across all accounts. It behooves me to mention a few things about performance reporting.

Like a lot of things where complex results are boiled down to a single number (such as perhaps I.Q. scores), the method of calculation and presentation of the numbers can be very important.

There was once a group of elderly ladies from Beardstown, Illinois that formed an investment club that they called the Beardstown Ladies. They achieved nationwide notoriety when they reported investment returns of 23.4% compounded for 11 years, a world-beating record on par with that of Warren Buffett. This led to the obligatory best-selling book on investing, and a lot of people thinking that great investing is easy, since a bunch of old ladies could do it during afternoon tea.

About 4 years after the book was published, while the Ladies basked in media attention, Chicago magazine revealed that the Ladies were including their cash contributions in their performance returns. Say that you start with $10,000, and you invest it in some stocks, and it grows to $11,000. At the end of the period, you contribute $2,000 of new money, and you end up with $13,000. Your "performance" during this period is +10% -- the difference between $11,000 and $10,000. However, the Beardstown Ladies reported this at +30% -- the difference between $13,000 and $10,000. This is simply incorrect and, if they were registered investment advisors like yours truly, it would probably get them in trouble with the regulators.

When their performance was calculated with commonly acceptable methods, it amounted to about 9.1% per year -- not terrible, but well below the 14.9% return provided by the S&P 500 during that period. The Beardstown Ladies actually underperformed the market by a few percentage points during their time, which is typical of amateur investors. Their claims of world-beating performance were a result of misrepresenting that performance.

There are important lessons here. One, don't believe all performance figures that you read, especially published by amateurs, and especially if they are extraordinary. Two, great investing is difficult, and it not something that comes naturally to most people.

There is a group named the CFA Institute (formerly known as the Association for Investment Management and Research, or AIMR) which publishes recommendations on how to calculate and report performance figures. Performance figures at Tidd Capital are done according to their standards. This is the reason for the switch to accrual accounting at the beginning of 2006, one of their recommendations. If you have any questions about how Tidd Capital performance figures are calculated are presented, please don't hesitate to contact me and I'd be happy to provide more information.

Oooh! Challenging!

My local sushi restaurant has menus on the tables that show pictures of the different kinds of sushi. At the top of the menu are the typical varieties -- tuna, salmon, yellowtail, California roll, etc.

Halfway down the menu is the caption "Oooh! Challenging!" and below that are the more unusual varities: salmon roe, sea urchin, octopus, giant clam, etc.

While I enjoy all kinds of sushi, I find the idea of presenting a food item as "challenging" to be a bit strange. Do you really want your lunch to be "challenging"? Wouldn't it be better to stick to the "easy" pieces?

The same might apply to portfolio management. It sure would be nice to put together a portfolio of "easy" investments, those that are are obviously both safe and likely to provide superior returns. This desire for things to be easy does not stem from laziness. Simple situations have fewer opportunities for errors and unpleasant surprises, and can be more comprehensively analyzed and followed. Adjusted for risk and certainty, "easy" investments should provide superior returns.

Unfortunately, it is rare to find investments that are both easy and extraordinarily profitable. It does happen, but, even for the most diligent investor, all too infrequently. By "infrequent", I mean as seldom as once every few years. I clearly (and fondly) remember the fall of 2002, when everywhere I looked, there were cheap , excellent stocks, ripe for the picking. World-beating manufacturers trading at 8-10x earnings, unflawed micro- and small-caps trading at 0.25-0.35 of book, etc. It was a time when fortunes were made.

Unfortunately, I haven't seen a time like that since, and I've been watching and waiting almost four years. I may not see such a time again if I wait four more years, and there is no guarantee that I'll ever see it again. Given this dearth of "easy" opportunities, what is an investor to do?

Some people say that we should just sell our investments and sit on our cash, waiting for the good times to come again. While this may have an austere appeal, how long might we have to wait before the money can be invested? And will clients be happy to pay their investment advisor to sit on a pile of idle cash for years? And when considering opportunity cost and the time value of money, is it really better to wait 5 years or more for a good investment?

But there is an important question that often goes unasked by these analysts that quickly dismiss a challenging market environment as "too hard" -- are you really trying as hard as you can? Have you truly turned over every rock, and done all that you can to expand your circle of competence to new areas?

Having been raised by my father with a strong midwestern work ethic, I've never shied away from hard work. So my approach to the current difficult environment is simple: work harder. I've been looking at the lower half of the sushi menu, to the sea urchin and octopus of the stock market, to find investments that are good, albeit more challenging. There are usually reasons why these stocks are avoided or unloved. They usually require a lot more time to understand, and have some kind of unusual accounting or complex structure. There is often some kind of scandal or purported scandal associated with them.

One such area is structured finance companies, or "securitizers". Companies in this sector have been frequent topics of this newsletter. These companies acquire or originate loans or other financial assets, aggregate them into asset backed securities, and sell them to institutional investors. Often their earnings are "noncash" -- mere accounting entries, that are calculated based on management estimates. I developed an appetite for these "financial boutiques" years ago, and I've been feeding at this trough ever since.

Aside from the usual financial statements, which are longer than normal, these companies publish securitization prospectuses which describe their deals, which can be hundreds of pages long. Some companies might have 4 or 5 of these per year. This adds up to 1000 or more pages of reading per year per company, and even then, the analysis of these figures is up for debate. Additionally, many of these companies suffer under a seemingly constant barrage of misinformation and criticism in the mainstream press due to their complexity.

This becomes even more "interesting" when the companies are involved in some kind of scandal. First Marblehead is a good example, as the CEO was ousted for giving gifts to the contract manager at their largest client. With other stocks, the "scandal" may be initiated by short-sellers who are trying to discredit the company and its management. The scandal may be nothing more than hot air, but this needs to be verified conclusively through analysis and research.

Over the past couple of years, this extra effort has paid off, as I have been able to identify stocks that, once the smoke cleared, were clearly undervalued, and provided superior returns. Developing expertise in these market niches provides a continued advantage as well, since it opens up parts of the market where many investors do not care to tread.

Closing

I hope that this letter has given you a better understanding of my investment process and our portfolios. 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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