

First Quarter 2007

Introduction

Our portfolios enjoyed outstanding performance last quarter and for the full year 2006. It wasn't just a matter of a rising tide lifting our boat – we outperformed the market by a very wide margin as well. However, I caution clients not to expect this kind of performance every quarter or every year. While a windfall quarter or year is certainly welcome, we all need to temper our enthusiasm when looking at recent performance figures, and think instead in terms of 2 or 3 year averages. Nonetheless, my goal remains to outperform the market, and I will stay focused on the task.

Nearly everything went right in 2006, including some extraordinary outcomes that can be attributed in part to luck (something I don't ever count on). Generally, I try to buy stocks at a discount to fair value, and sell them at close to fair value, a process which I believe should lead to above-average returns with below-average risk. The time it takes for stocks to make this change, however, can have an impact on our returns. A gain of 10% that occurs in 12 months is an annualized gain of 10%, while a gain of 10% that occurs in 6 months is an annualized gain of 21%. Annualized gains are what drive our portfolio performance over the long term, so the quick returns are certainly welcome.

Sometimes, a stock takes a long time to get to fair value, which reduces our return, even if my assessment of the situation was correct. In other cases, a stock will promptly soar to well above fair value, which gives us a super-sized return. There were many of these latter situations in late 2006 – companies that we purchased at 50-70% of fair value and quickly soared to 125-150% of fair value. The rise to fair value is easily explained, but the rise well above it is not. But when the market gives us gifts, why ask why? In many cases, I was able to time our sales well, which led to outsized returns. Many of these stocks promptly fell back to fair value after we sold. It is this kind of good fortune that we can't count on in the future.

All is not joy and sunshine though. In some cases, either my assessment of fair value was incorrect, or the company or its industry took a turn for the worse, or both. In these cases, the stock did not go up at all, but it fell and kept falling, and my decision was at what point to cut our losses instead of reaping gains. As painful as this is, it does happen occasionally, as it did recently with Novastar, which I'll discuss in detail later.

As Warren Buffett famously said, the first rule of investing is never to lose money, and the second rule simply refers the reader back to the first rule. I take this credo very seriously at Tidd Capital, and never enter into a new investment thinking I might be taking a loss. There is no attitude of "let's give this a try" or "let's buy and cross our fingers". The primary goal with every investment is to avoid losing money. If this is accomplished, the positive returns will usually manifest themselves.

New Client Contributions

Over the past 12 months, Tidd Capital has seen a steady influx of new capital from clients. This has been mostly from existing clients, though we have a few new clients joining us too. First let me thank clients for their continued contributions, and give you my pledge to manage these assets the best I can, and consistent with the philosophy that I have spelled out in these newsletters.

Clients often ask when and how the new funds will be invested, especially in light of the declining market, and problems in some specific industries, such as the blow-ups in subprime lending. My inference is that they are worried about the funds being rushed into investments that match some kind of model or allocation strategy, without due concern being given to the quality of the investment at that particular moment in time.

My strategy is simple – money will be invested only when there are excellent investment opportunities available. If there are no good opportunities available, the funds will sit in cash until I find something. Money is never invested just for the sake of getting it invested, nor do I strive to match some predetermined allocation at the expense of performance.

Most of our buying opportunities are fleeting, and something that is a good buy in January may not be a good buy in June. Thus, it only makes sense not to buy it in June, and wait for another opportunity. Given the choice between a bad investment and no investment, making no investment is the obvious choice. Over the past few years, I have generally been able to find new investments at a pretty steady pace, so we haven't really had much of a problem with surplus cash. The problem, if any, has been choosing among a number of good ideas to find the best ones. Currently, however, good buys are few and far between, so clients should not be surprised at seeing their funds sit in cash for 6-9 months before they are allocated.

Another aspect of this that some clients ask about is how I manage numerous separate accounts with this strategy. If buying is done differently in different accounts, then the accounts will not all be identical, making them harder to manage as a collection. I have touched on this in the past; please see the section titled "Portfolio Mechanics" in the Q3 2006 newsletter.

To summarize, given the choice between consistency and performance, I will always choose performance. Each account is managed as if it stands alone, and is given the best possible buy, hold, and sell decisions available at the time. In practice, this is usually only an issue with the initial period of each account. If it takes 6-9 months to get an account allocated, during this time it will be different than most other accounts. But over the ensuing year or two, the account will usually begin to conform fairly well to the other accounts as it goes through some buy and sell cycles. The additional oversight required by the early accounts is manageable, and is of benefit to clients, since their accounts get the best possible treatment from a performance standpoint.

Novastar Gone Supernova

The subprime mortgage industry has been in a rough period for several years. The industry started to turn for the worse in at the end of 2004, and really started to get bad in 2006. As the year progressed, various participants reported various bad news items – poor results, impairments, losses, and some participants either left the business or even went out of business.

Throughout this period, Novastar soldiered on, and appeared to keep competing in a tough environment. They had some important advantages, including a large, seasoned portfolio that was still producing cash, a broad low-cost origination platform, and ample liquidity. There were indications that they were taking market share from their competitors as their competitors faltered. I was keeping a very close eye on them, due to the difficult environment, and was convinced that they were still in decent shape and would be able to sustain their business and the dividend payments.

I got a lot of questions from clients in the second half of 2006, clients who saw the headlines and were wondering what we were doing in this stock. It turns out that their concerns were well founded.

I anxiously awaited Novatar's earnings report on February 20, when Novastar management was due to announce their results for the year 2006 and hopefully provide some guidance for 2007. The operating results in 2006 were not bad, in fact better than I had expected. I had predicted impairments of \$50-100M, but the actual figure was about \$17M, and otherwise their business in 2006 was fairly sound.

What I didn't expect was the bomb they dropped on their shareholders regarding their future. They stated that they were changing their fundamental business model, and did not foresee any "taxable income" or required dividend payouts after the end of 2007. They also announced that they were going to get out of the subprime market where they had been for the past several years, and were moving into a lower-risk, lower-return market.

This is a very negative development, and also an unexpected one. Something that would not have surprised analysts would have been deteriorating loan performance or impairment charges. But to fundamentally change the business plan, abruptly and with no notice, was a real shocker.

In retrospect, these changes make a certain kind of sense. Clearly the company is not generating the same kind of recurring earnings as it has in the past, and doesn't foresee the ability to do so, and maintaining a high dividend payout has become impossible. Also, subprime lending has gotten a lot harder than anyone anticipated, and may still get worse, and at some point you have to give up on a business that produces nothing but red ink.

However, something was clearly happening in the company that made these drastic changes necessary, which is a more looming question. Given the catastrophic nature of these changes, what other "more catastrophic" alternatives did they avoid? One of Novastar's peers is New Century, who recently announced that not only were they considering bankruptcy and had stopped taking loan applications, but there is a criminal investigation into the company. Perhaps Novastar is attempting to take preemptive action to avoid the same fate.

This leads to the crux of the matter, which is management ability and credibility. In this age of corporate scandals and Sarbanes-Oxley compliance, management is very careful about what they say and to whom they say it. Ironically, this can cause management to be less transparent, and leave shareholders in the dark. I believe that this definitely occurred at Novastar. The company has been under intense scrutiny from analysts and the press, due in part to a long-standing campaign by hedge funds and short sellers to discredit the company. As time passed, the gap between what was happening inside the business and what they reported to shareholders grew wider.

For example, the way management staged the conference call to discuss these results, their press release hit the wires at 4pm and they held their conference call at 5pm. Considering the dramatic nature of the changes, a period of less than an hour is nowhere near long enough for analysts to formulate decent questions. On the call, the thunderstruck audience asked their canned questions, few of which were relevant to the recent changes that nobody expected. Only near the end of the call did some analysts try to probe more deeply into the consequences of the changes, but barely scratched the surface. In the subsequent days, analysts finally had time to process the information, and blasted the company for these changes and the way they were presented.

As a shareholder, frankly this stinks. One of the primary things I look for is integrity and ability in

management, which means working for shareholders and keeping them informed. In any company, and especially a complex financial company, being unable to trust management makes the company unworthy of investment. The result was that I exited our investment in Novastar abruptly the day after this announcement at a loss.

Despite these surprises, I still take the blame for our investment and loss in Novastar. I consider it a key part of my job to give possible meltdown situations a very wide berth, which means keeping an attitude that is very conservative and skeptical. There was nothing forcing us to be invested in this sector or this stock, and there were ample other investment opportunities available. When I should have been listening to both analysts and clients, I convinced myself that this company was going to be the one exception in an industry experiencing widespread meltdown. As Warren Buffett has said, "When a management with a reputation for brilliance tackles a business with a reputation for poor economics, it is the reputation of the business that stays intact."

One modicum of good news is that I acted quickly to cut our losses. The stock fell to around \$11 the day after the announcement where my sales took place, and later fell as low as \$4. While we took the loss from the mid-\$20's to \$11, I avoided the loss from \$11 to \$4. The stock is currently floundering around the \$4-5 range, and it isn't clear at all where it is headed. It is possible that Novastar will rise from the ashes with its revised business model, but this is a very difficult thing to assess, or invest in. There is some outside chance that the company will be sold, though it remains to be seen if it will fetch a decent price. Some of their peers have been sold off at multiples similar to Novastar's current price, and some have not survived at all. In any case, the numerous problems and uncertainties make this situation unsuitable for our investment.

Closing

It is my privilege to manage your assets, and I appreciate the continued trust clients place in my firm. I hope that this letter has given you a better understanding of my investment process. 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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