

## First Quarter 2008

### Intro

There's no other way to say it. 2007 was a bad year. Due to both specific problems with some of our investments and a backdrop of financial turmoil and falling stock prices, we substantially underperformed the market during 2007. Our results were also negative on an absolute basis, making this my worst-ever one-year investment performance.

Fortunately for longer-term clients, this comes on the heels of excellent performance in 2006, and the longer term track record is still attractive, but that does not entirely dull the disappointment of the 2007 results. It is no fun to underperform, even for a short while, but as long term investors it is inevitable. As Bill Miller recently wrote, "It would be great if we could figure out how to never underperform. No one has been able to do that, but that does not make it any less painful."

The markets have good years and bad years, and occasionally there is a terrible year, as we have just experienced. Each terrible year is different in some way, and usually comes as a surprise to most market participants. However, the US economy and stock market are generally strong over the long term, and as an investor, it is sensible to strive to capture the benefits of the frequent good years rather than try to avoid the rare terrible years.

I have done my best to chronicle the events of 2007 and how our investments have been affected in the three prior quarterly newsletters. By giving insight into my thinking and investment process, my goal is to provide you with confidence that your money is soundly invested even if the market doesn't provide you any such feedback. Markets tend to "overshoot" in both directions, and it is wise to be skeptical of what the market is telling you at both extremes.

The good news is that, despite what stock prices might indicate, most of our companies are not suffering any permanent impairments, and some actually benefit from difficult economic times. Our companies are also trading at extremely low valuations. Given the chance, I would make each and every one of the current investments again at today's prices, and feel confident about our ability to preserve our invested capital and obtain attractive long-term rates of return.

My first goal with any new investment is to be as sure as possible about being able to get our capital back out of the investment in a reasonable time, in other words, to not lose money. This doesn't mean that the stocks we buy will never go down, in fact virtually all of them decline below our cost at some point. The safety of capital is found in paying a reasonable price for companies that are soundly financed with solid business models, run by people who have their own money invested alongside ours, and who have proven themselves to be capable and effective business partners. Every business hits problems at one time or another. A well-run, well-financed business with a sound business model will be able to weather storms and eventually deliver solid results.

Though I strive for as much certainty as possible, investing boils down to a game of probabilities. The most sensible approach is to only invest money when the odds are strongly in your favor. Additionally, investing should always be done with a margin of safety so that the negative impact of unpleasant surprises can be absorbed. However, even with an 80% chance of success, there is a 20%

chance of failure. Through repeated investments and a longer time frame, betting when the odds are with us should provide us with good results.

The current economic and market environment reminds me of 2002, when the economy was suffering a mild recession, and the hangover from the dot com collapse had made many investors wary of equity investments. Valuations were low and bargains were plentiful. Choosing new investments was like shooting fish in a barrel – excellent companies of all varieties were available throughout the market at bargain prices. Not surprisingly, 2003 was a spectacular year for those who confidently bought what everyone wanted to sell. The first part of 2008 seems like a very similar environment to 2002, and appears to be an excellent time to make new investments. The first place to start is with our current investments, which I believe are even more undervalued now than when we first bought them, and new opportunities are also emerging.

One of the ironies of the investment process is that the best time to invest new money is after a downturn, and when pessimism is high. Conversely, the worst time to take money out of the market is usually after a sharp downturn. I am very fortunate to have a very patient and knowledgeable client base which clearly understands these facts. Since inception, there have only been two substantial redemptions by clients, one of which was due to the client's death. Meanwhile there has been a steady stream of new accounts and contributions, including during the turbulence of the last 6 months. For any clients or prospective clients who have been waiting on the sidelines for a good time to get into the market, the iron appears to be hot.

## **A Good Cry**

Market panic reached a crescendo early in 2008, as the international markets had what can only be described as "a good cry" on January 21. On this day, the US markets were closed in observation of Martin Luther King holiday, so all of the bad karma was experienced only by international markets. According to Wikipedia, the FTSE 100 had its biggest ever one-day points fall, European stocks closed with their worst result since September 11, 2001, and Asian stocks dropped as much as 15% with the BSE Sensex making its highest ever day's loss of 1408 points. Because the US markets were closed, US investors could only watch nervously all day, wondering just how bad the declines would be when their markets opened on Tuesday.

Uncle Ben to the rescue! In a surprise announcement, the Fed led by Ben Bernanke announced a 0.75% rate cut on the morning of Tuesday, January 22 at 8am, clearly in response to the international market turmoil. This calmed the markets that day, though general stock price weakness continued. The Fed cut rates again by 0.5% on January 30, and "signaled" that they may cut further.

While these "surprise" rate cuts did help to inspire some confidence in the markets, the Fed cut doesn't have the direct cause-and-effect relationship on business value that CNBC might lead you to believe. As with the IQ score, people have a tendency to try to boil very complex things down to a single number. However, the complex US economy, not to mention the world economy, doesn't hinge on a single input controlled by the Fed.

Many companies are affected in one way or another by rate cuts. Generally, financial companies benefit from a lower Fed funds rate, because this can decrease one of their primary costs. More specifically, financial companies benefit from a "normal" yield curve where short-term rates are lower than long-term rates. While considered "normal", the yield curve has not had this shape since late 2005. For about 2 years, we have had an abnormal "flat" yield curve, which puts pressure on financial

companies of all kinds because their cost of funds is equal to their risk-free rate of return. This, I believe, is one of the things that led to the current credit crunch, as financial companies of all types had to take on risk to achieve any return on their investment.

Furthermore, there is still evidence of a very unhealthy deep freeze in many parts of the financial markets. Formerly liquid debt securities such as syndicated loans and auction rate securities have been completely illiquid as nobody is willing to buy them, thus nobody can sell them. Many corporate treasurers are mystified and frustrated by their inability to liquidate what are supposed to be fully liquid short-term AAA-rated investments. Prices on debt securities are reportedly down as much as 20%, but no assets are actually changing hands, calling into question the validity of those prices. Meanwhile, by and large borrowers are paying and corporate credits remain good, so there is a substantial dislocation between prices and quality. All of these things add risk and instability to the markets, and indicate knots that at some point must unravel in order for normalcy to return.

The Fed directly influences only the short term rates, which in turn improves liquidity. The long term rates have a mind of their own. However, if Uncle Ben's rate cuts lead to a sustained normal yield curve, I believe this will provide a breath of fresh air through the finance industry. In other words, the cycle may be starting to turn. This should have a positive effect on our financial holdings, which still represent a substantial portion of our portfolios.

## Investment Review

One of the most direct beneficiaries of a lowered Fed rate and a steepening yield curve is old-fashioned depository banks. One of our investments, Access National Bank, is just such an institution. Particularly valuable and relevant today, management at Access subscribes to the "belt and suspenders" school of banking, running a very conservative business, funded entirely through deposits and Fed borrowings and lending to only the best credits. They are also situated exclusively in Northern Virginia, one of the country's strongest local economies. They have an added benefit – in September 2006, Access did a stock offering to raise a substantial amount of capital, and the subsequent 15 months turned out to be a very good time to be well-funded.

Access was inevitably affected by the problems in residential mortgages, but at no time was the business significantly impaired. The surplus capital has allowed management to buy back substantial amounts of stock during this period, which will enhance shareholder returns going forward. Importantly, Access management has been personally buying stock on the open market, adding to already substantial holdings, reinforcing their commitment to delivering value to shareholders. I am delighted to continue our partnership with Access and its management.

Our investments in business development companies (BDC's) have declined substantially in market value over the past 6 months, however in two out of three cases, there have been virtually no actual impairments in their results or operations. It is merely the fear of some unknown future problem that has driven them down to record-low valuations.

For example, Gladstone Investment Corporation reported a 2% decline in net asset value (NAV) in Q3 and a 0% change in NAV in Q4, yet the stock fell 23% during this time. In my opinion, Gladstone represents the gold standard in BDC companies, due primarily to founder David Gladstone, who, as described by The Washington Post, "has been in this line of business longer than anybody". Investors would be hard pressed to find a more capable business partner, and we are able to invest with Mr. Gladstone at a substantial discount to fair value.

Similarly, Triangle Capital reported zero non-performing assets and a 2% increase in NAV in Q3, yet the stock is off 12%. These companies are performing quite well, and the tighter credit environment actually favors them since they will have less competition in making investments at better terms. Both companies have ready access to additional capital for making new investments without needing to tap the capital markets.

Highland Distressed Opportunities is unfortunately not faring as well. Highland unwisely had a substantial portion of its assets invested in the public equity markets in Q2 2007, and this proved to be a costly mistake when the markets declined in Q3 and Q4. This significantly impacted their NAV and robbed them of what should have been one of their strongest advantages, the ability to make new investments in distressed markets (the name of the company is "distressed opportunities" after all). Their net asset value declined 12.5% in Q3 2007, and they have yet to report their Q4, but I expect another significant decline. Fortunately, I first bought the stock at a substantial discount to NAV and thus we do have some margin of safety even against these problems. Considering their recent missteps, I have lowered my appraised value for the company. Even so, the market is discounting the stock far more than my new valuation, so we will continue to hold until the price reaches fair value.

All three of these companies are characterized by veteran management teams who have managed through many economic cycles, and are no strangers to recessions and credit turmoil. They are also each widely diversified, with dozens of individual investments in numerous industries, and in aggregate have very little exposure to the financial or housing sectors. BDC's are inherently less risky than many banks and lenders since they carry a much lower level of leverage and are broadly diversified. The current environment is an excellent time for them to make new investments, though we will have to wait a few quarters for those benefits to manifest. Fortunately, the stocks have high dividends, with yields varying from 9% to 13%, so this waiting is not unpleasant.

Brookfield Asset Management reported stellar results in all quarters of 2007, and hardly missed a beat even as the worst of the credit problems roiled the markets. The last two quarters of the year included only immaterial impairments, a testament to their resilient business model, while expansions occurred in nearly every business unit. Since the credit world changed in August 2007, Brookfield has been able to execute several major transactions, including buying, selling, and refinancing, demonstrating that their access to capital and ability to make deals is not impaired in this environment. The market for commercial property leasing is very strong, as are the Brazilian and Canadian economies, and Brookfield has substantial operations in all of these areas. Like the BDC's, Brookfield's excellent access to cheap capital in a market starving for liquidity should prove to be an advantage in making new deals. The completion of the Multiplex acquisition and the spin-off of Brookfield Infrastructure Partners provide them with two new platforms upon which to build starting in 2008. While the stock is down recently, perhaps in sympathy to other financial and real estate based firms, I think they are positioned for an excellent 2008 and I look forward to continued partnership with Bruce Flatt and his teams.

One of the particularly disappointing aspects of 2007 performance was that the stocks of international companies with little or no direct exposure to the US economy fell in unison with the US markets. KHD Humboldt for example derives more than 85% of its revenues overseas and is driven by the industrialization of emerging economies around the world. Yet the stock fell, as if the sub-prime mortgage problems in the US somehow have a negative impact on building of cement plants on the other side of the world. Despite its stock performance, KHD is still in firm stride, signing up new contracts and producing cash. KHD is entirely self-funding, carries no debt and an enormous cash surplus earmarked for acquisitions. Investment candidates should be particularly attractive in this

environment where valuations are down and there is far less competition for buyers, and I look forward to seeing what KHD decides to do with its cash.

A similar disappointment occurred at Allied Irish Bank, the largest bank in Ireland. Just as Access National operates in one of the strongest local economies in the US, Allied Irish Bank operates in the strongest European regional economy. Ireland has been called the "Delaware of Europe" due to their very pro-business policies, and their economic growth over the past 20 years has been impressive, and seems sustainable. Allied also has operations in Poland, which is one of Eastern Europe's strongest emerging economies. Despite modest connection to the US economy which has had some problems, Allied's stock price is down more than 30%. Meanwhile, most of their profits are derived from other markets that are doing very well. As the stock price better reflects the underlying fundamentals, I believe we will see attractive returns in the future.

We have made some new investments recently as well. One is The Washington Post Company, which, you may be surprised to hear, is not really a newspaper company. More than half of The Washington Post's business comes from their Kaplan for-profit education segment, which has been growing at a blistering 34% CAGR for over 10 years. Their next largest business is the Cable ONE franchise. The Post, of course, still publishes its namesake newspaper (which lands on my doorstep every morning) and Newsweek magazine, but these operations are of ever-dwindling importance, as they successfully reinvest their substantial cash flows in growth-oriented businesses. The for-profit education industry is being affected by the credit crunch because many students are having trouble finding financing for their education. While this will have a modest negative effect on Kaplan, I believe it will be more than offset by improved acquisition opportunities, as The Post is unquestionably fully funded by their substantial cash flows.

## 2008 and Beyond

This has been the toughest period that has been experienced by Tidd Capital and its clients since it was founded in 2004. It is easy to maintain patience and optimism when everything is going well, but much harder when the sky appears to be falling.

In light of that, I greatly appreciate the confidence that clients have continued to place in me and my firm to manage their assets. I would like to reiterate that virtually all of my own money is invested alongside that of clients, in the same investments, so I experience the ups and downs just as you do.

Warren Buffett has often said that the market overshoots in both directions – the market goes through periods where they are dominated by either fear or greed. I believe we are near the end of a period of abject fear. The sane middle ground is based on solid business fundamentals, and over the long term, stocks will reflect those values. I remain confident that our funds are well-invested, and also that 2008 is going to serve up some excellent opportunities for new investments.

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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