

Second Quarter 2008

Signs of Life

The equity market has begun to show some signs of life, particularly starting in the second quarter. Though there is still plenty to be worried about in the economy, the widespread panic in the financial markets seems to be subsiding, perhaps having reached its crest. Some segments of the financial markets are finally doing business again, bolstered in part by timely and effective actions by the Fed. Caution and uncertainty still remain, although some participants consider this air of caution to be a welcome return to normality.

Analysts and pundits have been wringing their hands for the past 10 months about whether or not the US economy is in a recession. This is probably a pretty good indicator that a recession of some kind is already underway. Certain markets such as housing, automotive, and mortgage lending are already deeply in a recession, but whether or not the rest of the economy will follow remains to be seen. In any event, any layperson can see that the economy is in a down cycle.

Outside of the financial sector, investors seem to have realized that the world is not coming to an end, and the stock prices of some companies that were unimpaired by the credit crunch but whose stocks declined anyway have started to recover. In many cases, this resulted in dramatic gains, though these gains are often just reversing previous losses. In some instances it is as if it was all just a bad dream.

Deja Vu All Over Again

If I told you that one of our investments was trading at \$37 per share in November and then \$37 per share the following May, that would probably not be noteworthy. If I added that, in the interval, it fell by 30% in a few weeks to \$26, and then gained 42% in a few weeks to return to \$37, that may be more interesting, even if very little changed fundamentally in the business. This type of thing happened to several of our stocks, demonstrating that we can't take short term movements of stocks too seriously. (The stock in this example, incidentally, is Brookfield Asset Management).

Several of our investments roared back to life after weak performance over the past two quarters. Brookfield Asset Management has increased more than 35% in just 6 weeks since the end of Q1, and KHD Humboldt Wedag has increased 41% in the same period. Fortunately, I was able to take advantage of these declines to increase some of our positions. Burlington Northern, a new position, has increased 18% during that time and 25% overall. Much of these gains are due to the resources boom, which I'll discuss in a moment.

Froth? Deals?

The opening to my newsletter one year ago in Q2 2007 was "Froth and Deals", and I went on to describe the "ebullient" market environment at the time. Little did I know that it would be less than 6 weeks before the "credit crunch" meteor would hit the financial markets. It sure seems like longer than a year since we've had such positive sentiment, though this illustrates just how quickly winds can change in the market.

Warren Buffett has often advised investors to be greedy when others are fearful, and to be fearful when others are greedy. The uniformly positive views one year ago had the effect of making me cautious. Though I definitely failed to anticipate the depth and breadth of the financial crisis that was about to unfold, what I did do was begin to take what I felt were defensive positions against the US economy and dollar. Several of our top holdings such as Brookfield Asset Management, KHD Humboldt Wedag, and Allied Irish Banks were chosen in part because they did most of their business outside of the US in currencies besides the US dollar. I felt that they had strong regional or global economies within which to work, and that the businesses and stocks would perform well even if trouble hit the US markets.

I was half right in my analysis. As the US markets roiled, these businesses have in fact performed well, never missing a single beat even as the trauma engulfed the US financial markets. The other half of the equation, the stock prices, unfortunately did not follow my reasoning, probably because the stock prices in the short term are driven by perception rather than reality. The prices of these international stocks fell just as dramatically as US stocks, even though the underlying businesses continued to perform. Observers had various explanations for this disconnect, suggesting that the global economy was not really that global, that the "de-coupling theory" (between US and other economies) was faulty, or that the US was going to "export its recession" (whatever that means?!) However, over long periods of time, stock prices always follow business performance, so I continue to believe that, eventually, our investments will deliver solid performance regardless of the swings in the US markets.

The Resources Boom

Concerns over financial stability and inflation has caused a boom in oil, commodities and gold. This tends to become a self-reinforcing cycle, as the prices of these items increase, which causes inflation, which stimulates more demand for them as investors seek to hedge against inflation. For example, in some areas, skyrocketing prices for food items such as rice has caused buyers to begin hoarding, which has caused a sharp increase in demand, which has further increased the price. This has caused a bit of a mania in these markets — as always, the markets tend to overshoot in both directions.

Oil is at an all-time high at over \$130 per barrel and the prices of many other commodities are skyrocketing. This has a major effect on certain businesses, hurting some while being an enormous boon to others. Businesses that have these resources as an input cost, such as trucking and pulp mills, are hurt. Other businesses stand to benefit, such as resource exploration and production companies.

Two of our investments are enjoying strong tailwinds from the resources boom. Brookfield Asset Management has major commercial and infrastructure investments in resource-driven markets around the globe including Calgary, Alberta, the UAE, Brazil, and Australasia. When oil prospectors flock to Canada's Oil Sands to extract high-priced oil, many pay Brookfield for their houses and office space. Brazil, whose debt was recently upgraded to investment-grade, is primarily a resources-driven economy, and Brookfield has a strong presence there, with some businesses going back 100 years. Brookfield owns the Chilean electricity distribution system, the revenues of which are indexed to inflation. Inflation in Chile was 4.4% in 2007 and 7.1% in the first quarter of 2008, directly increasing Brookfield's revenues there. Brookfield is also one of the world's largest operators of hydroelectric power. With low, fixed costs, hydroelectric power plants are an enormously valuable asset in this environment, which Brookfield very fortuitously began to expand on a large scale just 5 years ago.

Another benefactor of the resources boom is our relatively new position in Burlington Northern, the US railroad. Rising oil prices actually give Burlington a large cost advantage over their trucking competition. Rising energy prices raise truckers' costs four times more than they raise railroads' costs*, and Burlington has an effective fuel surcharge and hedging program. Railroads have long competed with trucks at a relative disadvantage, but the balance has now shifted strongly in favor of the railroads for several lines of business. Secondly, the value of the freight hauled by Burlington such as coal and agriculture has increased with the resources boom, and Burlington is able to capitalize on this increase as they re-negotiate their contracts in a higher price environment. As always, it is nice to invest alongside Warren Buffett, who owns about 18% of Burlington Northern.

Mistakes: Rules 1, 2 and 3

Investing has been described as trying to predict the future better than the next guy, which in my opinion is not a bad description. Another truth about investing is that mistakes do occur. While avoiding mistakes is the best possible outcome, the second best outcome is to recognize the mistake quickly and cut losses. 2007 was a year of an unusually high number of mistakes on my part. The mistakes are embarrassing and hurt our collective performance — clients should remember that I have my own money invested in the very same investments as clients, so I feel the losses too. One flimsy silver lining to the cloud is that when mistakes did occur, I was able to act quickly to cut our losses.

The first big mistake was our investment in Novastar in 2006, which went pear-shaped in early 2007, which I described in detail in prior newsletters. In retrospect, investing in Novastar to begin with was a mistake. The company was earning enormous profits in a business that was certain not to last — sub-prime mortgage lending. Acknowledging the risks, I felt that I would be able to see the end of the road and jump off of the speeding car before it crashed. I was not correct — the car was already crashing when I stepped off. I sold out of our position at about \$10.60 per share, a substantial loss from our cost basis (not including dividends). But that price looks pretty high compared to today's price which, adjusted for splits, is about \$0.45.

Similarly, our investment in First Marblehead, while not a mistake of the same proportions, was also not successful, for reasons that I feel were very hard to anticipate. Even though Marblehead did not have direct credit exposure, they did have enormous exposure to the financial markets in general, and the credit crunch effectively destroyed their business plan. This meltdown, incidentally, was not predicted by those either positive or negative on the company — it was widely unexpected. I sold out of our investment in First Marblehead at about \$22 per share. That also represented a substantial loss from our cost basis, but looks like an astronomically high price compared to today's price of about \$3.

The first rule of mistakes is not to make them. The second rule is to recognize when they happen and act quickly and decisively to cut the losses. In this activity I give myself a grade of C minus — an F on the first rule but an A on the second. I am determined to perform better in the future — and strive to never reach rule #2.

The third rule of mistakes is to learn from them — which, though an enormous amount of post-mortem analysis, I hope that I have done. In retrospect, I made commitments to investments that, while I knew were not 100% sound, I felt that I could jump off of the treadmill in time. I was right about the unsoundness but wrong about the timing. A much simpler and more effective way to invest

* Source: Charlie Munger

is to follow Warren Buffett's advice, which is that if you won't own a stock for 10 years, you shouldn't own it for 10 minutes. While I had followed the "10 year rule" for a long time, I got caught up in the ebullient aromas and drifted away from it. But clients can be reassured that my appreciation for that piece of advice has been renewed.

Unusual Transactions

The past few months have included a few somewhat unusual securities transactions, and since I've received a number of questions about these from clients, I thought I'd take this opportunity to elaborate. As always, if you have any questions or concerns about things going on in your account, don't hesitate to contact me.

ECC Capital is a small company that has terminated its primary line of business and has begun to liquidate. The company has been de-listed and, having bought into the investment at below liquidation value, I expect our return on investment to come primarily from cash distributions throughout 2008 and 2009. For instance, the stock was trading in December 2007 for \$0.10 per share. In March 2008, the company paid a \$0.10 distribution, and after the distribution the stock continued to trade for \$0.10 per share, an effective return of 100%. The company has approximately \$0.25 per share of cash on the books, which I believe should be available for distribution to shareholders, though the timing of those distributions is uncertain.

This is somewhat of a strange situation since the share price clearly does not reflect the underlying value, which is the simplest kind of value to calculate — cash. However, the investment is consistent with the most basic value investing philosophy — buying a dollar for less than a dollar. In this case we are buying a quarter for a dime, an action that seems highly likely to provide an adequate return concurrent with safety of principal.

Another unusual transaction was the rights offering from Gladstone Investment Corp. A "rights offering" is a request by a company for shareholders to contribute more capital to the company. Companies can do this when they feel that they are looking at compelling investment opportunities and require additional capital to pursue them.

This is precisely the situation with Gladstone, and David Gladstone himself, the founder, made the request. A rights offering requires a company to issue more shares of stock. If these shares are issued at a premium to book value, the offering is accretive (i.e. increases book value), and if the shares are offered at a discount to book value, the offering is dilutive (i.e. decreases book value).

Gladstone Investment's shares were trading at a substantial discount to book value (about 30%) when the offering was made, which would make the offering dilutive. Such a request must be met with skepticism and concern, since shareholders are being asked to dilute their own stock. If the shareholder chooses to participate, the dilution is neutralized by their increased interest in the company, but if they do not, they are diluted by other shareholders who do participate. This makes the offering somewhat coercive, and raises the bar substantially for the type of investment returns shareholders should expect.

David Gladstone is well aware of this, and held a conference call to state his case. With his credibility on the line, he convinced me. In a lending market starved for liquidity, fresh capital can be invested very advantageously, since spreads are high and the terms favor the lenders. Gladstone said he felt they could achieve a 20% IRR on the current opportunities, which justifies the discount to book.

Rights offerings are usually made near the prevailing stock price, so the actual execution price is not known until it is actually done. In the weeks after the announcement, Gladstone Investment's stock surprisingly declined an additional 20%, which caused the rights offering to be done at an astonishing 50% discount to book value. The stock has subsequently recovered, giving us an immediate 20% return on the shares that we got in the offering, though the overall position is still held at a loss. I look forward to seeing what Gladstone is able to do with the additional funds.

Closing

I hope that this letter has given you a better understanding of my investment process. As always, 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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