(703) 652-4613
(703) 738-6359 (fax)
http://www.tiddcapital.com

TIDD CAPITAL, LLC

1563 McNeer St.
McLean, VA 22101

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Intro

Fear and uncertainty continue to dominate the markets, as does extreme volatility. According to the statistics, we are officially in a "bear market" and the economy is in a recession. The ongoing news and data is not good, and it isn't clear how or when things will recover. The resulting market value declines have negatively impacted our performance recently.

Contrary to the panicked selling in the market, now is the time to judiciously buy new investments rather than sell. A down market provides an excellent opportunity for investors focused on business fundamentals because valuations are cheap around the globe.

We are fortunate to have a rational and patient client base because we have not seen any redemptions at all during this period, and clients have maintained or increased their capital under management. In fact, Tidd Capital has only seen one significant client redemption in its 4-year history, and steady increases in both clients and capital. Clients who have been waiting for a good time to put new capital to work are encouraged to do so promptly, provided that they have a long-term time frame. The stock market is never a good place for your butter-and-egg money or savings for a down payment on a house. But history has shown that buying into excellent companies at excellent prices provides for excellent long-term returns.

After spectacular performance in 2006 (+42%) and abysmal performance in 2007 (-20%), so far in 2008 we are down slightly (-7%), but substantially ahead of our benchmark, the S&P 500 index (-12%). A few years is not enough time to judge overall performance, and our numbers have been particularly volatile. Nonetheless, I would judge our overall performance so far to be adequate, and I look to do better in coming years. Clients can remember that I have my own money invested alongside clients in the same investments, and feel the ups and downs too.

Ups and Downs

Some observers (and some clients) ask why we don't just sit on our cash and wait for times like this. This is a great idea, but notoriously difficult to implement. Market downturns (and upturns) are entirely unpredictable, and sitting uninvested in cash in a strong market can hurt performance as much as being committed in a downturn. Ron Muhlenkamp has aptly described risk as "the chance of permanently losing purchasing power". Over long periods, holding cash is a very risky activity by this definition, because it loses value due to inflation.

There was a brief market downturn in early 2006, and investors who got spooked and pulled all of their money out of the market would have missed the great returns in the rest of 2006 and early 2007. Similarly, investors cautiously holding cash in late 2002 when the market was weak would have missed spectacular performance in 2003. The downturn that started in June 2007 at first looked to be brief, though it obviously was not. However, on balance, it pays to remain invested in high-quality companies at below-average prices and ride out the storms.

The approach that we take that is shared by all long-term value investors is to simply focus on business fundamentals and buy cheap with a margin of safety. We also try to sell when prices range from fair to high. Market upturns and downturns will happen, but this approach has proven to be satisfactory over the long term if properly executed.

This is not to say that we should expect the market to snap back in a "V-shaped" correction. Major drivers of the economy are weak and no sign of recovery is apparent. Inflation, unemployment, and defaults are still rising, the worst may be yet to come, and this may go on for years. Clients should adjust their expectations to expect more difficult times in coming quarters.

The market has been unusually volatile recently, which makes any discussion of short-term activity difficult. Some stocks have gone up and down as much as 25-100% in short periods. Our performance is measured by the market price of our holdings on the last trading day of each quarter (March 31, June 30, September 30, and December 31), which means it is based on the last few minutes of trading on four days each year, a very short period of time. These dates, while popular in the financial community, are really somewhat arbitrary from a long-term perspective, and some other firms use different dates.

Recently, choosing slightly different dates would have lead to very different short-term performance. If we had "marked to market" in late May of 2008, our quarterly numbers would have been much better. If we had done it in mid-July, they would have been much worse. These discrepancies become less relevant the longer the time period. Thus, clients are encouraged (once again) to decrease their attention on short-term results and instead focus on the long term.

It's A Hard Time To Be A Value Investor

Curiously, this market has been particularly unkind to value investors with excellent long-term track records. The last market downturn caused by the "dot com" collapse was relatively easy for value investors to avoid, because valuations were absurdly high by any measure. However, many value investors were drawn into this market because valuations were not that high prior to the downturn. In my newsletters in early 2007, I noted that while the market was doing very well, stocks still appeared to be cheap. I didn't know that they would get so much cheaper.

For instance, Bill Miller, once an industry darling for having beat the S&P index 15 years in a row, has seen his Legg Mason Value Trust fund lose 36% in the past 12 months. Marty Whitman is the 83 year old guru of the Third Avenue Value fund, which is down 19% in the same period, and the Longleaf Partners fund is down 17%. Berkshire Hathaway's equity portfolio is down approximately 14% in the first half of 2008, and Berkshire's overall book value is down 3% during the same time. Our own performance is in the same unfortunate vicinity, down about 27% in the past four quarters and down about 7% in the first half of 2008.

These declines only tell part of the story. Many of these investors had waited patiently during the hot markets of the past few years to invest the cash they had been holding, and quickly deployed that cash after the first market hiccups a year ago, only to see continued severe declines. Marty Whitman pounced on the stocks of financial companies such as Ambac and MBIA after they had fallen 50%, only to see the stocks fall *another* 80%. Warren Buffett invested billions to add to his already substantial stake in Wells Fargo, only to see the stock fall another 25%.

Bill Miller's funds owned 15 million shares of Freddie Mac at the end of 2007, worth $34.07 per share. At March 31, 2008, the shares had fallen 25% to $25.32 each, and Bill Miller had more than tripled his position to 50 million shares. At July 31 he owned 80 million shares, now worth $8.17, and as I write this in mid-August 2008 the shares are at around $5.50. Remember that this is one of the best-performing fund managers of the past 17 years, yet he has lost hundreds of millions on paper in this single investment.

While I wonder about some specific investments such as Miller's position in Freddie Mac, I don't think that value investing has suddenly gone out of style. That was an allegation made during the "dot com" era for a different reason – at that time, value investors were underperforming because they were not invested in the hot technology stocks at the time. Value investors later emerged as the heroes that avoided losses. This time around, value investors are underperforming for different reasons. But time has shown that, though there will be periods of disappointment, over the long term value investing provides the foundation for good performance.

De-Leveraging

The sub-prime crisis and subsequent credit crunch has gushed into other parts of the market and the economy. The housing market is a major driver of the economy, and it is currently as dead as disco. Though "dead as Prohibition" might be a better term, because the housing market is said to be the worst since the Great Depression. This leads to lower home values, decreased consumer spending and confidence, fewer jobs, and reduced corporate activity in many sectors. Currently, we are in the middle of the tunnel and there is no light in sight.

Meanwhile, financial companies have seen their asset values decline, which hurts their balance sheets and their ability to lend money. Most financial companies are counterparties to other financial companies, so this has a cascading effect as each party reins in their capital. In cases where the company carried assets financed with debt, this can cause forced selling of assets regardless of their prices, causing asset values to fall further in a self-reinforcing cycle. Newly raised capital and earnings (if any) are used to shore up the balance sheet rather than produce earnings. The effect is what analysts are calling "de-leveraging", which is currently widespread and in full swing, and I think has a long way to go.

The concept can be illustrated with an example. Say that Joe Consumer buys a house for $300,000 and finances it with an 80% mortgage for $240,000. The house appreciates to $330,000 and his lender allows him to take out a second mortgage up to 90% of the value for $57,000, so he has total financing of $297,000. He uses this second mortgage to buy a new car, plasma TV, new furniture and clothes, vacations, and other "essentials".

The housing market declines, and Joe's property value goes from $330,000 to $290,000. Joe's lender, under siege from defaults and liquidity problems, changes their policy and reduces the maximum loan to value they'll allow back to 80%. Now his house is worth $290,000 but has $297,000 of financing, which must be reduced to 80% of its value or $232,000, which means that Joe must come up with $65,000.

No other lender will loan Joe this money for the same reason that his lender changed the terms. He has to come up with this money with “equity”, i.e. savings or earnings. If Joe has poor credit and no cushion nor assets, he may have to declare bankruptcy. His lender may give him a break and let him pay of the deficiency over time. If he has surplus assets or earnings, they will go into repaying this debt, perhaps including penalties, perhaps for years. Buying new televisions and cars (i.e. consumer spending) is now out of the question, as he will spend the next few years just trying to pay for his excesses of the past few years. This hurts not only Joe but his favorite stores as well who won't sell him any goods. Multiply this by millions of consumers and you have the makings of a recession.

This is an apt analogy for what happens at the corporate level. Companies who overextended themselves are now faced with shoring up their balance sheet and halting growth plans while they try to get out of a hole. Conversely, companies that are self-funded with strong cash flow and equity can use their financial strength as a competitive advantage. Such companies are seeing less competition, higher rates of return, lower risk, and a higher volume of business. So the future will be very different for companies depending on how they are financed.

In the short term, the stock prices of companies both weak and strong are falling since the market tends to have a "baby and the bathwater" attitude during declines. Choosing the right investments at a time like this allows us to buy into great companies at great prices, and I've very excited about our current selections.

Puff, Puff

One category of investments that have come available recently are special situations where a stock is trading below the company's liquidation value, and the company is likely to go through one or more transactions that will return this cash to shareholders for a positive return.

For example, a stock might be trading on the market for $5.00 per share, the company may announce the intention to cease its operations and liquidate within 12 months, and the liquidation proceeds could be conservatively estimated at between $5.25 and $7.00 per share. A shareholder buying this stock could expect a return on investment ranging from 5% to 40% spread over approximately 12 months, assuming everything goes according to plan. The mid-point in this range of returns (i.e. 22.5% CAGR) provides an attractive rate of return combined with a reasonable (i.e. low) amount of risk. Perhaps more importantly, the shareholer shouldn't expect to lose money even under pessimistic scenarios. (These figures are roughly representative of one of our actual investments.)

This is not always simple though – companies in liquidation are often distressed, and distressed companies are prone to unpleasant surprises, and aren't always enthusiastic about fulfilling their obligations to their shareholders. Nonetheless, through diligent study and finding an honest management team, a handful of attractive situations of this nature can usually be found.

These kinds of investments used to be a major component of the portfolios I managed during the period 2000-2005, often making up 25-50% of total assets managed. But curiously, starting in 2006 they became nearly impossible to find. This type of investment was very hard to find for most of 2006 and 2007, but now thankfully have come back around as a result of the market decline. It is analogous to attractive seashells being revealed when the high tide waters recede.

These investments also tend to be very small, with market capitalizations less than $100 million and sometimes less than $10 million. One advantage of the small capital base at Tidd Capital is our ability to pursue investments of any size, giving a broader scope than many asset managers. In many cases these are investments that institutions can't even consider because they are too small, which provides us with less competition in finding them. For the same reason, I am reluctant to describe them in detail in this report, since drawing attention to very small companies can significantly affect their stock price. This makes buying them difficult, and selling them after such an increase unethical.

One particularly attractive attribute of these investments is that they tend to be "market neutral". A company that is on a 6-18 month timeline towards liquidation exists in its own bubble of activity that is largely insulated from the market and broad economy. This provides the opportunity to obtain returns that vary from adequate to good regardless of what the market does, which is particularly attractive in a weak market. These investments also tend to "self-liquidate" as they pay out large distributions, which means that our capital is not tied up for very long. These attributes provide useful balance to a portfolio that is otherwise invested in long-term stocks.

A disadvantage of these investments is that they tend to be one-shot deals. Like a disposable razor, they are cheap and useful for a short time, but it isn't long before you need to find another one. Warren Buffett colorfully termed these investments "cigar butts". Like finding the stub of a used cigar, they might be a bit yucky, but they're cheap and will provide you with a few good puffs. You will never get a multi-year, long term compounded return from one of these investments as you would with my preferred type of holding, but a steady supply of them can provide ongoing positive returns.

Thank You

This August marks the fourth anniversary of Tidd Capital. There are probably few things as exhilarating and challenging as starting a new business from scratch, and I owe a tremendous debt of gratitude to my clients, whose trust has been the cornerstone of my success thus far. My first three clients were my father, brother, and a good personal friend. Today I have 33 clients and a four-year track record, which, while disappointing recently, I'm proud of. I have had only one significant redemption, and have lost two clients – one due to the death of my father in 2006, and another when two clients married each other and their accounts were combined. They say that most startup business fail after less than 3 years, but in its 4th year, Tidd Capital is going strong.

As mentioned earlier in this report, now is a wonderful time to invest in the stock market. Clients who have additional capital to invest are encouraged to contact me to put it to work. If you have family or friends who are interested in long-term investing in the market, please send them my way or direct them to our web site.

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.

Randall Tidd
President, Tidd Capital
703-652-4613
rtidd@tiddcapital.com