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When it rains, it pours

After about 15 months of financial news that varied from weak to scary, in October the news somehow got horribly worse as recession fears were confirmed seemingly worldwide simultaneously. Stock markets that had been in a slow slide from June 2007 until September 2008 suddenly saw the bottom fall out and market prices of virtually every tradable asset plummeted worldwide. This included stocks, bonds, oil, commodities, and virtually everything besides cash and US Treasury Bills. And it isn't as if they hadn't fallen already. Market indices worldwide showed declines of 10-20% in a month which resulted in declines of 40-60% year-to-date in 2008.

Grizzled stock market veterans have often quipped that, in order to be invested in the markets long term, you have to be mentally prepared to see your portfolio decline by 50% or more. Up until recently, many may have thought this counsel needlessly pessimistic. Today, many folks are probably wishing the declines were *only* 50%.

Through the end of Q3 2008, our portfolios were actually slightly ahead of the S&P year-to-date by virtue of having declined less, which is cold comfort given the generally poor performance. Things got worse in Q4 and so far we are underperforming even the poor market indices, and things look very gloomy indeed.

We have not been directly invested in any of the long list of companies that were traumatized such as Fannie Mae, Bear Stearns, Lehman Brothers, AIG, Citigroup, and many others. We have also avoided companies that needed emergency help such as GE, Goldman Sachs, GM, or Ford. We haven't had any "zeroes" or permanent losses forced upon us by companies that we held failing or being sold or liquidated at discounted prices. However this hasn't helped us to avoid sharp declines.

In fact, with a few exceptions, from the perspective of business fundamentals, our companies have thus far reported very little evidence of damage or even slowdown. Many of them are still posting record results as of Q3 2008. Nonetheless, our market performance has echoed the dismal performance of virtually every other fund or asset manager, and we have seen very sharp declines in portfolio value. This has been a bear market that has shown no favorites -- virtually every kind of company and asset has seen jaw-dropping declines, as can be seen in the value of investment funds of all stripes, and the stunned shareholder letters they have been publishing.

Clearly, this downturn caught me completely off-guard, and with the benefit of hindsight, the best course of action would have been to liquidate our investments about 15 months ago at the first sign of trouble. Merely holding cash would have outperformed the markets by an envious 30-50%. For this oversight there is nobody to blame but myself, though at least I have plenty of company in my misery. It is a very rare investor indeed that avoided being drawn into this mess (I'm only aware of one, Prem Watsa at Fairfax Financial). Investing greats with plenty of gray hair have been alternately plunging new money into the declining market and apologizing to their clients for over a year.

Every market decline and period of economic turmoil is different in some way, which is what makes them unpredictable. Unlike most other bear markets of the past 35 or so years, this one was not preceded by a period of ebullient equity prices or visible speculation market-wide or even in selected segments. Equity prices, by and large, looked entirely reasonable both one and two years ago. The

largest fear most investors had was slightly below average performance from what looked to be fairly average prices. In contrast, the "dot com" mania was relatively easy for rational investors to avoid since the valuations made absolutely no sense for a long time before the collapse. The same can be said, in retrospect, of other manias that preceded declines such as the "Nifty Fifty" of the 1970's or the 44% market increase before "Black Monday" in 1987. In this case, it was all too easy to be lulled into the calamity through the "boil a frog" syndrome. The heat was turned up very slowly over a period of many quarters until fund managers found their portfolios fully cooked.

From the Bottom Up

Through thick and thin, my approach to investing has always been "bottom up", which is to research and find individual companies that are cheap and safe, run by talented management with proper incentives, and with strong capital structures with rare or unique advantages. This approach, which is certainly not unique to me, has proven over time to yield satisfactory results over the long term if properly executed.

Currently, many of our companies are priced as if they will never earn money again, as they are trading at or below tangible liquidation value, or in some cases, below their cash value. It is difficult to justify these valuations through any quantitative or qualitative approach, they seem entirely psychological. I find it very unlikely that these businesses will suddenly shut down or that their cash will suddenly disappear. While my appraisal of many of our companies has declined somewhat over the past 12 months to reflect weak economic conditions, these appraisals are nowhere near as poor as current market prices. While a recession is now definitely underway, many of our companies have entrenched competitive positions and strong capital structures which will enable them to defend themselves against this turmoil, and perhaps even go on the offensive to make new deals while prices are low. They are also in a position to repurchase their own securities, so shareholders will experience additional upside when the circle turns.

Acme United is a small manufacturer of office supplies, and through continuous innovation and expansion into new markets has posted 12-15% growth for 7 years running, a streak which has still not been interrupted as recently as Q3 2008. This quarter they raised their dividend by 25% and have announced that they are looking for acquisition opportunities among the flotsam and jetsam.

Triangle Capital Corporation is a specialty lender that invested a bulk of its available capital during the past 12 months when it had little competition from commercial banks, and is posting record earnings and has increased its dividend by 35% in the past 12 months. They are still seeing negligible non-performing assets and are seeking new capital to continue their growth.

The Washington Post Company (which is not a newspaper company at all these days) has shown very weak results in its newspaper segment, but that business represents less than 20% of its revenues. Their core business is the Kaplan for-profit education segment which has seen operating earnings growth of an astonishing 33% over the past year. Completely self-funding, the Post has continued its acquisition activity in this segment with a new deal in November.

Brookfield Asset Management has seen some minor impacts from its few business segments that are tied to market valuations, but it has continued to grow cash flows by 12% year over year and now sits on a cash hoard of nearly $2 billion, with another $2 billion available in credit lines. Its assets include hydro power plants, timberlands, and commercial real estate, the performance of which is measured in decades and which are still performing well. Brookfield is also buying back substantial

amounts of its own stock while prices are weak.

However, this kind of performance has been wholly ignored by the market, which has sent these stocks down 30-50% or more. It is possible that these companies are late in the recession cycle and have not yet felt the impacts that everyone is worried about. It is also possible (likely, in my opinion) that the market has overshot the worst case scenarios and priced these companies irrationally.

This valuation paradox can only be undone through the passage of time. I feel strongly that, on balance, our share prices will recover to more reasonable levels that reflect underlying business fundamentals, and this recovery will at some point be very quick and pronounced. Many of our companies can easily double from current prices and still be cheaply valued, a value that includes significant unforeseen impairments.

Forced Selling

In the years that follow, the events that led up to this market decline will undoubtedly be scrutinized and analyzed ad nauseam. We are, unfortunately, witnessing history in the making. One of the things that is making the current problems even worse is forced selling, which through a spiral effect, drives down prices of all assets including stocks. This is described very succinctly by Ron Muhlenkamp in his Q4 letter:

> In 2005, the Financial Accounting Standards Board (FASB) issued FASB #157 which states that banks, insurance companies, and brokers must mark the value of the assets to market prices in their quarterly and annual reports. Regulations for each of these industries limit the amount of business they can do and the liabilities they can carry is a multiple of the assets and/or equity. Thus, FASB #157 allowed firms to expand their business as the market prices of their assets moved up, and forced them to contract their business as market prices moved down. This has become self-feeding.
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> Had we a similar accounting rule in effect in 1989, nearly every S&L and bank in the country would have been bankrupt. Most of you know that, in the 2005-2007 period, banks and mortgage brokers made mortgages and, therefore, home ownership available to people who could not have afforded a home by prior standards. (You may know that Congress mandated that mortgages be made available to low income people.) As some of these mortgages failed, the market value of the remaining mortgages fell. Any that were owned by financial firms, (banks, insurance companies, or stockbrokers), had to be "marked to market," forcing the firms to raise capital or sell assets. Most had to sell assets — into a vacuum of no buyers. This caused further mark-down and the spiral began.

Without getting too far into technical accounting details, I believe that this mark-to-market mandate is one of the major factors contributing to today's malaise. During the good times, it allowed companies to front-load gains and overleverage themselves based on anticipated future profits. But once the wall started to crack, it effectively forced companies to front-load and amplify potential future **losses**, which delivers an immediate impairment to a rickety balance sheet. In many cases, cash accounting would not have allowed the excesses on the way up, and also would not have shown any impairments (and in many cases still has not). The problems associated with defaulting financial assets would have been much more localized.

This I believe is what started the snowball rolling down the hill. This was exacerbated by the high level of leverage throughout the system. Holding cash or securities directly on one's balance sheet seemed to have fallen out of style for both individuals and businesses. This situation is exemplified by one of the more astonishing anecdotes from a period that has no shortage of them.

Aubrey McClendon co-founded Chesapeake Energy in 1989 and through nearly 20 years of savvy dealing, built it into one of the country's largest natural gas and oil exploration companies. His personal fortune in his company's stock was worth $2.4 billion in July 2008 when the stock peaked at about $69 per share.

However, as the stock market started its perilous decline immediately after this peak, Chesapeake stock fell all the way to $16.52 on October 10. On this day it an astonishing announcement was made. McClendon received a margin call on his stock which, it turns out, he had been buying using borrowed money. This margin call forced him to sell his entire position -- more than 33 million shares -- wiping out substantially all of his net worth. A fortune that had been accumulated over 20 years was wiped out in three days because he had foolishly overextended himself on margin.

While this is an extreme example, the forced selling that goes along with margin calls and redemptions is another major contributing factor to the continued market decline. Mutual funds and hedge funds are seeing enormous redemptions as investors paradoxically seek to liquidate their investments after a sharp decline. Brokers call this "get me out selling" as clients instruct them to just get them out of the market at any price, which is a sure way to lose money in investments. These redemptions force fund managers to sell stocks into a declining market, which forces share prices even lower.

Silver Linings

It is during periods of universal doom and gloom that great investors emerge to take advantage. It is perhaps both surprising and unsurprising that several renowned investors have emerged recently to provide optimistic projections diametrically opposed to what you read in the news media.

Seth Klarman was quoted in October saying, "The seeds of recovery and eventually of substantial profit are sown amidst the carnage. The world is not ending".

At around the same time, Warren Buffett wrote an op-ed piece for the New York Times on October 17 titled, "Buy American. I Am". His message was simply that bad news is an investor's best friend, since it allows you buy valuable things that nobody wants and thus will sell cheaply. His advice is so comprehensive and rational that I have included a copy of his article with this newsletter.

In his July 2008 shareholder letter, famed 83-year old value investor Marty Whitman wrote, "You may lose money on your Third Avenue Value Fund investment from here on out; but, if so, it will be because Ian [Lapey, his Senior Analyst who helps him manage the fund] and I are stupid." This fund declined another 41% since that letter was published. But I do not, by any means, believe that Mr. Whitman and his senior analysts are stupid. I believe that their views and subsequent poor short-term performance just exemplify the disconnect between market valuations and reality here in the short term.

A speech attributable to Buffett's business partner Charlie Munger is particularly interesting since it gives some detailed observations (though I should mention that I have not been able to verify its

authenticity 100%). Munger is said to have told his audience that the longest recession in US history was 16 months, and that we had likely been in a recession for about 9-11 months at the time (this was October 2008). This observation was validated today when US economic news was released in December 2008 that, indeed, the US was not only in a recession but had been so for about 12 months. While there is no rule stating that this recession cannot be longer than the previous worst, it does put some perspective on the problem. It is paradoxical to me that the market and the media could worry about being in a recession for 15 months, when most recessions last less than 15 months. The stock market is typically a "leading indicator" of economic progress, so it is likely that the markets will have turned higher by the time the news turns positive.

While I don't believe that this spells "the bottom" for markets, nor is such a bottom predictable. But recessions are a natural part of economic growth, and they do end. There is an enormous amount of bad news priced into stocks and markets worldwide, and this perception is sure to reverse over time. Buffett has often commented that markets overshoot in both directions, and there are many indicators that they have overshot to the down side. Trying to "back into" current valuations requires catastrophic assumptions that have not yet even been contemplated by the media, such as long-established companies being unable to continue their current lines of business for more than a year or two.

Closing

These are very hard times to be an investor, and are soon to be hard times to be any participant in the economy. Unemployment and inflation are going to increase, in combination with severe volatility and individual companies suffering fatal failures. Perhaps the hardest part of the crisis is not knowing why it is happening or when it will end. It does help, particularly at this time of year, to remember the non-financial assets that we all have, namely our family and friends and the many blessings so associated.

While the numbers are currently not fun to either report or receive, clients can be certain that my own investments are directly tied to their portfolios and that I remain diligently focused on the task of preserving our capital and maximizing investment returns. While it is impossible to know when our fortunes will turn, I remain sure that they will, and that patient investors will be rewarded.

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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