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Is It Over Yet?

Optimism fled the markets at the end of 2008, the likes of which few investors have ever seen. Unfortunately, like so many other investors, our portfolios were caught up in the dramatic decline in values. The declines affected virtually every asset that can be traded, including stocks, bonds, oil, gold, commodities, and real estate all over the world. The dramatic market declines continued through the beginning of 2009, bringing the markets down to 13-year lows, until a small rally at the end of March finally stabilized the markets briefly.

The market had one or two more "legs down" than virtually any observer expected. Warren Buffett wrote an op-ed piece in October 2008 saying that it was time to buy stocks, only to see the market fall by almost another 20% over the subsequent four months. Prem Watsa of Fairfax Financial very presciently predicted the current crisis, calling for a "100-year flood" as long as two years ago. For much of 2008, Prem had his large portfolio fully hedged against market declines with substantial "short" positions (which increase in value as markets decline). This led to enormous windfalls for his companies in 2008. However, even he was caught off guard by the last decline, as he pulled the hedges off of his positions in November 2008 and started to make new purchases, and bore the brunt of the continued declines after that point.

The markets continue to be like a bad dream from which we can't wake up, and the performance of numerous companies reflect a deep recession. The auto, housing, and banking industries are showing the worst results, while most other industries are in what looks like a more typical recession. Even stalwarts like GE and Berkshire Hathaway are facing liquidity issues and credit downgrades, and are priced in the market as if they might never earn again.

2008 In Review

While the market price of virtually all of our investments declined in 2008, some of the companies actually performed quite well.

Triangle Capital grew their earnings and dividends by 76% in 2008 by successfully deploying their capital. The stock is now yielding about 21%. They had access to one of the few sources of capital that did not dry up in 2008, namely SBIC debentures which are issued by the Small Business Administration. This made them the only game in town in some markets. This advantage should continue through 2009 as they receive additional benefit from the recently enacted stimulus packages.

Access National Bank grew earnings by 28% in 2008. As a regional bank primarily in the commercial and residential mortgage business, they would seem to be at the vortex of the current crisis. But CEO Mike Clarke and his team run a very tight ship, and non-performing loans are only 1.28% while their earnings and capital are strong. They are also fortunate to be focused on one of the country's strongest regional economies in Fairfax County, Virginia. Access National has a very strong capital position and can choose if they want to participate in the various stimulus and liquidity programs based on whether or not they wish to accept the conditions. This is in contrast to many other banks large and small who must participate as a matter of survival. Access National qualified for the TARP (Troubled Assets Relief Program), indicating their financial strength, but declined to participate due to the conditions. They also qualified for the TLGP (Temporary Liquidity Guarantee Program), in which they participated for $30 million. I expect Access National to use their capital and competitive position to continue their growth in 2009.

Acme United continued their 10+ year trend of increasing revenues, earnings, and cash flows, posting an 11% gain in earnings in 2008 over the prior year. They have reaffirmed their dividend and have announced that they are looking for acquisitions, reflecting the underlying strength of their business and strong capital position.

Other investees posted solid but unspectacular numbers for 2008. Brookfield Asset Management grew cash flows by 8% year over year reflecting some new deals, though assets under management declined about 16% to $80 billion reflecting the decline in market values. Their cash-generating and competitive positions remain undisturbed, and I am particularly excited about Brookfield's prospects over the next few years, as the current environment provides them with once-in-a-lifetime acquisition opportunities. Brookfield currently trades at about half of liquidation value, a startling discount considering the quality and long life of their assets and fortress-like capital structure.

Gladstone Investment Corporation posted nearly breakeven results with a small decline in earnings and book value, though they have reaffirmed their dividend (currently yielding over 21%) for most of 2009. Quirks in Gladstone's accounting make their results look worse than I believe they are, something I'll talk more about in a moment.

Specialty Underwriters Alliance, a small insurance company, avoided any major investment missteps and grew book value by 3% in 2008. The company is being pursued by a suitor, and has already turned down a buyout offer at more than twice the current stock price, reflecting the underlying value present in the stock.

Despite the performance of these companies which has varied from good to great, their stocks were almost all cut in half or worse in 2008. This disconnection between price and value should eventually correct itself, and stock prices should snap back to reality like a rubber band.

Some of our companies were more severely affected by the downturn. USG is right in the crosshairs of the housing industry problems as half of their business is in residential housing construction. Earnings and cash flows fell dramatically in 2008 and recovery is a long way off. USG is 17% owned by Berkshire Hathaway and a long list of well-heeled value investors, so I believe that they can get financial assistance from these investors if they need it, and that the company will eventually recover when the US housing markets do.

KHD Humboldt Wedag is an international cement engineering company focused on emerging markets. The credit crisis abruptly drained these markets of their capital and halted engineering and infrastructure projects of all kinds, leading to broad cancellations of KHD's projects. While they continue to generate cash in the near term, they see significant deterioration of their business in 2009 and 2010. KHD has no debt, is way overcapitalized, and is run by an excellent management team with a long track record of strategic investment. I feel that KHD will manage through this crisis and use their capital to enter new markets while prices are cheap, which will eventually lead to increases in stock value.

"Mark to Market" Accounting is Contributing to the Crisis

"Mark-to-market" accounting rules were enacted relatively recently as an attempt to add transparency to the financial markets. However, I believe an unintended consequence was to exacerbate both the market highs and lows, and ultimately fan the flames of panic once they started burning.

The idea behind mark-to-market accounting is that companies must value their assets according to prevailing market prices at the end of each quarter. This seems pretty natural, as market prices are usually widely available, and it is important for everyone to know what a company's assets are worth.

But in some cases, a investment might be held for years, yet must be valued every quarter. This places undue attention on short-term pricing which is not really material. Investors may see wide swings in book value or earnings – positive or negative – that aren't really meaningful and draw the wrong conclusions.

Markets tend to over-react in both directions, and mark-to-market accounting brings this volatility onto company balance sheets and makes it real. When markets are unrealistically ebullient, mark-to-balance sheets look unrealistically good, allowing companies to take greater risks. When markets are unrealistically pessimistic, mark-to-market balance sheets look unrealistically poor, forcing companies to pull in their horns. Thus some companies are at the mercy of market prices rather than being able to take advantage of them, and similar companies are more likely to move up or down in unison. This I believe helps explain why so much of the market seemed to go from "too good" to "too bad" in such a short span.

Make no mistake though, widespread poor lending and risk management practices were the primary force behind the downturn, and this is not an attempt to blame the crisis on accounting. But I believe that mark-to-market accounting helped to both start and propagate the crisis. As the disruptions began, market impairments caused company impairments, which in turn caused market impairments. This created a self-reinforcing cycle that has added jet propulsion to the current tailspin.

One good example of this is Berkshire Hathaway's recent large derivative investments. Berkshire entered a contract whereby it will have to cover the counterparty's stock market losses starting in about 11 years. While the markets have declined, nobody knows if Berkshire will actually suffer any losses, as 11 years is a long time. But because of "mark to market" accounting, Berkshire must post eyebrow-raising multi-billion dollar losses each quarter in the meantime, even though Berkshire won't have to pay a dollar for more than a decade under any scenario.

As another example, consider two companies, one of which owns an office tower in Manhattan, and another company that loans that owner the money to finance the tower. The owner might carry the tower on their books as a hard asset, carried at cost minus depreciation. They might have 10-20 year estimates for how much cash they can draw from the asset, and use this as the basis for their "fair value" estimate. Market value does not factor at all into the book value of this asset, so even catastrophic market declines have no effect on their balance sheet whatsoever. Even a 2 or 3 year crisis in the markets would only be a blip in a 20 year estimation and would not have much affect on fair value either.

Contrast this to the lender, which holds the loan to the owner as an asset on their books. This asset, as a financial instrument, is marked to market each quarter. When the credit markets entered their terrible crisis, this lender was obligated to mark the value of this asset down, reflecting the presumably increased likelihood of default, and the unattractive interest rate on the loan compared to current rates. Never mind that the underlying asset – the office tower – has not changed in value, nor that the borrower remained a perfectly sound credit. The lender might mark this asset down 20%, 30%, or more, resulting in impairment charges, decreased earnings, increased losses, and a decreased ability to make other loans. Meanwhile, the borrower might continue paying as agreed.

In normal times, this kind of disparity might only be a few percentage points, and could be reasonably explained by one company's increased sensitivity to the market. But these days this disparity can be enormous, such that one company might be unaffected while the other company might go out of business, yet their interests are ultimately secured by the very same asset!

Incidentally, the "owner" in this example is an apt example of Brookfield Asset Management, which is fortunate to have an accounting treatment that leaves their core business largely unimpaired by the crisis. Somewhat ironically, a company's established accounting treatment can actually be a competitive advantage in this market, something I am sure that the accounting boards did not intend. It can also be a disadvantage, as we'll see with another example.

Another of our investments, Gladstone Investment Corporation, has been affected by this accounting absurdity. Gladstone is essentially a lender which loans money to companies. They have two kinds of loans in their portfolio. One type is "syndicated" loans, where they are one of many lenders on the loan, each of which holds a small portion of the overall debt. These loans are accounted for by mark-to-market accounting. The other is a "control" loan where Gladstone is the only or majority lender and actually has a control position in the borrower as a result. These loans are valued based on the EBITDA or cash flows of the underlying company, a typical and conservative way to value any cash-producing asset.

Over the past 18 months, the value of Gladstone's syndicated loans (which are marked to market) has declined by about 25%. Virtually all of these loans are still current – the borrowers are not delinquent – this decline reflects only the "fair market value" of these loans which reflect the current crisis. Over the same period, the value of Gladstone's control loans has *increased* by about 10%. Albeit with some differences, the terms of these loans are similar, made to somewhat similar companies in similar industries. However, the accounting treatment of the two types of loans is radically different.

Gladstone has been adversely affected, as their reported book value has declined and their own lenders are imposing much harsher terms upon them, despite the fact that the underlying loans are largely unimpaired. Unlike Brookfield, Gladstone unfortunately has a business model that is affected by market value changes, even if they are temporary.

Outlook

2009 is likely to be what sports teams call a "rebuilding year" for the economy. President Obama and other leaders around the world are acting quickly, decisively, and with enormous scale, and I believe these efforts are staunching the problems and laying the groundwork for recovery. It is this kind of action that was missing during the Great Depression in the US, which caused that crisis to drag on much longer than it should have. I believe the current policies are likely to eventually lead to economic recovery, but it isn't going to be quick, so all investors should not expect much improvement by the end of the year. I think these cash injections will lead to significant inflation once the recovery starts, which is another story.

Listening to the statements the companies are making about their businesses has been interesting. Many report that capitalism basically ground to a halt in the last quarter of 2008 as virtually nothing could get done on any terms. However, starting in 2009, the blood of capitalism has started to flow, and this time not in the streets. Lenders are cautiously beginning to lend, companies are returning to their growth plans with revised expectations. Some merger and acquisition deals that was scuttled in mid-2008 have come back around. As companies figure out who is left standing and who is not, they can figure out how to move forward. The future has not been canceled – just postponed somewhat.

Investors must inherently be optimists – they must believe that things will get better, reasonably soon, or they would not put their money at risk. My fault throughout this crisis has been to be overly optimistic, and not foresee these problems and avoid them. I have plenty of company in these mistaken perceptions, but the company doesn't improve the misery.

Today, grumpy pessimists who have been hoarding their cash can tell us that they told us so. But it is extremely unlikely that hoarding cash is going to be a wise investment over the next 5 or 10 years. The combination of very likely recovery in the stock market and fairly likely significant inflation will make cash, as an investment, much less valuable in 5-10 years in absolute terms than it is today.

I remain focused on our handful of carefully chosen investments, and continue to seek to sell them at high prices and buy them at low prices when possible. Over the past 6 months, a high price has not been seen, so there hasn't been much to do but hunker down and wait out the storm. This environment won't last forever though and I think we can all look forward to more prosperous times ahead.

Investors have always enjoyed their largest gains in the periods following bear markets and recessions. This crisis will eventually come to an end, and I believe that patient investors will be rewarded.

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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