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Second Quarter 2009

Intro

The economy rose to its knees during a tumultuous second quarter. While the threat of a major systemic breakdown seems to have passed, there are few bright spots in terms of economic activity. Economists are now predicting what they call a "weak recovery" through the balance of 2009 and into 2010.

The news flow has been so fast lately that it hardly bears recapping in a quarterly newsletter, as it would become obsolete immediately after publication. The major upheaval events seem to have subsided, and now consumers and businesses are left to find a way to move forward.

It is interesting to hear comments made by business leaders about the preceding 9 months. Warren Buffett says that the economy was "in shambles" and continues to be so, and that there has not been any "bounce" in recovery. Brookfield Asset Management representatives said that during the fourth quarter, the phone simply didn't ring, as no deals were being done at any price. Economic activity had essentially ground to a halt in all of their approximately one dozen markets around the world. In the first quarter of 2009, they reported that essentially nothing happened, which they felt was an accomplishment. This demonstrates how far expectations have fallen, as the lack of a catastrophe is considered to be good news.

Fundamentals have visibly improved in 2009 as capital has started to flow. Brookfield has raised over $1 billion in new financing, and several other large financing offers were completed in other sectors. Capitalism, of course, depends upon capital. The cost of financing is higher than it was, though not too far from 20-30 year averages, and the rates available on new investments are much higher than in the recent past. Some large financial institutions are finding ways to repay the taxpayer funds they used to bridge the chasm, which bodes well for both those companies and the government that loaned the money to them.

The current environment is better only by comparison to the end of 2008, otherwise it is clearly a deep and prolonged recession. The housing market continues to be weak which puts a damper on demand throughout the economy. Companies have seen their business drop by 25-50% and stay there, which is reflected by the 25-50% decline in most stock prices during this time. Unemployment is at its highest level in 25 years, and is as high as 12-13% in some states, indicating that as many as one person out of nine is unemployed.

It is looking more and more likely that inflation is on the horizon, as all of the obligations governments around the world are making to shore up their financial institutions will need to be paid for. This factors into all portfolio decisions, and while we aren't specifically betting on inflation, we are considering how each portfolio holding would perform in an inflationary environment.

Portfolio Update

The first quarter of 2009 provided an extremely challenging environment for investing as the price of virtually everything fell dramatically. Incredibly cheap bargains were everywhere, but everything in our portfolio also fell. Selling one extremely cheap stock to buy another is a tricky business as it is hard to predict which ones will bounce first and fastest, as the price action is driven almost entirely by psychology. In many cases I prefer to own something that we are more familiar with than something new, given the enormous uncertainties present. So we ended up not doing a whole lot as stocks fell and then recovered.

Fortunately as stocks rose most of ours rose as well, some booking gains of 300-400% in the 2-3 months following the end of Q1. Observers have been incorrectly trying to call "the bottom" for the past 18 months, but I am leaning towards the first quarter of 2009 finally being the fundamental bottom for the economy. After the recovery that started in Q2 I was finally able to sell some stocks at decent prices and turn over the portfolios to some extent.

Despite the terrible environment there are a couple of bright spots. In mid-2008 we bought shares of a small insurance company named Specialty Underwriters Insurance at about $5.00 per share, a substantial discount to a growing book value. Earlier in 2009 they had mysteriously refused, and fought vigorously against, a buyout offer for $6.50 per share. This week they agreed to a different deal worth a minimum of $6.51 per share that looks likely to go through. This provides a respectable ~30% gain from our cost basis a year ago and about 79% gain from the price at the end of Q1. I'm familiar with the acquiring company, Tower Group, and am considering retaining our shares in the new company.

We own the unsecured senior debt of Allied Capital, a venerable business development company based in Washington DC. We bought the bonds at 40% of face value with a current yield of 17%. Allied has shown some distress in this environment including a breach of some debt covenants, but despite this I feel that the bonds are well covered. The market price is about what we paid while we're collecting the interest payments, and we should favorably participate in Allied's ongoing restructuring.

Triangle Capital successfully issued equity during the second quarter to raise new capital. Raising second-round equity capital is normally a fairly routine transaction for a growing BDC company, but can be regarded as an accomplishment in this market. Triangle continues to execute on their growth plants despite the difficult environment, and is very fortunate to have one of the cheapest and most secure capital sources available today.

We have several holdings that provide yields ranging from 8% to 17% that I feel is sustainable, including Triangle Capital, Allied Capital, Gladstone Investment and Brookfield Infrastructure Partners. These stocks trade at meaningful discounts to their net asset value and provide high current income, a combination that would seem to provide us with both security and acceptable cash returns.

While the results are not currently reflected in the stock price, other companies we hold continue to do well. Access National Bank reported excellent Q1 results with the highest earnings and asset level in its history. Non-performing assets are below 2% of total assets and they have been reaping the benefits of being well-capitalized and strongly positioned while their competitors are failing. Unemployment in Access National's markets is less than half of the national average, and commercial real estate development has continued almost unabated even during the downturn. Access National has done an excellent job of managing its capital during the crisis and is now in a position to resume their growth plans.

We have also started to initiate some new positions, one of which is The St. Joe Company. St. Joe has an interesting history tracing back to a struggling railroad company bought in 1933 by a DuPont family trust, and it later got into the paper mill business. It has gone through many changes over the years and today its primary asset is approximately 586,000 acres of land in Northwest Florida (the "panhandle"), one of the largest privately owned parcels of land in the United States.

Much of this land is rural and not worth much, but some of it attractively located near the Gulf of Mexico and surrounding a new airport that is due to open in early 2010. Due to the severe correction in the housing markets, we were able to buy shares at a price that valued its land as nothing more than swamp land, which would seem to be an obvious bargain. St. Joe has almost no debt and should be able to develop their land bank profitably over the coming years.

Anyone who has seen the dramatic change in land values that accompanies the successful development of areas like Hilton Head Island or the Outer Banks of North Carolina can understand the potential upside in St. Joe. I also feel that the land value should provide some hedge against inflation. However, this kind of development can take years to pan out, so this is definitely a holding that must be viewed with a long-term perspective.

Another new position is in Level 3 Communications, another company with a an interesting history. Level 3 operates one of the largest fiber optic data networks in the world, built during a debt-fueled construction binge 10 years ago. Demand for their data transmission services has increased exponentially since then, as they correctly predicted widespread adoption of fiber optic networks to transmit voice and video data around the world. Level 3 has consolidated many of their peers over the years and is now one of the few remaining companies in its industry.

Level 3's network is probably the best in the world, but it came with an enormous price tag and a lot of debt, which represents their primary risk. They manage this debt and continue to roll it over with the help of their institutional investors, a lifeline that I feel they will retain. Once again, our entry price is a primary consideration and we were able to buy into the company at an extremely attractive price due to the market malaise.

A final new position is Fairfax Financial, an insurance conglomerate run by Prem Watsa. Watsa and his investment team are one of the very few groups that played the current environment as maestros, as they were heavily “short” several markets in 2008 when the meltdown occurred, and reaped hundreds of millions in profits as world markets fell. Now enjoying a very strong capital position and lots of dry powder, they are uniquely positioned to invest in and benefit from an upcoming recovery.

Watsa’s prescience in predicting this crisis was truly incredible. A few years ago he specifically cited leverage and credit weakness as a growing bubble and predicted a “100 year flood” in the financial markets. He also put his money where his mouth was by hedging his portfolio against declines and taking huge short positions. At the time he sounded like a crackpot, but now we know that he was, literally, right on the money. I only wish I had been listening to him more closely at the time!

These positions, like almost all of our others, are long term in nature, and aren't intended on providing us with a quick profit next quarter or the one after. I expect these companies to do unusually well in periods measuring 5+ years, and it will take time for these situations to play out.

Closing

These are very difficult times to be an investor. I feel that we have experienced the worst of this down cycle, and with some patience can expect to see a substantial recovery and resumption of growth in the coming quarters. Patience and perspective are always important virtues for investors, and are even more valuable today.

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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