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Third Quarter 2010

Intro

The market has continued its see-saw activity throughout most of 2010. After several peaks and valleys, the market is approximately flat – technically up about 1% – for the year as of September 30, 2010. This "sideways" performance reflects the mixed economic news and views during this time, as analysts and investors try to figure out "where we are". Some enthusiasm in April that the worst might be over was reversed by fears of a double-dip recession. Some economic indicators began following the dreaded "double hump" pattern, and the fear that we would slip again, or further, into a recession took hold of the markets.

Leading up to this, our performance in 2009 was satisfactory, returning approximately 50% compared to the market's 27%. In 2010 so far performance has been less impressive, basically tracking the market year-to-date, which is to say roughly flat (the Q3 numbers are still in the works). This performance is somewhat disappointing to me; however, it is not catastrophic, and I encourage clients to remain patient. A pattern that I have noticed in prior years is that our portfolios tend to track the market during poor periods, and outperform the market during good periods. As the macro-economic backdrop shows signs of improvement, I am optimistic that we will once again outperform.

The Recession is Over, Long Live the Recession

During the third quarter, the economic news did start to turn tentatively positive. On September 1st you could almost envision Wall Street returning from vacation as positive analyst reports began to circulate all at once. In mid-September, Warren Buffett declared unequivocally that there would be no double-dip recession. Such a definitive statement about something so difficult to predict raised some eyebrows, but then Buffett does have quite a bit of credibility.

A week later, coincidentally or not, the National Bureau of Economic Research officially declared the recession over, effective June 2009. This made the duration of the recession 18 months, which makes it the longest since World War II. This seemed to settle the matter, and market participants breathed a sigh of relief and market prices reflected this sentiment... until Buffett stated on CNBC a week later that, in fact, we were still in recession. Huh?

What is a recession exactly? The US economy has generally followed a long-term trend of steady if uneven growth for more than 100 years. The most common way to measure this growth is through Gross Domestic Product (GDP). Simply put, a recession is a period when GDP declines, which is usually accompanied by stock market declines, and increases in unemployment and bankruptcies.

There are, however, many ways to try to pinpoint when recessions begin and end. Analyzing the blizzard of weekly or monthly economic figures trying to find the definitive answer is nearly impossible, even though many try, because everyone wants that answer. The change in economic direction is really only evident in retrospect, so the answer is not that "the recession is over today" but that "the recession ended about a year ago". Even so, depending on what you believe the most important numbers to be – GDP, employment, lending, consumer spending, etc. – different observers can have different opinions.

I find that following the advice of real live investors such as Warren Buffett and Prem Watsa instead of academic organizations or the media provides information and opinions that are much more relevant to us as investors. Warren Buffett for example has a unique and valuable insight into the US economy not only because he is one of the world's most successful investors, but because he sees the actual economic results from the more than 70 businesses that he owns. When he says that businesses are hiring and we are headed out of recession, he has better data and perspective than other observers.

While recessions can be economically traumatic, recessions are a "normal" part of the business cycle. The US has had about 11 recessions since 1945 (not including this one) lasting an average of 10 months. While each caused hardship, the US recovered from them all. As a matter of perspective, the US has been in recession for approximately 19% of the months since 1945. Many observers think that recessions are highly unusual or infrequent, however, it is more accurate to think that, over the long term, approximately 1 year out of every 5 will be in recession. This puts both the good and bad years in perspective.

So where are we? I think it is clear that the worst is behind us, and the risk of the economy collapsing into a Great Depression scenario is gone. Most areas of the economy that saw problems have bottomed, and we are on our way up. Investors should have realistic expectations about what we will see over the next quarter or two, but I believe that over periods longer than that, performance should be satisfying.

Value Investing in a Recession

Aside from the "Great Recession of 2008", the US had had only two relatively mild recessions since 1982. So there was an entire generation of investors and consumers who had never really been through a tough recession, and many probably lost some perspective (myself included). That may partly explain why this recession snuck up on us and why it seems difficult to tell when it started and will stop. I am confident, however, that the US will recover from this calamity and go on to prosper, and investors who choose companies with the best long-term prospects will prosper as well.

This macro-economic backdrop has been getting most of the attention from the media and analysis recently, to the point that the valuation and quality of individual companies has largely been forgotten. This is reflected in the market values of stocks, where few stocks have risen above the mire of low expectations reflected in the overall market. Companies good and bad, weak and strong, are all trading at the same cheap valuations. This makes for a difficult environment for investors, because in the short term at least, positive business results do not provide positive market results.

However, the valuation and quality of individual companies *do* matter, because that is what will drive their long-term performance. As has happened in numerous market cycles in the past, value and quality will eventually emerge to outperform the broad market. Accordingly, I have been focusing almost all of my attention and our capital on sound value-based investments that I feel will outperform over the long term.

Our portfolios are positioned for an economic recovery. While we have a fairly high level of cash compared to historical levels, we are fully invested in equities, including some in the economically sensitive portions of the economy where the damage has been more severe. I believe the “slow and steady” performers will continue to do that, while other more aggressive investments could stand to double or more in value under favorable economic scenarios.

Brookfield Asset Management

As chronicled in previous newsletters, Brookfield Asset Management first survived the downturn and then spent the last 6-8 quarters doing deals that built substantial shareholder value. With uninterrupted access to cheap capital even through the depths of the credit crisis, Brookfield has succeeded in both raising capital and making sizable deals.

Brookfield Asset Management (BAM) is the parent company of the conglomerate, and there are several other publicly traded companies that are roughly half owned by Brookfield. Owning the parent company means being exposed to all aspects of the Brookfield empire, whereas owning a single subsidiary means increased exposure to that entity's asset base.

I have always viewed the parent company as the best combination of diversification and total return and this has been a core holding of Tidd Capital portfolios since our origins. Brookfield has been a solid performer, having outperformed the S&P by about 50% over the past 5 years. Recently we also bought units of the Brookfield Infrastructure Partnership (BIP), a Brookfield subsidiary that is focused on international infrastructure assets such as electricity distribution, ports, terminals, and timberlands. These two securities make up 2 of our top 5 holdings. In the third quarter, BAM increased by 30% and BIP by 23% (including dividends) and were the best contributors to our performance.

The Washington Post

Our experience with The Washington Post was unfortunately not as positive. As mentioned in prior newsletters, despite its name, The Washington Post is not really a newspaper company, as less than 20% of its revenues actually come from its namesake newspaper and other print media. The company is first and foremost a for-profit education company, and its Kaplan subsidiary generates more than half of the company's revenues and most of its profits.

We invested in The Washington Post before the recession really took hold, and the company's economic performance since then has been excellent against a bad economic backdrop, even while the stock performance has been poor. For-profit education tends to be somewhat counter-cyclical in a downturn, because people who are laid off seek training to become re-employed, and vocational training such as what is provided by Kaplan is relatively faster and easier than other forms of higher education. As a result, Kaplan's revenues and earnings continued to grow through the recession.

The stock, however, has been pressured by some concerns brewing in the for-profit education industry. One concern is aggressive and possibly fraudulent marketing tactics used by these companies to convince students to sign up. Another more serious concern is the industry's dependency on student lending, which is an industry that has its own problems. Student lending got out of hand during the credit bubble and many students were able to borrow huge sums of money that they had no chance of repaying. As a result, government regulators have been moving to limit and control this lending. The for-profit schools are unfortunately right in their crosshairs.

This began to come to a head over the summer as the U.S. Department of Education and even Congress got involved. The Washington Post's Kaplan division was far from the most serious offender in the marketing infractions, though their name did come up. The Post also has among the least exposure to student loans, but they do have some exposure. So the Kaplan business was drug into the fracas, and the impacts on the business are hard to determine but unlikely to be positive.

As we have seen so often during the recent downturn, when politicians begin to meddle in businesses, the outcome can be very unpredictable. In the face of these unfavorable developments, I sold our position in The Washington Post until I can get more clarity on the outcome of these events. I am still generally favorable on the business, and even with some possible impairments, it may make for a good long-term investment. We may well again become shareholders of the Post again in the future.

ATP Oil & Gas Corporation

ATP Oil & Gas is our one holding focused in the resource exploration industry. ATP is a “big little guy” in the space, being one of few independent exploration companies undertaking major projects in the US, UK and North Sea. We got involved in the stock when it became very cheap in the wake of the BP oil spill this spring.

The drilling moratorium enacted after the BP spill has had an effect on ATP, but fortunately a minor one, even though it had a major effect on the stock. In June, it was announced that one of their major projects was allowed to proceed even though the moratorium was enacted. The company’s fortunes will now be determined primarily by their execution in developing their ongoing projects. Here, fortunately, we have heard a string of good news. The flow rate on their wells has thus far been at or ahead of expectations. They were able to “monetize” their interest in one well – essentially sell a partial interest in it – at favorable terms. GE has been a strong partner to them for about 2 years and has helped finance some of their wells, and the two companies have even discussed an acquisition transaction. I think such a deal is very unlikely, though it does demonstrate GE’s commitment to the company and puts a sort of floor on the value of the company.

ATP is more of an “asset acquisition” company than a traditional E&P company, because they tend to get involved in projects that are already producing, often buying projects that are cast off from the majors. This approach can require less capital to own a producing well and carries less risk of failed projects, but requires access to financing and solid execution. So far ATP has shown excellence in both. CEO Paul Bulmahn owns about 12% of the company, worth about $93 million, and other insiders own another 1%. This insider ownership ensures that our interests are aligned and that insiders are working for their shareholder owners.

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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