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Third Quarter 2011

Intro

The market and global economies were very quiet during the first half of 2011, as I noted the last newsletter. If this were a cowboy movie, someone should have quipped, "it's quiet… too quiet". Indeed, during the third quarter, the market was once again engulfed in a panic in ways very reminiscent of the now well-known crisis of 2008.

When I say "the market" I should really say "all global markets", since not only did all industries in the US stock markets decline simultaneously, but all global markets declined sharply as well. Different global markets are usually not strongly correlated with one in another, but in this case, the correlation was very strong and all markets moved southward in unison. This reflects a rare unanimous viewpoint of the markets, which usually only occurs at very extreme highs and lows.

This scenario is eerily similar to almost exactly 3 years ago in 2008 when the global financial crisis first took hold. At that time, virtually all assets in all global markets declined sharply in value, and government economic officials spent evenings and weekends cobbling together plans to keep the economies running. Like groundhog day, this scenario is playing out again, as officials scramble to control and manage a growing global debt crisis.

Starting at the end of July, the S&P 500 fell by more than 16% in just two weeks, and unfortunately our portfolios were taken along for the miserable ride. A parade of headlines worried about debt situations in Europe, lack of job growth in the US, mortgage concerns facing the US banking system, among other things. Sentiment turned first negative and then irrational, and once again a "sell at any price" mentality took hold.

We Were Ready This Time

When the market declines of 2008 came about, we were admittedly not very well positioned. At the time, we were fully invested with little investable cash, and mentally I was not really ready for a downturn. As markets declined, we could only go along for the ride, or try to make very difficult decisions about selling very cheap stocks to try to buy other very cheap stocks.

This time around, we were much better positioned. As I mentioned in the newsletters, market valuations were not especially cheap and I had been trimming stocks and holding cash. At the end of the second quarter, our accounts were about 10-15% in cash, and we had two large positions that were ready to be sold. When the markets declined, we were much better able to take advantage of the low prices by selling high-priced stocks and buying very cheap stocks, and by getting fully invested at very cheap valuations. In a moment, I'll highlight these transactions.

Something that gives me comfort in times like this is looking at the underlying performance of our specific investments to see how they are really doing. It is impossible to say what the stock market will do in the short term, but if underlying fundamental performance of the businesses is satisfactory and prices paid are reasonable, there will eventually be an opportunity to profit from it. As is often the case during a stock market rout, the underlying business performance is nowhere near as poor as market prices would indicate.

Top holding Berkshire Hathaway for example is performing extremely well, and last week Buffett commented that most of Berkshire's businesses are actually posting record profits. Brookfield Asset Management, another core holding of ours, continues to grow net asset value and cash flows by 1-3% per quarter. This ultra-low rate environment is great for Brookfield, which can roll over their debt at these historically low rates. Access National, another of our top holdings, operates exclusively in the strongest regional economies in the US and has been completely unaffected by either the weak economy or the global debt crisis, and continues to grow at 8-10% per year. New holding Citizens Republic Bancorp (which I'll discuss later) reversed a string of losses to post solid profits in Q2 2011 and is in the process of successfully turning around. These stock prices, however, reflect the negative macroeconomic views even though the businesses continue to grow.

Sold Investments and New Investments

When the market decline first began, I sold two of our larger holdings at excellent prices and used the proceeds to invest in new companies. The first was Fairfax Financial, which famously profited from the 2008 downturn (I guess I can't just say "the downturn" any more, but must specify the recent year!) by being "short" corporate credits. Since this enormous windfall, the company has hedged its portfolios so completely that they are fully insulated from both increases and decreases. The result is limited downside, but also limited upside. I still admire the company, but from a valuation perspective, selling them at a significant premium to book value when other excellent opportunities are available at ridiculously cheap prices was warranted.

Core holding Brookfield Asset Management has several publicly traded subsidiaries, one of which is Brookfield Infrastructure Partners, which focuses on power generation and other infrastructure businesses. We bought units (technically not shares since this is a partnership) of this investment in late 2008 and early 2009 at prices of around $13-16 per unit. These prices reflected a big discount to tangible value due to what I felt were erroneous perceptions about the weakness of the business. During Q3 2011 we sold these units at about $25-26 each, and received dividends of 4-6% in the interim, an excellent return in any market, and especially in a weak one. Incidentally, this is the investment that has required us to include an additional schedule K-1 on our tax returns, so 2011 will be the last year that this will be necessary.

One of our new investments is another Brookfield subsidiary, Brookfield Properties, which focuses on commercial property assets around the globe. I believe that the low point in the premier commercial real estate market passed a year or two ago, and was happy to buy shares of this company at a nearly 20% discount to book value and a yield of about 3.5%. There is no debt crisis at Brookfield, which is taking advantage of the the low-rate, high-liquidity environment to execute deals that continue to build value, including refinancing debt at rock-bottom rates and creating new funds.

We also started a position in the Howard Hughes Corporation. As the name implies, this company was originally founded by eccentric billionaire Howard Hughes, and nearly 100 years ago was in the oil drilling bit business. Through the company, Hughes had amassed huge holdings in undeveloped real estate around Las Vegas and other areas, and those remain this company's principal asset today. The company has gone through a series of ownership changes, and in November 2010 was spun to the public under the control of billionaire investor Bill Ackman. Brookfield Asset Management participated in the spin-off transactions and also holds a significant stake.

The company interests me for several reasons. First, as I noted above, I think that we have seen the worst of the downturn in commercial real estate, and I think now is a great time to invest in well-managed commercial real estate businesses. Second, Bill Ackman has proven to be a brilliant shareholder-focused investor and having him at the helm gives me comfort that shareholders will receive any benefit they are due. Third, the valuation of the company's development-stage assets is somewhat uncertain, and having done lots of analysis, I believe the assets either are or will be worth much more than their currently carrying value. Generally, I am a big fan of diverse wealth-creation companies run by savvy and incentivized managers, and this company definitely fits that bill.

We also initiated a position in Bank of America. This company is currently at the cross-hairs of controversy and seems to be in the headlines every day, which explains the incredibly cheap price of its stock, at around 33% of book value. Warren Buffett famously said, "a great investment opportunity occurs when a marvelous business encounters a one-time, but solvable problem." Bank of America definitely has problems. As an enormous bank with over $2 *trillion* of assets (that's with a "T"), they are woven into the fabric of the US economy and affected by its weakness. More urgently, through its own originations and the unwise acquisition of Countrywide, they are exposed to enormous mortgage liabilities from loans that have gone sour in the weak economy. These liabilities are hard to quantify but are mounting, which is scaring the bejeezus out of the market.

However, I agree with many savvy investors such as Fairholme's Bruce Berkowitz and Warren Buffett (both of whom have sizable investments in the bank) that these problems are indeed solvable. Bank of America has enormous resources with which to address the liabilities (including these two well-heeled investors), and while some amount of dilution or impairment is probable, in my view the current share price more than accounts for that. A decently-run large bank should be able to earn about 1% on its assets. Bank of America's assets top $2 trillion, though not all of these assets are traditional "earning" assets. Even cutting that in half yields profits of $10 billion, putting the bank below a P/E of 6. Bank of America is a very cheap stock and a play on both the US economy and the financial sector specifically, which seems like a very solid long-term bet.

Another new holding is also a bank, Citizens Republic Bancorp. This is a small regional bank based in Flint, Michigan. The bank got into some trouble during the 2008 crisis, and in 2009 accepted some bailout money on the TARP program and recapitalized itself, then briefly went into damage-control mode. The recapitalization represented a turning point. They had been posting losses for a couple of years, and at the beginning of 2011 management reported that they expected to return to profitability in Q3 2011. They actually did so a quarter early, and their Q2 2011 numbers were very good, far better than anyone expected. You would think that this excellent news would push the stock up to unattractive levels, but fortunately for us, the news coincided with the broad market meltdown and the stock actually declined to roughly half of tangible book value. When a company becomes significantly more valuable but the stock price falls sharply, you can bet I'm interested. There is also a tax asset that, if realized, could give an additional boost to upside. Generally, aside from the mis-steps in 2008, I am very impressed by the company and its management. This buy seems like a no-brainer, and I look forward to seeing what happens with the company if and when the market rebounds.

Closing

We are once again in difficult financial times. Up until the 2008 crisis, we had not really seen a big meltdown in the markets in about 25 years. Now, we have had two in three years. It is no fun to be invested during a crisis, and no fun to be able to report only bad news, but I don't feel that the news will be bad forever.

Every meltdown is different, but every meltdown also ends. The specters of debt, recession and inflation continue to haunt the markets. However, it is important to remember that we are invested in carefully selected individual businesses, not the macro-economies. As noted, many of our companies remain largely unaffected by the macro-economic picture even through their market valuations are suffering. Patient investors must be ready to wait out temporary periods of insanity in the markets, and should also look for opportunities to take advantage of the mania. I feel comfortable that we are able to do both, and look forward to reporting better news in the future.

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