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First Quarter 2013

Intro

The S&P 500 hit a new all-time high on March 28, 2013, closing at 1,569.19, beating the previous high of 1,565.15 which, amazingly, was reached about five and a half years prior on October 9, 2007. In those days when all financial news was all good, few would have even guessed that we would soon see an economic catastrophe so bad that the markets would not recover for over 5 years, yet that is what happened.

Tidd Capital investors beat the S&P soundly in 2012, returning 28.4% (after fees) vs. 15.8% for the S&P 500 (including dividends), outperforming by a margin of 12.6%. Choosing to focus about 18 months ago on the areas of the economy that were doing the worst but in a good position to rebound, namely finance and real estate, has paid off. These stocks have significantly outperformed the market, yet many of them are still not expensive.

After an enthusiastic 2012, the market continued it upward swing in the first quarter of 2013, as a steady supply of good news painted a picture of a slowly improving economy. Slowly decreasing unemployment, increased corporate investment and stability in the housing market have all contributed to a feeling of well-being in the markets. As I've mentioned in the past, I believe that a firming US housing market in particular is perhaps the most important aspect of the recovery, and we are seeing signs of this now.

The housing market is an integral part of the economy, not only for the actual housing and construction related activities but also for the related financial and consumer services. Stable and increasing housing prices provide consumer confidence, since consumers are a lot less willing to part with their dollars if they are nervous about what is often their largest monthly expense and largest investment.

However, given the run-up and generally weak economy there is definitely cause for caution. Some investors are skeptical of this robust market action, feeling that it is an over-reaction to a small amount of good news. The stock market is a forward indicator, and current market action reflects where investors think we will be in a few years. For example, when the market first began to fall dramatically in late 2008, unemployment was still at around a relatively benign 6% and didn't peak until over a year later.

I am less concerned with the overall market than I am with the 10-15 carefully selected companies in our portfolios, and these stocks I believe are inexpensive despite their recent run-up. Bank of America for example has seen its stock double in the past 2 years but still trades at about 60% of book value. Leucadia is up 27% in 2013 but is still only at book value. Berkshire bought back over $1 billion of their own stock in December, indicating that it was very cheap. Access National is trading at a P/E of just 7. Brookfield Asset Management trades at 82% of its management's estimate of fair value. These cheap valuations of high-quality companies should provide long-term safety in the value of our investments.

To recap our investment strategy, we are invested in a mix of "stalwarts" and economically sensitive companies. Stalwarts are diverse wealth-creation companies run by best-in-class managers with long successful histories. Examples of these companies are Berkshire Hathaway, Brookfield Asset Management, Leucadia, and MFC Industrial. We generally buy these companies at attractive valuations and intend on holding them for the long term, since they produce long-term market-beating returns. Charlie Munger calls this "sit on your ass investing", and what can be better than beating the market by doing nothing? These investments usually make up at least half of our portfolios.

Economically sensitive companies are those that are subject to wider swings in value based on their specific industries or situations and are more affected by the global economy. These stocks are more volatile but offer the opportunity for outsized gains. Here we tend to buy stocks that are downtrodden for some reason, either their industry is in a slump or the company has had a significant but solvable problem and I feel that the situation will turn around. Our focus a couple of years ago on companies in the real estate and finance sector is a perfect example of this, and these stocks have significantly outperformed both the market and our stalwarts since then.

This approach tends to produce results that can be volatile in the short term, but which should be solid in the long term. Our outperformance tends to come primarily in good markets. Unfortunately there haven't been many good years in the past 6 and our performance has at times been disappointing, particularly in 2007 and 2011 when our economically sensitive investments went off the rails. Going forward, I expect a slow but bumpy recovery in the economy and am optimistic that our investments will continue to outperform.

I have not found it necessary to make many portfolio changes in the past 5 or 6 quarters, though we do have a couple of new positions, and I wanted to give some updates on existing positions.

New Position: Apple

It seems that everyone has an opinion about Apple, which amazingly has gone from near bankruptcy in 1997 to one of the world's most valuable companies. Nearly everyone is familiar with their products, and Apple has created and dominated several new markets over the past 10 years. Continuous innovation is the key to creating value in a technology company, and I believe that Apple has this in spades. The vision of the late Steve Jobs has become institutionalized in Apple's corporate culture and will allow them to continue developing great products.

Additionally, I believe that Apple stock is simply cheap. The company has amassed more than $135 billion in cash, which is increasing at a rate of more than $2 billion per month. With a market cap around $400 billion, about a third of the value of the company is cash. Management has been struggling with the question of what to do with this cash, and this question has been hanging over the stock, though I feel that they will come up with a shareholder-friendly answer shortly. Backing out the cash, the company is valued at approximately 6 times earnings, which I find to be very cheap for a company with Apple's market position and growth prospects. It is rare for a technology company to be a value investment but I believe that is the situation with Apple.

New Position: Sears

At one point in its history, Sears was a dominant retailer with widely read catalogs and a stable of some of the strongest brands in the US including Craftsman, Kenmore, DieHard, and Land's End. However those days are, unfortunately, long gone, and Sears is now at best an also-ran retailer up against a lot of tough competition. They are also saddled with enormous pension obligations that are a holdover from generous benefits given to employees during their successful years. So what makes it an attractive investment?

Sears has significant economic value in its real estate, since many Sears locations are in the cornerstone position of shopping malls in the US and Canada, and if Sears can't successfully utilize this real estate, they can sell or sublet it to another retailer that can. These holdings are carried on the books at a very low cost that doesn't reflect their economic value. The pension obligations are being worked out through a combination of negotiated settlements and cash flows. Meanwhile Sears primary brands are still strong in the marketplace. Sears is controlled by successful hedge fund manager Eddie Lampert who has shown the wherewithal to manage these aspects of the company. On the backdrop of an improving economy, I believe that the Sears boat will be lifted by the rising tide and provide us with a positive outcome in our investments.

Berkshire Hathway

Core holding Berkshire Hathaway benefitted from an improving economy in 2012, and businesses improved pretty much across the board. The stock kept pace with the S&P 500 but no more. Berkshire tends to outperform the market more significantly when the market has a bad year. Berkshire has numerous businesses in the housing industry that are coming back to life and will begin to add to the bottom line. Acquisitions continue to be the primary source of economic improvement at Berkshire. The company did not make any major acquisitions in 2012, but early in 2013 closed on the acquisition of Heinz through a leveraged buy-out.

Succession continues to be an issue at Berkshire, because probably nobody but Buffett can make the multi-billion dollar acquisitions that the company needs to propel its growth. However, this does not concern me because I am comfortable that, when Buffett finally goes to the great board room in the sky, the company will be rational in how it returns money to shareholders, most likely through significant dividends and share repurchases.

Leucadia

Leucadia National Corporation is an investment conglomerate run for decades by two of the savviest investors of our time, Ian Cumming and Joseph Steinberg. For decades the company profited from successful deal making in industries as diverse as beef processing, Pepsi bottling, telecommunications, mining and wine vineyards. As an example of their investing acumen, Leucadia recently exited an investment in Australian mining company Fortescue. Amazingly, they reaped a gain of more than $1.2 billion from an initial investment of just $100 million, and this is after a separate gain of over $1 billion on a different investment in the same company of $444 million.

In late 2012 the company announced that they would merge with investment banking firm Jeffries Group, in which they already had a 29% interest. This transaction provides many benefits to the combined company. First, it addresses the issue of succession which had been hanging over the company. The management team at Jeffries including Richard Handler will now run the combined company, providing a management bench that is both younger and deeper than Leucadia had on its own. Secondly, the combined company will be well capitalized, especially after exiting successful investments such as Fortescue. Third, the core investment banking business at Jeffries will now be unfettered in its growth prospects due to sufficient capital and broader reach. I look forward to remaining invested in the combined company for the long term.

Spin-offs

A few of our investments have spun off companies to us recently. Spin-offs can be considered "dividends with legs", and famous investor Peter Lynch often quipped "spin-offs are cheap". In a spin-off, we receive new shares in a company and then have the option of holding, selling, or adding to those holdings.

Leucadia spun off shares of Crimson Wine Group, a small wine maker that it helped to develop through investment and financing. The company was primarily a land play, that is, it had holdings of land that would potentially be valuable in the future, but which were being used to generate relatively modest cash flows currently. It appears to be somewhat of a pet project of of Cumming and Steinberg. After a careful look I decided to sell our shares in the spin-off after they had appreciated about 8%, which ends up being essentially a one-time dividend payment of 3%.

Brookfield Asset Management recently spun off shares of Brookfield Property Partners, a new company that holds some of its global real estate assets. Brookfield already has another commercial property company Brookfield Office Properties and there is some overlap between these businesses. We will hold this investment in the near term because I believe there are excellent opportunities in the global real estate market. This spin-off amounts to a one-time dividend payment of about 3% which I believe will increase in value as we hold it.

Closing

I hope that this newsletter has provided you better insight into our investments. If you have any questions, please don’t hesitate to contact me.

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