

Harper Asset Management, LLC

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The past year was the most challenging for investors in many decades. Accelerated by the snowballing credit crisis, in 2008 the S&P 500 posted its biggest annual loss since 1937. The events of the past year have prompted us to re-examine past assumptions and sharpen our focus on the most critical investment factor: risk.

Back to Basics

Ben Graham's investment partnership lost 70% between 1929 and 1932. For Graham, the experience shaped and helped put on paper his famous and timeless principles as spelled out in *The Intelligent Investor*. The experience also left a generation of Americans permanently thrifty and averse to risk.

Financial crises of one stripe or another seem to hit fairly often (on average every five years in the past few decades). But the collective memory tends to be short in response to less than cataclysmic events. Following the bursting of the tech bubble, a bumper sticker appeared asking, "Please God, just one more bubble." That prayer was in turn granted, with homes and other real estate becoming the Next Big Thing. The ensuing credit bust resulted in a financial crisis which made all recent ones pale in comparison. Prior financial market freezes lasted for weeks or perhaps months. The present one has dragged on for two years, with the spring of 2009 finally bringing signs of a thaw.

While comparisons to the 1930s are ubiquitous in the media these days, actual conditions are not comparable to that time. The banking sector has been preserved largely through government intervention: the chief cause of the Great Depression was government mismanagement of banking, which resulted in a one-third collapse in the supply of money. Unemployment, while high for the modern era at a recent 9.5%, was more than 20% throughout much of the 1930s, and nearly 11% in 1982. Nominal GDP collapsed by 45% over the four years ending in 1932, whereas

we may see a decline in the high single digits from peak to trough. Relative to macro-economic fundamentals, the market's current reaction may be as extreme as the 89% peak to trough drop in the early 1930s.

It took four years for Graham to recoup everything lost during the prior four years. The principles he later laid out stressed buying stocks under a stringently conservative set of guidelines which resulted in a *margin of safety* for the investor.

Since Graham's time, computers have made stock analysis and screening more efficient, and the profession of security analysis has grown markedly. With overall higher valuations across the board for most of the past decade, stocks that meet all of Graham's criteria have, under normal conditions, become increasingly scarce.

But at present, one can have both the protection that comes with a quality, well capitalized business and the low valuations that set the stage for above average future gains. Even after the significant rally since early March, we remain in a far more fertile investment environment than the last bear market in 2002.

For stocks, our focus remains on investing in issues selling at less than half of our appraisal value. But the most paramount emphasis for a value investor is on having high conviction that the appraisal value retains its worth, particularly in the face of extreme events. Rule #1 is to not lose money. Rule #2 is to never forget rule #1. Ben Graham focused first and foremost on the balance sheet, insisting that any investment have the financial ability to survive the harshest of storms. While Graham suffered during the depression, his 70% decline actually outperformed the 89% decline of the Dow Industrials over the same period.

Equities

Following a sharp drop in the first two months of the year, stocks rebounded sharply in the 2nd quarter to close June up slightly for the year. Our results have improved markedly as of late, leading the market substantially and resulting in

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strong gains for the year to date. The doomsday scenario that markets were discounting in early March has lifted as the banking sector has stabilized, leading investors to return back to fundamentals rather than fear.

In our opinion, stocks on the whole remain the cheapest than they have been since the early 1980s. While there has been a return to risk in the past few months, potential return relative to risk remains very high. Avis Budget Group, for example, which was below \$1 a share in early March, is now above \$5. While this represents a seven-fold increase, shares remain valued at less than four times our normal earnings estimate.

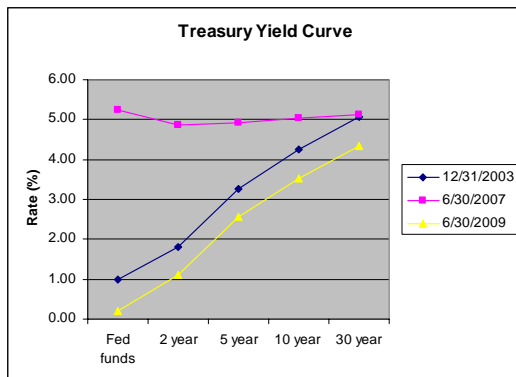
Many high quality companies remain cheap as well. We are focusing the bulk of our capital allocation on quality companies with strong balance sheets selling at abnormally low valuations. The current investment environment allows both strong protection of capital and high implied future rates of return.

Fixed Income

Along with the rebound in equities has come a recovery in riskier bonds, particularly high yield and investment grade corporate bonds.

Opportunity remains strong however; 4-5% is available on many non-financial investment-grade corporate bonds maturing in 2-3 years. This is favorable in a near 0% short-term interest rate environment.

Treasury rates rose significantly in April and May, pushing up mortgage rates and thus impeding the housing recovery.



As illustrated in the yield curve above, interest rates are essentially a “right-ward shift” from where they were in late 2003—parallel but lower. During the prior period, deflation was a concern, the economy was rebounding from recession, and interest rates, particularly on the low end, were near record lows.

We’ve eclipsed the record lows of that time with a Fed funds rate near zero, as the Federal Government has thrown everything in its arsenal at the credit collapse and economic downturn. The result in early 2003 was inflation, if not in the headline numbers, then certainly in housing, metal and commodity prices, which soared.

Treasuries have eased but continue to reflect a strong bid due to investors’ elevated aversion to risk. We continue to avoid treasuries, and are mostly sticking to shorter term bonds except in cases in which high yields compensate for the risk of going longer in the maturity schedule.

Stock Briefs

We recently sold **Ford Motor** at a loss after holding for several years. Shares had rebounded five-fold from lows only a few months prior. Ford has fared far better than Chrysler or GM (both in bankruptcy), as the company came into the recession with stronger finances. But Ford remains in a difficult competitive position relative to global peers who have lower labor and legacy costs, and there is little margin of safety. Ford could potentially be at a cost disadvantage to their restructured U.S. peers. There are too many unknowns and a decade plus history of poor financial performance. So we sold the shares to buy **Dell**.

Dell, is the ubiquitous U.S. manufacturer of desktop and laptop computers, servers,

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printers and provider of related services and consulting. Dell has more than \$10 billion in cash, representing half of the company's market value at our purchase price. Dell is one of the lowest cost operators in the industry, and is selling at a significant discount to our estimate of intrinsic value. Their unique direct sales model allows the company to cut out the retail middleman, and the firm dominates the corporate PC market.

Sun Microsystems reached an agreement to be acquired by Oracle for \$9.50 a share in April, and we sold Sun to add other more discounted names.

Boeing was added in the 2nd quarter as the stock's price fell to well under half of our estimate of intrinsic value. A hot stock only a year ago, Boeing is one of two global manufacturers of large commercial jets. Boeing also makes military aircraft and satellites and provides maintenance services to commercial carriers. Boeing has a record backlog of orders due to strong global demand and a relatively old fleet for domestic carriers.

We re-added **Fidelity National Financial** in late May after the stock fell 40% from early April levels for no discernable reason. Fidelity is the largest title insurer in the nation and significantly grew their market share in December by purchasing a major competitor out of bankruptcy at a nominal cost. They have thus been a huge beneficiary of the financial crisis. We had sold the

shares in early April for better relative bargains.

Universal Stainless & Alloy is a Pennsylvania-based manufacturer of stainless and specialty steel. The company's product lines are less cyclical than the steel industry as a whole, with USAP only reporting one small annual loss in its 15 year existence. USAP has a strong balance sheet, and we purchased shares at a third of our estimate of long-term value.

Citigroup is converting a large chunk of their preferred stock to common at favorable terms for preferred holders but at significant dilution to common shareholders. While the swap doesn't seem financially necessary, pressures from the financial crisis forced the hands of a number of banks and resulted in regulators raising the bar for financial institutions.

Harper Asset Mgmt's Services

Harper Asset Management, LLC is an investment advisory firm, providing clients with investment management and financial advisory services since 2001. If you are concerned about your assets' capacity to support you, please let us help you evaluate your position.

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