

Harper Asset Management, LLC

January 2009

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Lessons From the Past

“Be fearful when others are greedy and greedy when others are fearful.” –Warren Buffett

The small Australian island of Macquarie had a problem in the late 1990s. Feral cats, which had originally landed on the island via shipping vessels in the 19th century, were killing the native seabird population. The Parks and Wildlife Division decided to take action. They removed all the feral cats, thus ensuring a less hazardous life for the birds. Right?

Wrong. The feral cats had been keeping the non-native rabbit population in check. With the cats gone, the rabbits multiplied profusely. The higher population of rabbits laid waste to the island’s vegetation.

Many groups felt that the Parks Division also should have removed all non-native rabbits, rats and mice. So the plan now is to remove all non-native species within seven years. The cost is estimated at \$16 million. That amounts to \$250,000 per square mile of the tiny island.

What is the lesson here? One is that intervention often has unintended consequences. The late Milton Friedman noted that most good-intentioned government policies ended up having the exact opposite effect from which they were intended. It’s food for thought given today’s circumstances.

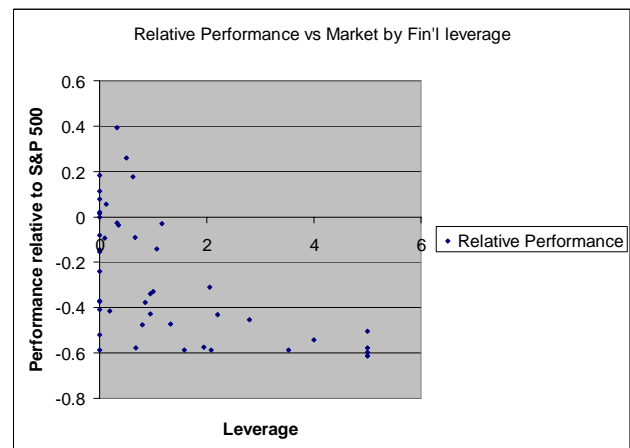
Are the government’s current interventions into markets replacing capital or undermining confidence? Is the insistence that “banks lend their bailout money” a wise one given that bad lending is what got us into this mess in the first place?

By far the actions of government had a stronger influence on the housing bubble and inevitable collapse than any corporation, housing speculator or mortgage broker. The Federal Reserve’s easy money policy – 1% interest rates for nearly two years – was like gasoline on a fire.

Initial rates on ARM mortgages were in the 3% range, making a home affordable in the short-term for virtually anyone. Congress mandated that Fannie Mae and Freddie Mac annually ratchet up their percentage of “low-income” mortgages. We now know these mortgages by another name, and around 40% are in default or foreclosure nationwide.

The fallout has been brutal. In 2008 stocks had their biggest calendar year loss since the 1930s. The drop has been sharper and faster than the 2000-2002 loss, which took 27 months and resulted in a 45% peak to trough drop. The S&P 500’s recent low in November represented a 52% drop from July 2007 closing levels, in only 16 months.

The biggest casualties and sharpest decliners since mid-2007 have been financial companies and businesses with high leverage. See below:



The dots above represent every stock we have held since mid-2007. The X-axis represents financial leverage (net debt to equity). The Y-axis is the relative performance of the stock in comparison to that of the S&P 500, as expressed in decimal (i.e., -0.2 represents an underperformance of 20%, or down about 59%).

Without exception, businesses with modest to high amounts of debt have dramatically underperformed the market. During an

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environment in which everyone seems to be de-leveraging at the same time, the stocks of those with high debt are considered most at risk.

Stocks, corporate bonds, mortgages, commodities, energy, commercial real estate, and homes all fell precipitously in 2008. There has been no shelter from the storm, save U.S. Treasury securities. And Treasuries are now priced at bubble levels: In exchange for lending their money to the U.S. government for 30 years, investors are now paid 2.96% annually, which is likely to be around the level of inflation over that time.

Equity returns are -1.5% annually over the past 10 years. The last time U.S. investors saw negative 10-year returns were periods ending in the late 1930s. And thus investors are skeptical and wary of equities. This isn't the first time.

Equities

Stocks are cheap for the first time in nearly 20 years. Lately more bad news has meant further price declines, even when a company is already selling at less than the net cash on their books, or two to three times earnings, or so forth. A wide number of decent companies are selling at penny stock valuations: less than \$5, some even less than \$1.

Indeed in history, stocks have only become cheap when things feel uncomfortable. But stepping back and taking a rational view, history is a guide, when applied conservatively. Several themes dominate long-term investing value investing. These themes are timeless and have held steady through every market and crisis in history.

- 1) Stock prices overly weight the near-term outlook on both the down and up side.

Few would dispute this, but swimming against the tide is rare. Sell-side analysts, deemed the

public fact checkers of corporate America, are notorious for having a short-term time horizon. Analysts rate stocks overwhelmingly based on the near-term outlook. A common refrain goes something like: "We have limited visibility on the companies near-term operating results," and thus an analyst cuts his one-year target price by a third.

Prices of cyclical businesses are historically more volatile than defensive ones, even if long-term economics are favorable and the business is good. The volatility of the operating results weighs on investors emotions. Wall Street says "the market hates uncertainty." In reality uncertainty often discounts a stock far more than a certain but negative outcome.

But we know that stock prices are supremely unpredictable in the short-term. We see this in returns: One year returns vary wildly, from a 22% fall in 2002 to a 29% rise in 2003. Even 10-year numbers can vary significantly, as proven by the last two decades.

- 2) Future *long-term* returns are inversely related to price.

It's common sense that paying low prices for an investment should result in better future returns than paying high prices. But investors of all stripes seldom heed this advice. Money trickles in when stocks are cheap. Investors grow more confident and eager to dive in when prices are high. Value investors seek to exploit this by paying strong attention to the price paid for a security, as weighted against its value. Market timing is not the idea as it is impossible to consistently execute. The idea is pricing.

- 3) Risk is best defined as the chance of permanent loss. Low prices are a critical defense against risk. Low leverage is critical in times of stress.

Presently many investments which would generally be considered "riskier" actually entail fewer overall risks due to the prices they are trading for. Risk is not a single factor, but

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instead there are a variety of risks within an investment, including credit risk and inflation risk. U.S. Treasury securities are the best credit out there, but presently carry a myriad of other risks as prices are so high and yields are so low.

We're presently being cautious but opportunistic. We aren't allocating meaningful capital to businesses reliant on leverage or in weak competitive positions, and the former includes most financials. Given the dysfunction in the market, we're demanding that investments be far more discounted than we normally would. Our rule in normal times is to buy dollar bills for at least 40% less than intrinsic value. The present requirement is a 60% or greater discount.

One last piece of data. Only five times since 1900 have value stocks posted consecutive negative years. 2007-2008 was the fifth such occurrence. In the prior four instances, value posted an average of 60% in the third year. There has never been a negative third consecutive year for value.* There are no guarantees, but we like the odds.

Fixed Income

Rates on non-treasury securities spiked in the 4th quarter, offering significant yield advantages for fixed-income investors. Treasuries are now near record low yields. 30-year treasuries, for example, were yielding 2.54% on December 18th. Assuming 2.5% inflation, which is comparable to the historical level, investors buying such bonds and holding to maturity would earn a real return, over thirty years, of 0.04% annually.

Instead investors can get the same safety, and significantly higher yields, by buying agency securities (Fannie Mae/Freddie Mac/Federal Home Loan). Such securities also have explicit government backing. Additionally, the government has been guaranteeing newly issued debt of some of the big banks, and such debt is available, over 2-3 year terms, at rates of 3-4%.

The dislocation in credit has created unprecedented opportunities in mortgage-backed securities. We've been adding prime, fixed-rate mortgage backed bonds to replace maturing bonds, many yielding 10-14%. The risks of loss are near zero for many of these securities, yet the returns are in excess of historical equity returns.

One of the best specific risk/returns available is Public Storage preferred stock. The company has a low-leverage balance sheet and the business is relatively resistant to recession. The preferred had significantly underperformed the common stock until a couple of months ago, which makes no sense given that the preferred is senior to the common. The proverbial baby has been thrown out with the bathwater.

*Fama and French

Stock Briefs

We've been re-adding **Goodyear Tire**, a long-time holding we trimmed in 2007. The stock price is at the same level as mid-2003, although the company has made huge strides in improving its finances and obligations and cutting costs and is now solidly profitable. We estimate Goodyear to be worth \$35 long-term.

We've also been adding to **Celestica**, an electronic manufacturing company. The business is dirt cheap, generates stable cash flows and has an immaculate balance sheet, with net cash equivalent to half their current market value.

We sold **Eastman Kodak** recently after holding for several years. Kodak was initially purchased because, despite the decline in traditional film sales, the company had a valuable medical imaging business and continued to generate significant cash flow from its various businesses. Ultimately the co sold the medical imaging business and bought a number of commercial

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and consumer related imaging businesses, which are in more competitive industries and have less certain profitability. While Kodak shares remain cheap, the recent market swoon offered up **American Express** at a very rare bargain price. Amex has a valuable credit card franchise as well as travel related businesses with entrenched market positions. While credit cards are subject to normal cycles in credit, issuers have the ability to change rates and terms to protect profitability.

Freddie Mac was placed in conservatorship by their regulator, along with Fannie Mae, in an effort to bring down rising mortgage rates which were restricting the housing market's recovery. The cost is being born by shareholders, who are being diluted by 80%.

AIG was bailed out by the U.S. Treasury, with shareholders experiencing 80% dilution. While AIG has many world class businesses, they company went into a liquidity crisis due to collateral requirements on debt-related insurance policies it had written several years ago. The majorities of these swaps have been settled or will expire in the next year. AIG is selling off assets to raise cash to pay back the government, and this is no sellers market.

Citigroup is well-capitalized after asset sales and significant new capital infusions, but is suffering from a severe lack of confidence in financial businesses. So far, shareholders have

experienced 30% dilution, but under new leadership the firm is finally slimming its bloated cost structure, a point lost amid all the pessimism on the business. Citi is breaking into two businesses, but both will likely remain under one roof.

Interval Leisure Group primarily operates a global time-share exchange network, with more than 2,000 resorts under contract and over 2 million members. There is only one other company in the business, and scale is a major barrier to the entrance of new competitors. Growth and pricing power are strong, the business is recession resistant, and returns on capital are comparable to those of Microsoft. We think shares are worth a multiple of the current quotation.

We recently re-added **Service Corp Int'l**, which we owned previously until selling in the fall of 2007. Service Corp is the largest owner of funeral homes in the country. The stock is down by two-thirds in a little over a year, although we think intrinsic value has actually grown over the period.

We recently sold **MDC Holdings**, a major homebuilder, as the stock has held up relatively well during the downturn due to the strength of the company's balance sheet, and better values beckon.