Alpha and the New Normal

Alas, music is no talent of mine. Percussion was the natural choice when I joined middle school band. It required no tricky reeds, no knack for reading music. You could be tone deaf for all it mattered. Just a boy, hitting an animal skin with a stick.

My musical career was short-lived. But let's just pretend I'd kept the flame alive all these years and was contemplating the name of my newly formed band of financial nerds. What would I name said band? A recent epiphany sent pangs of regret through me for cutting short my drum career. *Alpha and the New Normal* would be certain to sell out shows in every financial district from Boston to Bangkok.

We are in a *new normal*, many contend, and the old assumptions are best left behind. Indeed the chief topic among Wall Street pundits these days remains when/if things will ever look like they did before the crisis. The economy has emerged from recession, growing in the 1st quarter of 2010 for the third quarter in a row. Unemployment, however, remains very high relative to historical levels, at 9.7% recently. Combined with elevated debt levels, skepticism is high that the consumer will be able to pull the economy up by its bootstraps.

Well, maybe. Our approach has always been to remain agnostic with regard to the economy. For us, the financial crisis reiterated the fallacy of thinking that one can time the market successfully via economic forecasting. It also highlighted the importance of constant vigilance and cautious assumptions when valuing individual securities.

New normal may prove to be as fleeting an obsession as *new economy* was in the late 1990s or as *decoupling* was a few years ago. Regardless of which scenario plays out, we continue to find a decent selection of quality companies trading hands for bargain prices.

Equities

Stocks continued rebounding in the first four months of the year, up 7% through April, before tumbling in early May on European financial worries.

Markets have re-embraced risk as fear has ebbed, with more speculative and leveraged names leading the charge.

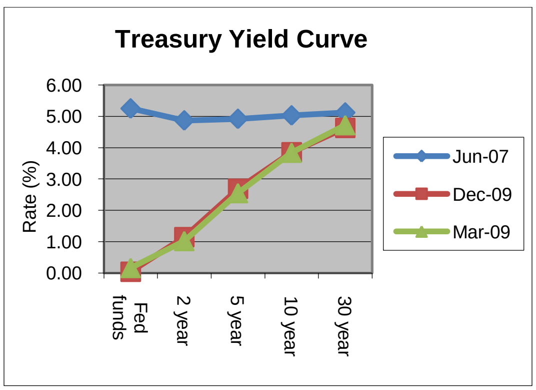
On the other hand, boring, defensive names, such as many medical companies and insurers, have been relative laggards. We've been finding opportunity in many such names. Oil refiners have also been dogs due to the lagging recovery in energy consumption and weak refining margins. Most of the major refining companies are selling at significantly below book or replacement value. While we don't know when margins and demand will turn up, current share prices are absolutely cheap, and balance sheets are in decent shape.

The general market (S&P 500), at 1,150, is trading at between 15 and 17 times estimated 2010 earnings, depending on which estimate you use. This is not cheap. But it is fairly normal at this stage in an economic recovery when earnings are rebounding rapidly.

We continue to find more opportunity in equities than bonds. Recent addition Everest RE, for example, is annually earning around 15% of their current share price, whereas their long-term bonds are yielding around 8%. Over the long-term one would expect these two "yields" to be fairly comparable.

Bonds

With the Federal Reserve waiting for the recovery to further progress, market interest rates were little changed in the first part of 2010. The biggest drama has occurred overseas, as Greece's unsustainable fiscal situation came to a head in April.



While not the only challenged economy in the EU, Greece suffers from a bloated public sector, graft, and poor growth. Greece's case highlights one of the problems with a common currency among diverse members: countries lose control of their own monetary policy. Prior to the EU, Greece had other choices, in particular allowing higher inflation by printing more money, thus inflating away their heavy debt. Several countries (Italy comes to mind) were notorious for increasing the money stock shortly before elections, thus juicing the economy and boosting the standing of incumbents. It's a tricky situation, and forces Greece to make some difficult decisions which are unpopular with some of their citizens.

The U.S.'s situation, while not as severe, is also somewhat tricky. Fiscal deficits remain extremely high, and debt is now 85% of GDP, versus 60% in 2000. The costs of the twin bubbles (tech and housing) have largely been shifted to the public sector.

We continue to be very cautious with regard to longer maturities, as they stand to lose the most should inflation surge. Treasury rates have recently come down due to the Euro crisis, offering investors less than a 1% real return over 10 years if inflation averages historical levels. Better value can be found in corporate bonds, but overall it's difficult to be anything but bearish on the credit markets at this point.

Harper Small Cap Highlighted

Harper Asset Management's Small-Cap Value composite was ranked third in its category for one-year performance for the year ending 3/31/2010 in Morningstar's database, with a net return in excess of 154% for the one-year period. Harper was featured in a recent *Pensions and Investments* article about top small-cap performers.

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Stock Updates

Tesoro owns and operates oil refineries, primarily in the western U.S. The near term outlook for gasoline remains tepid due to slack in the economy. As gasoline supply and demand rebalance over time (either through demand recovery or industry curtailments), we expect Tesoro will return to earning decent returns on capital. The stock is significantly discounted from book value, and their balance sheet remains decent.

Boston Scientific manufactures and sells medical devices. Boston has significant "non-cash" expenses due to purchase-related accounting vagaries, and we expect strong free cash flow over the next few years as acquisition related payments wind down.

Everest RE is a Bermuda-based company with reinsurance operations in the U.S. and abroad, and U.S. insurance operations. Reinsurance is the practice of accepting a portion of an insurer's risk in exchange for part of the premiums. Everest was a beneficiary of the financial crisis due to their rock solid balance sheet and conservative underwriting, and the stock is currently on sale.

Boeing and **Freightcar America** were sold due to valuation.

Harper Asset Management specializes in managing capital for private clients according to a long-term, value-oriented process. We also assist clients with financial and life planning. Please contact us if you would like a review of your financial situation.

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