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# The Long and the Short of It

## In a Nutshell

To avoid any misunderstanding, the idiom nutshell, meaning "concise summary," has no relationship to another expression, nut case. Mark Twain, no stranger to the world of speculation (his occasionally impulsive behavior was certifiably nutty), at least philosophically grasped a central tenet of investment success—an imperturbable temperament. Webster defines serenity as "tranquil composure that suggests imperviousness to agitation or turmoil." Unlike the undersigned, the American icon with the homespun wisdom had a unique capacity to squeeze big insights into a nutshell. Twain's definition personalizes Webster's: "He was always a cool man; nothing could disturb his serenity."

Early Wednesday morning, July 16, the day this missive was leaving the drafting table, the following are a few of the less-than-upbeat, Internet-edition headline stories that keynoted the day:

- *New York Times:* "Fed Chief Bleak on Economic Outlook"
"A sense of gloom gripped Washington as the Federal Reserve chairman warned of the risks of a slowdown." Retrieved at 2 a.m. EDT

- *Wall Street Journal:* "Regulators Move to Aid Bank Liquidity"
"U.S. regulators are stepping up efforts to ensure banks' access to short-term cash amid liquidity worries." 4:13 a.m.

- *Financial Times* (London): "Bernanke highlights risks facing US economy"
"Ben Bernanke highlighted the 'numerous difficulties' facing the U.S. economy in sobering testimony that sent the markets on a rollercoaster ride as he signalled serious risks to growth and of higher than expected inflation." 21:38 (London time, 24-hour clock)

As the captions relentlessly evoke images and emotions that range from unnerving too downright frightening for many readers, we trust you see your investment manager as serene, long ago coming to grips with the critical importance of managing temperament, of truncating the emotional highs and the lows. Our actions speak for themselves. MCM's well-documented decision-making history leaves little doubt that, at least up to this point, a disposition of equanimity has been our behavioral signature, no matter what state of mind Mr. Market (or even agitated or anxious clients) may be exhibiting at any particular time. Most recently, on page 6 of the 2007

Annual Report, a chart shows that cash as a percentage of the total assets we manage was at a record 70% in June, just before the August 2007 financial meltdown. Despite a little good-natured needling from some clients (to a more adamant group that, concluding we were out of touch with a new reality, sought greener pastures elsewhere), we went about our business as usual. We would not serve you well, nor would we add much value, if, like a reed, we bent all too readily before the winds of ever-shifting sentiment.

For those satisfied with a nutshell commentary, suffice it to say that we are neither myopic nor paralyzed with fear. The slow-motion train wreck that is transpiring before our very eyes is in no small part the result of a Fed chairman and Treasury secretary, to say nothing of the (rolling) heads of state of yesterday's financial titans, who have disclosed the bad news on the installment plan—a little bit at a time and only when and if obfuscation is no longer an option.

Our implicit mandate is to buy fractional interest in publicly traded businesses at prices that we believe are well below what they are worth—and hold cash when they are not. On rare occasions, such as now, we feel justified in demanding an even greater discount, a more generous margin of safety. Metaphorically, we are in the batter's box and will swing at fat pitches that come floating by in our sweet spot. That we will not connect on every swing and not necessarily send the ball out of the park when we do (another way of saying we will rarely buy a stock at its lowest point), does not, in the slightest, deter us from our focus. We encourage you to enjoy the game and ask that you remain in your seats, gripping the arm rests with white knuckles if necessary. Like the parent at the Little League game, well-intended coaching from the bleachers is likely to be more of a hindrance than a help. ☺

We have no idea of how close we are to the seventh-inning stretch. Still, as the confirmations you are receiving indicate, we are finding a few fat pitches crossing the plate in our sweet spot. In the second quarter, even after closing out a number of profitable positions, the percentage of assets committed to equities rose from 36% to 50%. We lay no claim to adroit timing, nor do we unduly fret about quotation losses. Applying Ted Williams' theory [from *The Science of Hitting*] to investing, "The Splendid Splinter" calculated that if he swung only at balls in a certain cell of the 77 he identified, right in the middle of the plate, he'd bat .400, but if he swung at balls in the worst cell, which is the lower outside corner, he'd bat .230. So he concluded that the most important thing in terms of being a good batter is to swing at good balls. And in investing, it's the same principle. Analogously, "Make your purchase so attractive that even a mediocre sale gives good results."

There are a few important subtleties that we should not slip by. From long experience Williams knew that batting .400 would put him in the Hall of Fame and that the odds of topping that number were next to nil. Many investors come into this game arbitrarily determined that they will hit .500 or more, only to find themselves in a perpetual funk, with the further insult that their irrational expectations will forever keep them hundreds of miles away from Cooperstown. Second, to paraphrase Lloyd Bentsen's memorable riposte to Dan Quayle, despite our aspirations, we ain't no Ted Williams. If we stay focused and execute soundly, we may receive honorable mention.

That, friends, is the "short subject" preceding the feature-length film. If you're squeezed in the time department, what you've read thus far should capture the essence of what the next 16 pages elucidate in detail. If you want to see how sausage is made, sit back, relax, and take in the whole show.

## A Tectonic Shift?

The multiple meanings of this QCM's title may become apparent as you read on. In the first and most important application, there is a small community of analysts who believe that a tectonic shift toward acute risk aversion is imperceptibly but assuredly displacing a long-established and increasingly precipitous pursuit of return. Simultaneously, and with far more clamor, intriguing market-price anomalies are occurring in businesses impacted by the credit crisis or the cost of fuel, to name but two. We find ourselves facing inevitable trade-offs: Take a bite of the apple of presumed opportunity, thought to be true in the absence of hard proof to the contrary and, in so doing, expose yourself to the yet unknown risk that the whole bunch could become rotten—or forever forgo any presumed opportunity that, with the benefit of hindsight, ultimately proves to be ripe for the plucking. Let's begin with the "rotten bunch."

Switching to a geophysical analogy, we consider it reasonable to posit that a glacial shift is occurring, one that historians will record as a growth-crippling, regret-driven, heads-under-the-covers, gradually intensifying pervasive aversion to risk, the antithesis of the untrammeled (and ultimately imprudent) pursuit of gain that has been building, seemingly without limits, for several decades. Staying close to but on the surface of the earth, history tells us it takes much longer to build edifices, both physical and especially ideological, than it does for them to fall to wrecking ball or bomb. The former are painstakingly constructed, stone by stone or brick by brick, by the exertions of humankind; such structures can be reduced to rubble in figurative minutes by a vastly more powerful force of nature: gravity. The latter edifices, though less tangible, have similar characteristics. Whether the gradual emergence of an unthinking, hubris-driven financial services sector—including commercial banks, investment banks, consumer finance, insurance, and the mortgage and financial aspects of housing—is a "sunset phenomenon" is open to debate. However, because of the umbilical, leverage-fed interdependence of the financial and "real" economies, the question is enormously relevant. The direct impact of a rapidly shrinking financial sector on housing is manifestly evident, but the ripple effect throughout the economy is less conspicuous—but no less real.

To be sure, such an eventuality is well beyond the capacity of the vast majority of backward-looking risk models. Having only experienced what are commonly known as "business cycles" in the post-World War II era, even the most expansive models haven't been stress-tested for something worse. And yet, a keen observer of the scene is sure to notice that the confluence of forces continuing to build could, just possibly, crescendo into a "perfect storm." While the likelihood (the word "probability" should not be used, as quantification of the risk implies a precision that simply doesn't exist) may not be great, the consequences could be. Former Fed chief Alan Greenspan spoke of such phenomena, as did Blaise Pascal (1623–62) in his famous life-choice, probability-based decision tree, "Pascal's Wager." As you will read in a moment, you may be led down the primrose path looking for direction from the second most powerful man in Washington (hint: his initials are BB) on matters of such seminal significance. Joseph Chamberlain, the British colonial secretary, made the following statement to bankers in 1904: "Granted that you are the clearinghouse of the world, [but] are you entirely beyond anxiety as to the permanence of your great position?… Banking is not the creator of our prosperity, but it is the creation of it. It is not the cause of our wealth, but it is the consequence of our wealth."

No matter how well-intended or competent Fed Chairman Bernanke may be, the "permanence of [his] great position" is something, as history would insist, about which we should be most anxious. Much of the momentum behind the heedless propensity to embrace risk without regard to return can be laid at the feet of bankers of all stripes, including but not limited to Robert Rubin and Henry Paulson and all the other Goldman alums, who, seemingly ignorant of the teachings of history, insisted that the money changers could rule the temple.

The dilemma we and others face should not be dismissed lightly. Metaphorically, there are lifeboats for only a few, analogous to Keynes' observation about the markets, when he noted the obvious that there is "liquidity for some but not for all." By rationally reflecting on the possibilities, with equanimity and not fear, one stands the best chance of keeping one's head when those around are losing theirs.

## The Risk of Risk Is No Longer Simply a Bad Pun

Undergirding many of the intransigent problems weighing on the capital and credit markets, as well as on consumers and businesses alike, prior to the beginning of the "rude awakening" during the summer somnolence in August 2007 was the ever-riskier underpricing of risk. Whether because of bad judgment or defective rearview-mirror risk models (if adequate compensation is not demanded for a rational assessment of the risks incurred), untoward outcomes—on both sides of the transaction—are virtually foreordained. Were risks properly factored in, for example, over the last 30 years, financial services, including the ballooning debt- and credit-generating factories, would not have doubled to a record 20% of GDP while manufacturing dwindled by half to a paltry 13%. Chamberlain's prophecy, couched as a warning, obviously fell on deaf ears.

## The Devil in the 'Trivial' Details

As first brought to your attention in the 2007 annual report published five months ago, the invaluable insights of Dietrich Bonhoeffer, the German Lutheran pastor and theologian who lived (and was ultimately hanged for plotting against Hitler) during the Nazi regime, transcend time.

> To understand reality is not the same as to know about outward events. It is to perceive the essential nature of things. The best-informed man is not necessarily the wisest. Indeed, there is a danger that precisely in the multiplicity of his knowledge he will lose sight of what is essential. *But on the other hand, knowledge of an apparently trivial detail quite often makes it possible to see into the depth of things.* And so the wise man will seek to acquire the best possible knowledge about events,

> but always without becoming dependent upon this knowledge. *To recognize the significant in the factual is wisdom* [italics added].

What follows are excerpts from two recent speeches delivered by Fed Chairman Benjamin S. Bernanke. The first was to the 2007 International Monetary Conference, Cape Town, South Africa, June 5, 2007. On the subject of the housing market and subprime lending he opined as follows:

> [June 2007] We will follow developments in the subprime market closely. However, fundamental factors—including solid growth in incomes and relatively low mortgage rates—should ultimately support the demand for housing, and, at this point, *the troubles in the subprime sector seem unlikely to seriously spill over to the broader economy or the financial system* [italics added].

In a cover story in the July 9, 2008, *New York Times* titled "Fed Sees Turmoil Persisting Deep into Next Year," the Fed chairman was professorially delivering a decidedly different and downbeat lecture. What Mr. Bernanke declared to be benign last summer had mutated into something metaphorically comparable to the difference between a baboon and King Kong. Speaking at a forum in Virginia on lending for low- and moderate-income households, the Fed chairman rendered his expert opinion that:

> [July 2008] The Federal Reserve remains concerned that the declining housing market would not reach its bottom and financial markets would not become more stable before some time [elsewhere qualified as "well into"] next year [2009], and that the economy would continue to suffer as a result of declining consumer confidence, a sluggish global economy and the widespread effects of the rapid jump in oil prices.

There is much to be gleaned from a comparison of these two speeches separated by only 13 months in time but a lifetime in terms of events—the tip of the iceberg being a shockingly unanticipated convulsion in the housing and credit markets. There's a presumption that forecasters, particularly those at the pinnacle of power and the font of knowledge and wisdom (like the chairman of the Federal Reserve and the secretary of the Treasury) are able to foretell and sometimes forewarn. Mr. Bernanke does in fact offer many forecasts. Sadly, few, if any, have more than a faint resemblance to the events they're supposed to prophesy. Fewer still (if that's even possible) are scrutinized for their perspicacity. We find it nothing short of incredible that most practitioners accept forecasts at face value without doing enough cross-checking against earlier prognostications to see whether they serve to confirm or negate the latest pronouncements. Moreover, those who forecast are rarely contrite, as if yesterday's errant call is of no consequence. In an era of instant gratification, many prognosticators seem to count on the ubiquity of short memories! Mr. Bernanke's forecasting record is that of a "reactivist," not a "proactivist." That is, he rarely sees the bus coming before he finds himself flat on his back, tire tracks on his face like so much egg after a hastily eaten breakfast. So, as for what he said on July 8, 2008, we shudder to think of the consequences if he is as far below the bull's-eye as was his forecast of a year ago. Another semi-subtle but clearly evident bias resonates through most of the chairman's forecasts: They are uniformly myopic. We can only pray that this forecast departs from the pattern and is proven realistic. While he has no doubt read Chamberlain's admonition, it's far easier for Bernanke to change his perception of reality than to cope with nightmarish cognitive dissonance…

Using Bonhoeffer's mental model (one the likely left-brained chairman would find to be the wrong size), this short paragraph, rather trivial if you will, should allow you to see into the depth of things.

If you desire a detailed dissertation as to how and why we have found ourselves progressively less comfortable and more perplexed in recent years by the willingness of almost everybody to assume risks for which we thought they weren't being adequately compensated—all with the "Good Housekeeping" imprimatur of a Federal Reserve that was complicit in its denial of what was unfolding—it's all painstakingly documented in annual reports beginning in 2005, subsequent Quarterly Capital Markets missives like this, FDResque "Fireside Chats," and various letters. Even the name of the book *Speculative Contagion*, published in 2006, has found its way into the lexicon of market and economic pundits. [At its escalating sales rate, it's possible the book might break even as early as 2020. ☺] In listening to Daniel Schorr reminisce about the Great Depression while he was being interviewed on NPR, I wondered, as I often do, what we'll see as we look back on today five years from now. Already inundated, you'll hear no more dreary, long-term ruminations from Cassandra until the next "Fireside Chat." Stay tuned...

## The Liberating Power of Liquidity

Not long ago those of us with liquidity appeared to be singularly out of step and were even subject to some flak bordering on ridicule. Like bow ties and knickers, however, cash suddenly seems to be fashionable again. Fortunate to have plenty of greenbacks, we venture forth not with dread, for fear of loss, but with purpose in search of opportunity.

## Are There Apples Ripe for the Plucking?

At some indeterminate point in time, the short run and the long run converge and become one. Because of the phenomenon discussed in the next section, certain stocks are selling at prices (that we think offer generous enough margins of safety) that trading some of our liquidity so that others may turn their losses to cash seems prudent. By the way, we wouldn't make such a crude and uncaring statement if, like in a real estate transaction, we knew the counterparty. Indeed, anonymity in markets for tradable securities makes it possible for us to avoid personalizing the experience. The extent of these so-called opportunities may depend importantly on whether we are in the midst of what may or may not become known as the "perfect storm." As the late, great Sir John Templeton opined: "It is impossible to produce superior performance unless you do something different from the majority." He was equally well-known for his admonition, "Buy at the point of maximum pessimism." All that being said, the impetus to give up our liquidity will be inversely proportional to the prices we must pay in the exchange. If prices should fall to the point where they substantially discount the most pessimistic of outcomes that even I can imagine (as readers know, the 1930s are programmed prominently in my intuitive risk models!), by then we will have exchanged most of our liquidity for marketable securities from which the long-term expected returns may exceed the returns from liquid assets by a factor of 5 or more.

## 'It's a Market of Stocks, Not a Stock Market'

Like the title of this section, clichés are trite expressions that have just enough ring of truth that they can evade being characterized as categorically true or untrue. Another cliché (and its polar corollary), "A rising tide lifts all boats," likewise falls into the gray area between universally false and true. With that caveat in mind, the performance of the shares of many companies included in the indices are far from "average." In statistical terms, the standard deviation is getting larger. Some, as you will see below, have fallen percentagewise as much as the Dow fell from 1929 to 1932. All have fared far worse than the S&P 500, which is down the aforementioned 20% from its October 2007 highs. Clutching my clichés like life preservers, try this one on for size: "Beware of bargains in a bull market." The witches' brew that bubbles to the surface when all these variables are thrown into the pot is likely to be confusion-based indecision for most investors.

Should the overall market enter a free-fall stage, yet another aphorism is likely to be apparent: "When the paddy wagon backs up to the house of ill repute, it takes the good girls with the bad." Should we see that wagon, it will not come as a thief in the night; we've had a preview. When the enormity of the subprime crisis began to gain a chokehold on the financial sector's collective psyche, the scramble for liquidity at any price gave witness to incredible waves of panicky selling in some of the more vulnerable stocks.

So far overall investor confidence has remained relatively unperturbed, although I couldn't help but notice that on July 7 the NYSE recorded 628 new 12-month lows and only five new highs. Speculators have hopped from bubble to bubble: first technology and dot.com in the late 1990s, then to housing and the alphabet soup of housing-finance structured products from 2003 to 2006, and now onto industrial materials and agricultural commodities. Until or if we go through a systemic purging of the ultimately

**Price Change From 5-Year Peak to Current**

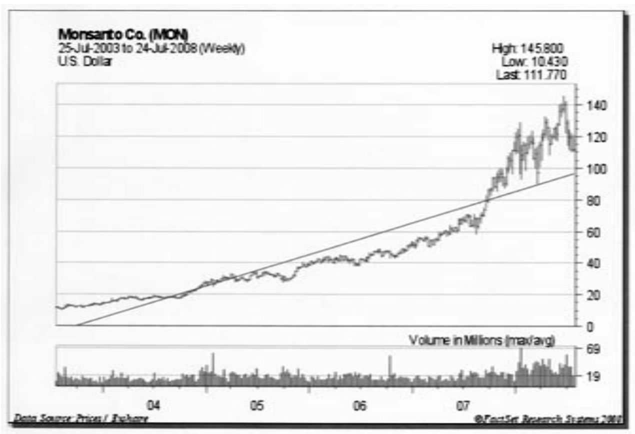
| | |
|---|---|
| **Mortgage-Related** | |
| Washington Mutual Inc. | -87.6% |
| Countrywide Financial | -90.6% |
| Radian Group Inc. | -98.1% |
| **Housing** | |
| Toll Brothers Inc. | -65.3% |
| Beazer Homes USA Inc. | -94.2% |
| D.R. Horton Inc. | -72.2% |
| **Credit-Related** | |
| MBIA Inc. | -92.7% |
| Ambac Financial Group Inc. | -97.5% |
| Moody's Corp. | -53.1% |
| **Financial** | |
| Fifth Third Bancorp | -75.1% |
| KeyCorp | -69.9% |
| National City Corp. | -89.1% |

destructive tendency to focus on returns without regard for risk, we're not likely to see a broad-scale scramble for liquidity. Should that occur, fear will reign supreme and the value investor, who has the temperament to stay focused, will be fishing—with little company—in a stocked pond.

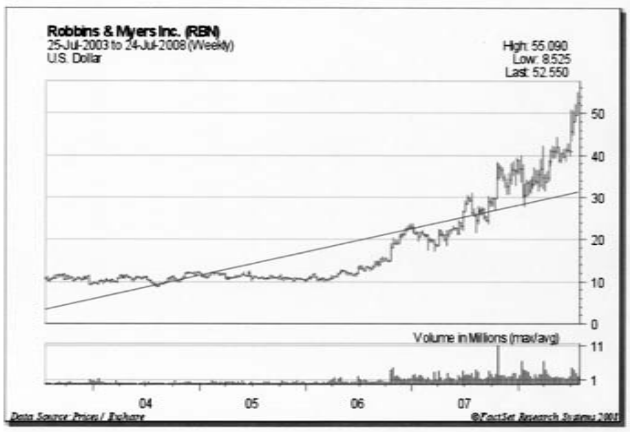
## Bifurcation in the Extreme

Money "at the margin," in the world of investment and speculation, is as excitable as a cat on a hot tin roof in search of the next "great" idea. As the charts below on agricultural and industrial commodity-based companies make abundantly clear, speculative money is most assuredly stampeding toward real assets. Like the contents of a water balloon, for one segment of the sphere to expand another must contract. Banking, from commercial to investment (the latest and thus far greatest "too big to fail" miscreants are Fannie Mae and Freddie Mac, stepchildren of Uncle Sam called GSEs, or government-sponsored enterprises), is among the industries whose short-term fortunes are highly problematic and from which, accordingly, money has bolted with a vengeance.

Additionally, momentum strategies, or buying stocks that have already registered big gains in their recent past, have been trouncing value plays, or buying stocks that are relatively cheap. By the end of June, a model portfolio of momentum stocks had returned more than 70% year after year, while a model portfolio of value stocks with high book-value-to-price ratios was down 55%, according to Joseph Mezrich,








head of quantitative research at Nomura Securities. In other words, in the battle between hot money and bargain hunters, the hot money is winning to a degree not seen since the tech-stock bubble.

The accelerated and often highly impulsive movement of momentum money creates pricing anomalies. As the preceding charts reveal, the favored industries are "priced to perfection" and, despite the appeal of the upward trajectory of their near-term business prospects as investments, the risks that euphoria bakes into market prices are likely to greatly diminish the results. On the flipside, as stock prices plummet, reflective of growing investor disillusionment, emotions overwhelm reason which brings about capitulation to one's fears. If the overarching mandate is to buy low and sell high, it's among the castaways where value investors must force themselves to search for opportunities. As members of the "buy low" camp, what the head of quantitative research at Nomura Securities observed is sweet music to our ears.

## Why Markets Misprice the Popular and the Unpopular

Warren Buffett once quipped, "I'd be a bum on the street with a tin cup if markets were always efficient." Pricing inefficiency is often most accentuated among the most popular and most unpopular outliers: those companies or industries which, in the short run, are either the darlings or the scourge of Wall Street. Most investors have a natural proclivity to cleave to the allure of rising prices which, in a self-sustaining feedback loop that George Soros dubbed "reflexivity," tends to foster further optimism by virtue of the price increase alone. This glorious process of enrichment, perceived as a self-fulfilling prophecy, continues until, in the words of the late formulator of "Herbert Stein's Law," "If something cannot go on forever, it will stop." When will it, you must surely ask? That's the question for which no one has an answer but one that John Maynard Keynes puts into context in the following paragraph.

The adage "You pay a high price for a cheery consensus" has its equal and opposite corollary. As a stock's price decline accelerates, made all the more aggravating when other stocks around it are rising, the pessimism feeds on itself like a metastasizing disease as it changes its form into crippling despair, a financially lethal condition for which there is no easy antidote or painless cure. Another relevant quote from Keynes, "The market can remain irrational longer than you can remain solvent," might be rephrased, substituting the word "patient" for "solvent." The aforementioned Blaise Pascal spoke often of patience, which can mean the calmness, self-control, and willingness or ability to tolerate delay or to defer gratification. One of his most famous observations is: "All man's miseries derive from not being able to sit quietly in a room alone." Humankind invariably prefers action over reflection. Thinking is as outmoded as well-crafted prose is to text-messaging and sound bites. While the following words from Pascal may initially confuse patience with market timing, a careful rereading should make clear that patience and timing are, in fact, synonyms: "Life is all about timing...the unreachable becomes reachable, the unavailable become available, the unattainable...attainable. Have the patience, wait it out. It's all about timing."

## The Short of It

Something interesting is bubbling below the surface but has yet to erupt into the public's consciousness.

The ethically compromised and soon-to-be outgoing chairman of the SEC, Christopher Cox, yielded, in our opinion, to the power of the hedge fund lobby and, in July 2007, repealed a Depression-era rule that had rendered the "gang tackling" variant of short-selling a practical impossibility. Sparing you the details, the "bear hugs" that greatly accelerated stock price declines during the market crash of the early 1930s are once again legal and, in our judgment, being exploited by the $1.9 trillion hedge fund industry that is running short on new games to play.

[Always on the prowl for fresh ideas to make a buck, Wall Street has engineered a new semi-speculative vehicle that may follow many of its predecessors by helping to separate investors from their money. A new iteration called the 130/30 fund is rapidly gaining legs. 130/30 funds are similar to long-only funds to the extent that they build a portfolio as normal, allocating 100% of NAV (net asset value) to long positions. They differ, however, from traditional long-only portfolios in that they then short-sell securities to the tune of 30% of NAV. The proceeds from the short sale are then used to acquire additional long positions, thereby bringing the total exposure to 130% long and 30% short. The 130/30 product provides market exposure or "beta" but also enables the fund to generate additional "alpha." As these mystical Greek words signify, modern portfolio theory (MPT), although long in the tooth, is far from dead. Short-selling is an acquired art for which a steely temperament is absolutely mandatory. The new Masters of the Universe are brash young fellows who suffer from a major flaw: a dangerous sense of invincibility.]

Few readers are likely aware of the 1938 rule and the potential for abuse as a result of its repeal. Parenthetically, if enough inquiries are received, we will publish a more detailed paper on the subject. In any event, who better than some of the more predatory hedge funds to raid the weak and wounded? What, you may be wondering, is the relevance of this to evaluating investments?

First, without some understanding of the concept the reader cannot appreciate its significance in exacerbating pricing discontinuities. Short-selling (unfamiliar to many because it's not amenable to most tangible assets where there's rarely an identical substitute) is a technique for reversing the normal order of the purchase/sale transaction in marketable securities. It involves selling first—having your broker deliver shares, on loan for a fee from another broker, to make delivery to the buyer—then buying later, ideally at a lower price, replacing the shares borrowed with ones actually purchased in the open market, at which point the transaction is completed.

The curious reader is likely to ask, "In order to walk away with the profits that resulted, at least in part, from the potent incremental (short) selling at the margin by hedge funds, from whom are the short-sellers going to buy shares to close out their short positions and realize their profits"? Voilà, this is where the retail investor inadvertently comes to their aid. Smart short-sellers are waiting for an "event" that will likely precipitate massive selling by hapless retail investors. While there are several possible triggering events, the most obvious is a reduction in or complete omission of a company's dividend. Dividend cuts are typically a lagging indicator, sort of the final insult after a long swoon in the stock price. Retail investors are inclined to futilely hang on in hopes that the dividend will be maintained. The more the stock price falls, the more the current yield rises. As the current yield eclipses anything else available, the retail investor adopts the I-can't-sell-it-at-this-price rationale. Most likely when, and not if, the dividend follows the stock, disillusioned retail shareholders are likely to capitulate to their fears and throw in the towel. The hedge funds, sitting on the telephone line like so many vultures, will swoop down and scoop up shares sold in the ensuing panic with the same indifference that they might display figuratively feeding on roadkill. If, by some miracle, the company is able to maintain the dividend, the worm just might turn, and it will be the hedge funds who will find themselves scrambling for "cover."

It's worth keeping in mind that there are a few old, bold short-sellers. Today the game is populated by more amateurs than ever before. At some point the growing realization that there just might not be an "event," coupled with the fact that short-selling is not a free ride (the accounts of short sellers are debited with the amount of the annual dividend that their broker must pay the buyer of the stock the short-sellers don't own) could cause the game to take a diabolical turn. Millions of shares that must eventually be purchased by the short-sellers—with only a few shares available for sale—could result in a clearing price (the price level where the supply of and demand for shares reach equilibrium) well above current levels.

[HNI, on which you have received some recent purchase confirmations, is a real-time case in point. On Thursday morning, July 17 the company announced somewhat-better-than-expected quarterly results. Under normal circumstances, the response would've been something modestly north of yawn. However, because more than 20% of the float (State Farm is a very long-term owner of 16%) is represented by shares sold short, the reaction was bedlam as the panicky "shorts" couldn't rustle up any sellers without raising the bid big time. In the first hour of trading the stock gapped up from the Wednesday close of $17.25 to $24.50, a gain of $7.25 points or 40% on, believe it or not, a minuscule 200,000 shares. In this instance the short-sellers were our friends. They drove the stock down to bargain levels only to push it back up when they got caught with their "shorts" down.]

We have compiled a list of companies where shares sold short represent more than 25% of total shares outstanding. During the first half of 2008, shares sold short represent 10% or more of the shares sold. While not a large percentage in absolute terms, such selling at the margin is likely to tip the scale dramatically. What makes these aberrations so intriguing is that they cannot be quantified and therefore cannot be plugged into any of the "black box" models used by quantitative traders. Relying on intuition alone, I would hazard a guess that a number of the companies we have identified are selling at prices 50% or more below where they would "clear" were they not in the grip of a "bear hug." That makes the margin of safety that much greater.  In addition, because this phenomenon is not widely known, we may have an additional "edge" beyond our longer-term investment horizons. [During the week of July 14, Cox recanted, sort of—that is, in typically oblique Washington style, suggesting that the shorts may have had something to do with the plundering of the financials. Bob Farrell, one of my favorite strategists of all time, was coaxed out of semi-retirement (after 50 years with Merrill Lynch) for an interview with friend, Kate Welling. He had this to say about the theater of the absurd where the principal actors are not expected to be clowns: "You can't make this stuff up. The uptick rule on short sales was dropped just as the bear market starts—that was *brilliant*," Farrell noted with palpable sarcasm.]

## What's So Hard About 'Buy Low, Sell High'?

Stripped down to its barest essentials, the mandate of the value investor is as simple in concept and classroom as it is profoundly difficult to implement on the battlefield: "Buy low, sell high." For the investor who perceives "high" or "low" in relative terms, putting the mandate to the test is problematic at best. For example, the shares of Lee Enterprises, a Davenport, Iowa-based, 51-city Midwestern and Western daily newspaper chain, traded at $50 three years ago. Today Lee changes hands for $3.30. Was the stock "low" at $25, when it was down 50%; at $10 after it had declined 80%; or is it now, finally, "cheap" at $3.30—less than 7% of what the shares commanded in the market in 2005? As the qualifier "value" investor should imply, without some vague notion of the "intrinsic worth" of Lee Enterprises apart from its evaporating market price, the notion of low or high based solely on some price at which the stock traded at an earlier date is both ephemeral and financially naïve.

Twentieth-century investment legend Benjamin Graham observed with black-and-white clarity: "An investment operation is one which, upon thorough analysis, promises safety of principle and an adequate return. Operations not meeting these requirements are speculative." Resorting to the homespun wisdom of "Too soon old, too late smart," many a dispirited investor eventually learns to his dismay that there is no moral obligation whatsoever for a stock to return to its earlier high so that an error in judgment can be miraculously remedied without incurring the indignity of capital loss. With little sense of context and groping their way through the investment maze absent some awareness of the intrinsic value of a business, investors are likely to find themselves wandering aimlessly on the path to confusion.

When investors dedicate themselves to ascertaining the value of a business without being overly influenced by others—perhaps most beguilingly represented by the presumed "almighty and omnipotent" market, which puts its seemingly sacrosanct price on businesses countless times every business day—their odds for survival, even perhaps success, are greatly enhanced. Beyond being deluged with distractions (from the imperious and relentless mental water torture of a market price that figuratively drips with maddening regularity on your forehead, refusing to confirm your judgment of value to the windstorm of economic and financial news that blows hot or cold from day to day), the investor can only estimate value. It cannot be determined with precision.

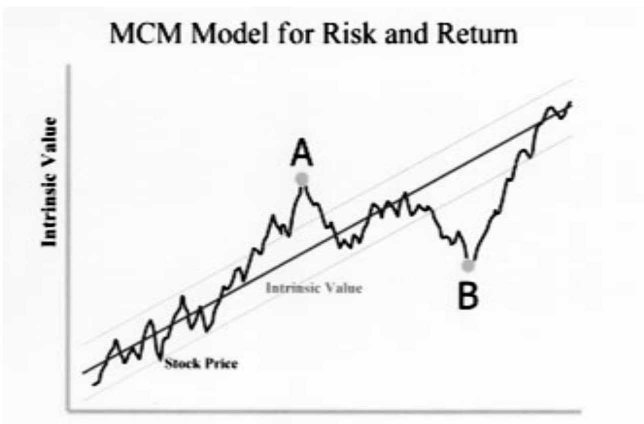
## The Agony of the Anchoring Bias

It's as subtle as it is destructive. Alluded to immediately above, it deserves special attention because of the power it holds over otherwise rational investment decisions. Just as investors who witnessed Lee Enterprises' stock hit $50 and have waited forlornly for it to eventually redeem their judgment, if $3.30 just happens to be the lowest price to which the stock sinks, many investors will be anchored there, lamenting their hindsight-based indecision as the stock levitates. Equally if not more important—and applicable today as we begin establishing positions—is the anchoring that occurs when the first purchase is made. For the lay investor, price anchoring occurs with that first purchase. If the price moves lower, he or she typically sees it as a non-confirmation of the initial judgment rather than an even more compelling opportunity to buy a slice of the company at a greater discount to intrinsic value. In markets like this, the deviation between price and value can reach extremes. Of course, there's always the possibility that the estimate of intrinsic value was the result of another bias: over-optimism. ☹

## The Ubiquitous 'A/B' Model

In Chapter 3 (pages 75–77) of *Speculative Contagion* (2006), which focuses on the year 2000, we first introduced the non-original, above-named model with the attendant explanation:

> The following diagram helps to graphically illustrate essential elements of our argument. The left-to-right, upward-sloping, solid linear curve—our approximation of a point value for intrinsic worth over time—is what differentiates our investment approach from those who are inclined toward MPT. It assumes, almost presumptuously, that the marketplace is not the final arbiter of value but that we, and others of a similarly independent and presumably rational bent, are capable of reaching a reasonable conclusion about a company's value without the market's help. To be sure, this is the most critical element of our decision-making model, upon which everything else hinges.




> It should be no surprise that deriving it places more rigorous demands on us as analysts than any other of our activities or, for that matter, any other analytical approaches should we choose to pursue them. The gaps between the "value line"—a representation that in reality is never linear—and the dashed lines on either side are known as the "confidence interval." The wider the gap, the more uncertain we are about our estimate of intrinsic value; in like manner, the narrower the gap, the more confident we are of such estimates. Most companies with high levels of business or financial risk simply don't make it through our rather exacting filters. The confidence interval would be too wide for us to find any practical utility in the idea.
>
> Valuation risk, as implied above, is more problematic. The more linear and upward-sloping the intrinsic-value line, the greater the degree of confidence in extrapolating it well into the future; the tightness of the confidence interval around it mitigates valuation risk for long-term investors. But few businesses offer that optimal package of investment attributes. In reality, most lines are not nearly so straight or steep in slope—nor is the future so certain or the confidence interval so tight. Only government bonds provide similar certainty, and they yield 5.1%, well below our threshold of required rate of return for equities. Working under those conditions of more frequently encountered uncertainty is not without its justification and rewards (as described in the following paragraph). That's where the concept of "margin of safety" comes into play. You'll notice that point B on the diagram is well below the intrinsic-value line immediately above. The spread between what we think a business is worth and the price at which it sells in the marketplace constitutes what might also be called a "margin for error." If our analysis of business, financial, or valuation risk proves to be optimistic, and it becomes necessary to shift the intrinsic-value line downward or flatten its slope (or both), the discounted purchase price gives us a safety cushion to minimize the consequences of our error. Conversely, point A, purchasing a company when it is wildly popular, affords none of the advantages implicit in point B.
>
> There is a corollary to the preceding thesis that appears to us to be entirely logical but puts us at risk

of being called heretics. If the corollary is to be believed, it turns on its head the tenet that high risk is the only means to high return. In other words, from our perspective, the world is no longer flat! For the long-term investor who is sensitive to the relationship between price and value, point B affords not only a margin of safety (i.e., lower risk), but the holding-period total return is likely to be greater than the growth rate in intrinsic value as well. As I hope is clear by now, point A promises above-average risk and below-average expected return, unless heroic assumptions are made about an upward shift in the value line. That's what we meant when we said, "If we carefully manage risk, the returns will take care of themselves." Comfortable now in our role as nonconformists, we must confess that MPT's use of price volatility as a measure of risk can be for us, as long-term investors, a measure of opportunity. The greater the volatility, the wider the vertical spread between points A and B is likely to be. If we insist on a significant margin of safety at the time of purchase, above-average volatility may well provide above-average returns. Rather simple, when you ponder it awhile.

Those engaged in investment activities more closely associated with shorter-term speculation are well advised to operate under the high-risk/high-return paradigm. Of course, last year's aberration in technology and Internet issues proves that it is possible from time to time to have the deadly combination of high risk and low return.

A significant portion of whatever advantage we gained over mainstream thinking last year arose because we were able to buy the businesses we longed to own below their intrinsic value. That doesn't happen every year. As with the CEOs of the businesses we own, we cannot escape the reality that capital allocation is a critical and unavoidable responsibility. If long-term returns are determined by the long-term performance of the asset, then we can logically expect to enjoy above-average returns by allocating capital to businesses that earn superior returns on capital, provided we are careful not to be goaded by the seductiveness of popular sentiment into paying too high a price.

It has been a long time since Mr. Market has presented us with such apparently compelling "B" prices. Superimposed on the 20-year historical price charts is a mathematically constructed linear trendline that, for those with a penchant for detail, is an attempt to explain, without knowledge of the cause of the price changes, the behavior of the measurement on the assumption that it can be statistically distinguished from pure randomness. Like the reference to inadequate models above, 20 years may not be sufficient history. At least in theory, however (given enough time), the tendency of price to not forever drift away from that to which it is ultimately anchored but, rather, to regress toward the mathematical "central tendency" (or, in this case, "intrinsic value") is more likely. Whether the 20-year trendline is a reasonable approximation of underlying value cannot be known with certainty.

## The Ineluctable Appeal of the Wallflowers

Please examine the charts of these wallflowers found on the next page. Take pen in hand and mark points A and B as you see them based on the discussion above. At the moment there is nothing about the short-term business prospects of these companies that could be considered appealing. To investors like us who believe that markets are occasionally irrational and therefore inefficient—and that prices, in their own time and at their own pace, regress toward intrinsic value (price and intrinsic value ultimately converge)—the wallflowers are the prettiest girls at the investment dance.


Fifth Third Bancorp (FITB)
31-Jul-1998 to 24-Jul-2008 (Monthly)
U.S. Dollar
High: 69.700
Low: 8.960
Last: 14.650
Volume in Millions (max/avg)


Briggs & Stratton Corp. (BGG)
31-Jul-1998 to 24-Jul-2008 (Monthly)
U.S. Dollar
High: 44.500
Low: 11.200
Last: 14.730
Volume in Millions (max/avg)


Brunswick Corp. (BC)
31-Jul-1998 to 24-Jul-2008 (Monthly)
U.S. Dollar
High: 49.850
Low: 9.290
Last: 12.530
Volume in Millions (max/avg)

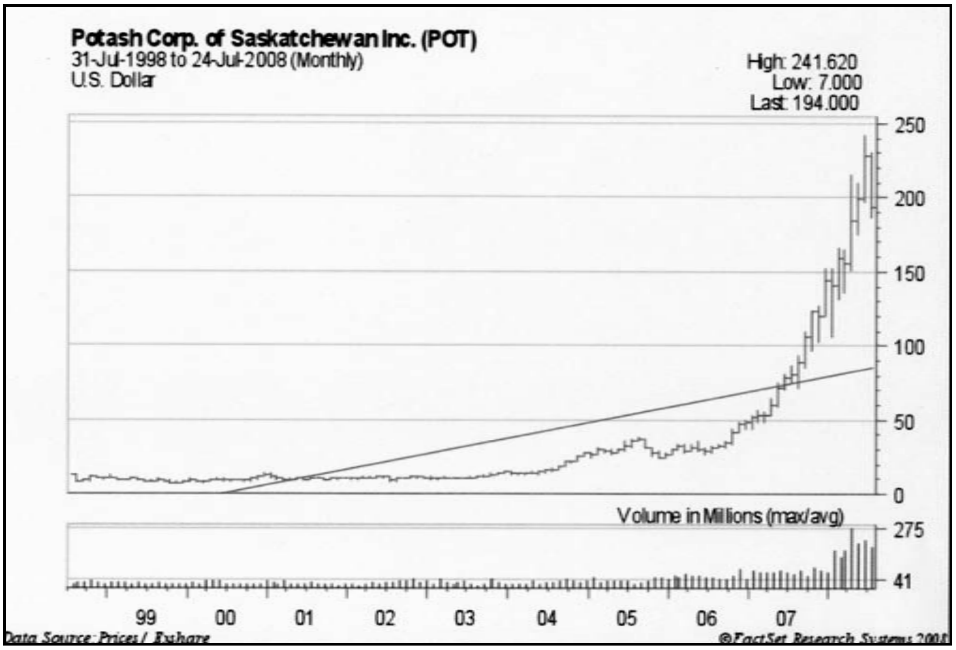

Gannett Co. Inc. (GCI)
31-Jul-1998 to 24-Jul-2008 (Monthly)
U.S. Dollar
High: 91.380
Low: 14.620
Last: 19.070
Volume in Millions (max/avg)


Lee Enterprises Inc. (LEE)
31-Jul-1998 to 24-Jul-2008 (Monthly)
U.S. Dollar
High: 49.830
Low: 2.990
Last: 4.120
Volume in Millions (max/avg)


HNI Corp. (HNI)
31-Jul-1998 to 24-Jul-2008 (Monthly)
U.S. Dollar
High: 62.410
Low: 15.562
Last: 23.580
Volume in Millions (max/avg)

## The Preposterous Price of Popularity

The price of potash, an agricultural fertilizer feedstock, remained in a narrow trading range of around $100 US per ton from 1980 until 2007. In the last 12 months prices have risen tenfold to $1,000, increasing by $660 in May alone. Is it any wonder that the shares of Potash Corp. of Saskatchewan (trading under the symbol "POT" which begs for but shall not get a retort!) are reaching for the moon? Never knowing how high is high without the benefit of hindsight, suffice it to say POT is an example of point "A"!




## Conclusion

Those clients who have suffered through reading the foregoing, seemingly serpentine explanations of why things are out of whack should not be at all surprised by the consequences that are manifesting themselves in many sectors of the economy. Those who were blindsided by the unanticipated are likely to react in irrational and often counterproductive ways. "To win, first you must not lose" has been our mantra. Having preserved capital in the face of persistent temptation, we are now in a position to put it prudently to work in the face of persistent resistance. Because of the perverse nature of the reward system in our profession, we seem to be adding the least value for our clients when, in fact, we are adding the most.☺

# Equity Holdings

## New Holdings

During the second quarter we added four new positions to our portfolios: HNI, Gannett, Lamar, and Fifth Third Bank. HNI and Lamar fit into our basic model of finding companies with enduring competitive advantages that are run by first-rate executives. We almost completed our position in HNI at $17 (we began purchasing the stock at just under $24) before the stock recovered when the company's second-quarter earnings were well-received by the market. We have established only a toehold in Lamar and will add to it at lower prices.

Gannett and Fifth Third have the "advantage" of being in industries largely despised by Wall Street. Such loathing and pessimism foster bargain purchases; time will tell if we have properly ascertained the operational risks in these companies. Having stayed clear of the financials for a long time, the question arises: Why Fifth Third and why now? First, FITB is a known entity, but most importantly it has a large and very valuable non-bank business (payment processing) that enjoys terrific economics. The why now should be obvious. The near panic on Wall Street in financials, some of it justified, has driven regional bank stocks down to the lowest valuations since the last banking panic in the early 1990s. The company's announcement that it was cutting the dividend and raising capital took away a good deal of the short-term market risk. Gannett, in spite of all the negative commentary on the newspaper business, still has some favorable characteristics. Earnings are in cash, capital expenditures are modest, and returns on capital are still reasonable. GCI also has some very valuable non-press properties, including Internet-based models (Career Builder, Cars.com, etc.) and television stations. We tried to add to our position around $16 but purchased only a few shares. We will likely add incrementally to our position if the stock moves back toward that level.

## Core Holdings

### Berkshire Hathaway

There is relatively little new to report on BRK. Berkshire has put almost $7 billion to work in public and private businesses, the largest of which was the purchase of a 60% interest in Marmon Holdings ($4.5 billion). Marmon is a diversified manufacturer/distributor that serves a broad range of customers in the construction and industrial sectors of the economy.

The going will be a little rough for many of Warren Buffett's businesses that participate in the construction, retail, and property/casualty industries. The increased volatility of the stock market and the difficult economy, however, will be of long-term benefit to shareholders if prices continue to fall—for private and public companies. Buffett continues to hold a $50 billion-plus war chest, though it is no longer growing, as he has put money to work at a slightly faster pace than Berkshire is able to generate cash. We are neither buyers nor sellers at current prices, having sold a substantial portion of our BRK position in the first quarter.

### Discount Retailers

As of this writing, we have sold all three positions in discount retailing (Wal-Mart, Dollar General, and TJX). It wasn't long ago that Wall Street had a clear disdain for retailers who relied on lower-income consumers. Now it's considered the place to be as consumers are adjusting to less-robust economic conditions by trying to stretch their budgets at value-based retailers. Stock prices in this segment of the market now reflect investors' renewed interest!

We didn't hit any home runs in this arena, but the returns have been respectable in the context of a tough stock market and a thrashing of many retail stocks. The remaining position in Wal-Mart was sold in the second quarter because of the combination of valuation and size. It's impossible for Wal-Mart to grow fast enough to support a high multiple; the company will have to create $23 billion in value during the next year simply to grow 10%.

We feel similarly with respect to TJX, electing here in July to sell our remaining position early in the third quarter; we sold half our position in the first quarter. Despite TJX being a much smaller company than Wal-Mart (and selling at a lower multiple), we nonetheless felt that solid comp-store sales and well-managed inventories have resulted in a stock price that warranted our taking a second (and final) bite of the profit apple.

## Consumer Discretionary (Mohawk, Lowe's, Pool Corp.)

Consumer confidence is at a 20-year low. Two national lenders have left the business of financing RVs, boats, pools, and other high-ticket consumer goods. Home-equity lines are under stress in the banking industry. Gas prices have further reduced demand for gas-guzzling vehicles and toys of all kinds. There is no recovery in sight and, indeed, many (including MCM) fear things will get worse before they get better. This, however, is our kind of environment—not because we enjoy the hardships and challenges, but rather because we like the stock prices it produces!

It's true we have been early in a few instances and "sucked our thumbs" when we could've sold Mohawk at a healthy profit in anticipation of increased consumer pressures to come. The losses we have incurred in Mohawk, Lowe's, and Pool total about 2.5% of portfolio value, and we acknowledge the stocks could fall still farther. The valuations, however, are becoming more compelling through a combination of lower prices and growth in intrinsic value. All three companies have well-defined competitive advantages, are growing market share by executing in the marketplace and/or acquisitions, and are reporting healthy profits (although below record levels). The stocks represent good value, but they aren't necessarily in the bargain bin. We can't know, of course, if these stocks will go from cheap to true bargain status.

There are other companies in this sector of the market that have less-compelling business models and capital structures, but they're much closer to bargain prices. These include boat, motorcycle, and RV manufacturers, in addition to other consumer-related businesses where the stocks have declined 60–70%.

This sector of the market is clearly under stress and a favorite of short-sellers. It has the added advantage (unlike the financial-sector stocks that are also under stress) of having companies that tend to enjoy better-defined, long-term-growth trajectories; more transparency in financial statements; and business models that come with competitive advantages. Expect more MCM activity in this area, either by adding to existing names if panic selling sets in or by adding a few new names that have been more or less left for dead.

## Insurance (Progressive, Brown & Brown, WellPoint)

The insurance industry is another sector of the economy going though headwinds, but it doesn't face the credit challenges of the banking industry. While insurance companies are technically "financials," the underlying economics are very different from the banking business. With insurance the first thing that happens in a transaction is receiving cash. In banking the first thing that happens is a cash outlay. The insurance industry is not without risk, however. Insurance companies can make mistakes in managing the "float" (investment portfolio). They also can make mistakes in estimating future claims, which can make estimating true earnings power subject to greater uncertainty.

With Progressive and Brown & Brown, we've avoided these risks. Progressive has a relatively short-tailed business mix in which claims are developed and paid quickly. BRO is a broker with no at-risk claims exposure. Brown & Brown does, however, have to deal with the cyclicality of the industry. The property casualty industry is well into the “soft” cycle where insurance rates are declining. This will be followed by reduced industry profit margins and returns on capital. Eventually, rates are sure to increase once again, and both companies will be big beneficiaries.

WellPoint is a health insurer, and its cycle, to the extent there is one, is distinct from the property/casualty cycle. After a number of very good years for the health insurance, it appears that the industry has found itself behind the curve of increasing healthcare inflation. Claims costs are rising slightly faster than premium rates for the first time in several years, and this has caused a very large correction in the stock prices of health insurers. Earnings and margins will be lower for a time, and political risks are omnipresent, especially as 2009 draws nigh. We’re comfortable with our insurance holdings and would consider adding to our property/casualty holdings if the stocks move lower. We’re unlikely to add materially to WellPoint, however, given the lack of visibility on core earnings and long-term structural issues in the industry.

### McGraw-Hill

From a business perspective McGraw-Hill is meeting our expectations. We knew the structured-finance part of the business would go away for a while, but the rest of the company is doing OK. MHP has, so far, survived the regulatory scrutiny that could have a material impact on industry practices. Comments and reviews by New York’s attorney general and the Securities & Exchange Commission haven’t introduced onerous changes. The regulatory risk, though, isn’t over, and we’re unlikely to add to our position at current prices.

### Emmis

Ratings have improved at several of Emmis’ large-market stations, but media spending is down virtually across all media. There has been no discernible progress in corporate governance, although the recently issued proxy states that CEO Jeff Smulyan now has his entire Emmis stake pledged to his bankers. We believe he will do whatever it takes to avoid the possibility of “change of control” provisions that come with the pledge. Certainly a higher stock price would calm banker nerves and, as we have argued in the past, there’s more than one way to unlock value at Emmis.

## Positions Sold

As noted earlier, we sold our remaining stake in TJX because of valuation issues. While not necessarily “expensive,” the stock wasn’t as attractive as when we bought it—nor in comparison to some of the alternatives we have purchased or that are under consideration.

### Website Information

www.mcmadvisors.com

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