# The Long & Short of It

Quarterly Newsletter
Second Quarter 2009

***Manic Depressive on Risk***

Investors entered the second quarter of 2009 having experienced one of the largest moves out of risk in modern history. At the end of the first quarter, credit spreads were huge, commodities had collapsed, and stocks were cheap. There was talk of a Treasury bond bubble. Among those who allow media coverage into their consciousness, there was a sense that the world had come off its moorings and might end soon.

Well, that was three months ago. While there remains plenty of uncertainty regarding the economy and the long-term impact of the policy changes contemplated in Washington, the low interest rates and numerous liquidity programs initiated by the Federal Reserve have at least restored functioning markets. Further, the U.S. government has been successful in its efforts to encourage investors to take risk. Spreads have narrowed, stocks have rallied, and US Treasury bonds have dropped as investors' fears moved from economic collapse and deflation to those of recovery, i.e. inflation.

The investments that led the recent rise were those closest to death during the decline. The riskiest investments, including small companies, low-priced companies, and survivors with significant debt exposure, led the way higher for most of the quarter. High quality, large cap names lagged somewhat, leaving plenty of opportunities for long-term investors. Some of these companies have stable businesses that are less sensitive to the economy, yet they are being punished with everyone else. Other well managed companies have made significant progress in cost reductions to ensure survival and success in the new environment, though they remain underappreciated.

**Contrarian Value Equity Composite**
**Portfolio Fundamentals**
***as of 6-30-09***

| | RVM Equity Composite | S&P 500 |
|---|---|---|
| Number of holdings | 29 | 500 |
| Wtd. Avg. Mkt. Cap. ($B) | 43.6 | 72.5 |
| Price/Earnings Ratio | 14.3x | 16.9x |
| Price/Book Ratio | 2.1x | 3.2x |
| Price/Cash Flow | 6.9x | 7.8x |
| Dividend Yield | 3.7% | 2.3% |
| Return on Equity | 22.5% | 5.3% |

Late in the second quarter, the hopes of further economic gain began to moderate, with investor consensus coalescing around the idea that the economy might stabilize at these lower levels and that significant growth or recovery may be a long way off. American consumers, constituting 70% of domestic GDP, are deeply impaired by debt and will need time to strengthen their balance sheets (pay down debt and increase income relative to debt payments).

We expect there to be some positive surprises by the end of the year as stimulus spending picks up, though we recognize its long-term benefit may fall short of expectations. The reduction in spending by state governments, as they try to reel in massive budget deficits, will certainly limit the impact of the federal stimulus package. The pressures causing these deficits are likely to increase over the next couple of years, as growing unemployment will force further reductions in federal and state tax revenues. Combined with the very large debt issuance taking place, the revenue shortfall will continue to place greater pressure on politicians to raise taxes.

The above-trend growth rates enjoyed by our nation while building up debt levels will now be below trend as debt levels are reduced. Government's ability to add debt and stimulate growth is limited since that the government is already heavily leveraged and not fully capable of offsetting the retrenchment by the American consumer. Economic growth rates will bounce around a bit while finding a lower, more sustainable level. After significant base building and retrenchment, recovery can eventually begin. The next several years should be a perfect environment for stock pickers, as there is not likely to be a rising tide lifting all boats.

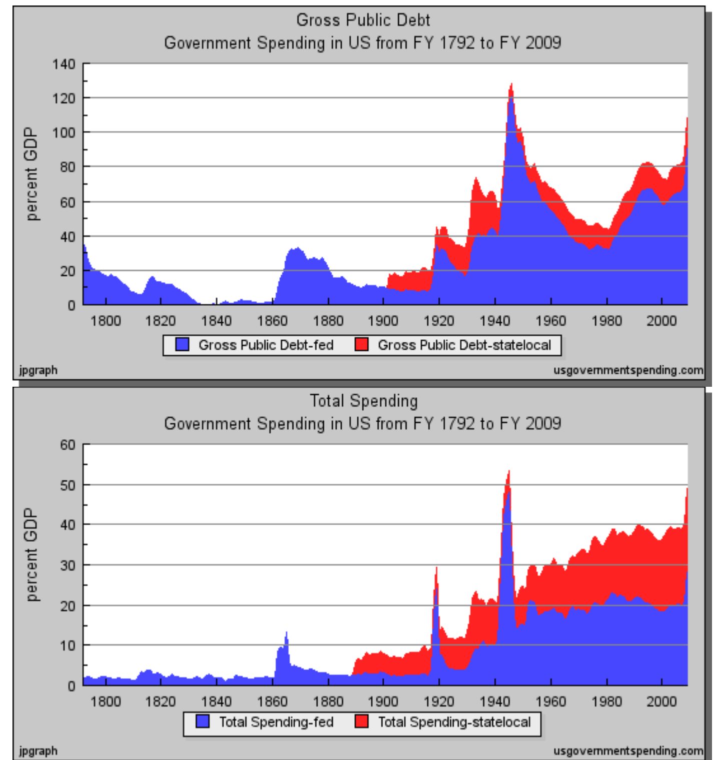
***Watch the Money***

As private sector debt is reduced, the government is attempting to do its part, spending enough through the issuance of new debt to stem the deflationary influence that has normally accompanied a consumer debt retrenchment. Yet the government's balance sheet going into this mess was no better than the American consumer's. An ever growing influence on the direction and momentum of the economy will continue to be the burgeoning federal debt and the

government's taxing and spending habits. In 1787, James Madison wrote Federalist Paper Number 10, whose words ring true as much today as they did 200 plus years ago.

> *The apportionment of taxes on the various descriptions of property is an act which seems to require the most exact impartiality; yet there is, perhaps, no legislative act in which greater opportunity and temptation are given to a predominant party to trample on the rules of justice. Every shilling with which they overburden the inferior number, is a shilling saved to their own pockets.*

In April 2007, long before this economic debacle, *The Christian Science Monitor* cited that approximately 53% of all Americans receive significant income from the government and nearly one in five Americans hold a government job or a job reliant on federal spending. As the size of government grows, the federal purse plays an increasingly larger role in the overall economy. From the two charts at right, gross public debt (federal and local) and total spending both as a percent of GDP are approaching World War II levels. During the Great Depression, much of the deficit spending went to infrastructure projects which fueled increased government revenues in the form of new tax receipts. Our debt buildup has been primarily to support increased spending on Social Security, Medicare and Medicaid, which have grown from 14% of the budget in 1970 to 45% of the budget today.




Moreover, the government's recent investments in the private sector, as exemplified by the bailouts of GM, Chrysler, AIG, Fannie Mae, and Freddie Mac, are increasingly overturning the market's verdict. As the administration said about AIG, "The combination of size, leverage, and interconnectedness could pose a threat to financial stability [*i.e. tax revenue - RVM*] if it failed." In such an environment, diligent credit and fundamental analysis become even more important. It is useful to observe which "inferior number" is being overburdened and into whose pockets the shillings are going.

Through June 2009, the bulk of government spending has gone into financial firms. The steep yield curve will continue to allow the financial sector to recover and re-build its equity. Financial firms with strong balance sheets, limited exposure to future charge-offs and no need for government assistance will perform exceptionally well. In addition, as bailed out firms are broken up and sold for less than they are worth, acquisition-minded firms may benefit from the fire sale opportunities. Growing transfer payments (entitlements) will allow consumer staples to remain an even more stable place to invest than in historic recessions. And yes, some of the new spending will go to infrastructure, benefiting firms providing these products and services. Finally, with all the debt that exists, and in the midst of unprecedented money supply growth and deficit spending, volatility for prices and the dollar is likely to continue. For our part, we will look for these and other opportunities, but continue to focus our risk exposures in high quality, industry leading companies, selling at historic extremes of low multiples, and currently out of favor with Wall Street and the media.

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