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It Is Different This Time

These are some of the most dangerous words an investor can utter in any time period never mind really believe them. It always seems different until it becomes obvious that it is no longer the case. Just look at all those internet companies and stocks that have either completely disappeared or if they survived are but a fraction of what they once were. Most will likely never get back to the highs that were seen during the recent bubble years. Financial manias are nothing new. There was the Tulip craze in Holland in the early 1600's where a single bulb could go for as much as $100,000 in today's terms. Stock manias include the South-Sea bubble in England and the Mississippi Scheme in France, both in the early 1700's where each was granted a charter to have a monopoly on trade with far flung lands.

My personal favorite tale took place in London in this period when people from all walks of life were scrambling to invest in the next big stock deal. One entrepreneur floated a prospectus which described "a company for carrying on an undertaking of great advantage, but nobody to know what it is". The prospectus stated that the required capital was half a million, in five thousand shares of 100 ℓ each, with a *2ℓ deposit. Each subscriber would be entitled to 100 ℓ per share per annum in dividends.* On the first day the entrepreneur received 1,000 subscription deposits and the next day was on a ship bound for the continent. This sounds somewhat similar to the blind trusts being raised by some hedge funds today. A great book on these and other speculative bubbles is "Popular Delusions and the Madness of Crowds" first published in 1841. .

So what happens when a speculative bubble bursts?

The first thing to happen is the sell off. Occasionally the duration of the sell off is long and drawn out like our great depression, the recent NIKKEI drought or our recent 2000 to 2002 downdraft. More often though the selling is done in a relatively short period and brings the market back to equilibrium as was the case in 1987. What is important is to differentiate what is happening in the stock market as opposed to the overall economy. The health of the economy, level and direction of interest rates, and most importantly, corporate profits ultimately drive the stock market in the long term. Of course (excuse the mixed metaphor) in the long run we are all sandwiches for a worm.

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After 1987's stock market crash the economy, corporate profits and the stock market continued to move ahead for two more years and the stock market marched ahead before the 1990 recession finally set in. Preceding the 1987 crash the Fed had been tightening, long corporate bonds yields were above 9% and CPI inflation was moving up from 3.5% to 5%. The economy was obviously overheating.

When the most recent bubble burst, the following slide was justified due to outrageous valuations. Pundits had been talking about being back to the nifty fifty mentality where valuations no longer mattered. Some academics argued there should no longer be an equity premium (i.e. stocks were no more risky than a risk free asset) and that stocks could rise indefinitely, NASDAQ 10,000 was in sight. This time around was quite different. Once the slide was underway by 2001 the Fed began aggressively lowering rates and didn't reverse direction till 2005 (see chart). Both long term interest rates and inflation were not only historically low but falling further. Corporate profits did decline once in 2001 but since have surged ahead, inflation has remained subdued (yet to break 3%) and long term interest rates have remained low (under 6%). Despite all the good things happening in the economy in 2002 the market was irrational and continued its blow off. Just like the bubble going too far up in 2000, in 2002 the opposite was happening and babies were being thrown out with the bath water. Despite falling interest rates and rebounding profits good companies that were no longer over valued were dropping like rocks. During 2002 Pepsi fell 30%. But even during the three year swoon some investors were finding some stocks to be very good values. These were more often than not companies and industries that had been overlooked during the bubble years. Most home builders doubled or tripled. Lennar was up four fold between 2000 and 2004. A number of old economy companies in manufacturing, materials, chemicals etc, were going up very nicely as well. i.e. Engelhard, who we'll mention later, doubled between 2000 and 2002.

How have things done since the bubble burst?

Investors that continued to hold many of the big tech stocks probably do not think the market has come back that much since the NASDAQ is today still less than one half what it was at the peak. This is true but over a ten year period the NASDAQ is double where it was ten years ago which is virtually identical to what the S&P 500 has done in the same period (see charts). The S&P 500 and Dow Industrials are approaching their all time highs and the smaller company averages have easily topped their previous highs.

After the capitulation took place in 2002 the market has roared back. Virtually every index imaginable has been profitable. The S&P 500, in the 3 ¼ year period ended 3/31/06, has seen a cumulative 56% return or 14.66% annualized. In the 2000 to 2002 the S&P 500 lost just over 15% per annum leaving an S&P 500 (only) holder still not quite back to where they started on 1/1/2000 but very close. The S&P mid-caps and small-caps

lost far les than the S&P 500 in 2000-02 but have surged back even more strongly. Mid-caps (91% compounded, 22% annualized) and Small-caps (107% compounded, 25% annualized).

What is different? Can the "Goldilocks" economy continue?

In the 1990's and the early 2000's we really have been in this Goldilocks economy. Not too hot. Not too cold. The only years that corporate earnings did not grow were 1990-91, 1998, and 2001. CPI inflation has only been above 3% three years 1990-91 (5.4% & 4.2%) and 2000 at (3.4%). Long term interest rates have not been above 8% since 1994. There are a variety of factors that contribute to this Goldilocks economy that were not the case 20 years ago. Oil in particular and energy in general (though expensive) make up far less of the cost of goods sold than they used to. 25 years ago energy costs were 40% of industrials input costs. Today energy is less than 20% and the services sector uses far less than that.

The growing economic importance of China and India represent a major factor. China's ability to produce the lowest cost goods ultimately keeps prices low everywhere. China's high saving rate and trade surplus, which are largely invested in US government bonds, have helped to keep interest rates low here and around the world. Allan Greenspan talked frequently about productivity gains which continue to come through at an amazing rate. The use of computers and the internet continue to drive productivity. Software has made so many companies and industries so much more productive. Semi-conductor design being an excellent example as is SAP type business integration systems that drive just in time inventory management and so many more applications. Twenty or thirty years ago whenever a paper or chemical company would make a little money they'd build a new plant just in time for the inventory glut and the next downturn. Today managers are far more sophisticated about getting a return on capital over the cycle rather than building empires. But the biggest factor of all, in our opinion, is the fact that trade barriers are falling. One of the major advantages the US has enjoyed throughout its history is being a large economy that allows and encourages both its citizens and their capital to move to where they are most productive. This principle of comparative advantage (some times referred to as guns vs. butter) has both people and capital moving to where they are best deployed and leads to fuller employment, lower prices and all participants being better off income wise. As more and more barriers to trade fall around the world we should all be better off which should bode well for equity investments in general.

What we like going forward

What we like going forward are hard assets and resources oriented plays. Our definition of hard assets or resources casts a wide net to include agriculture, metals, materials, oil and gas, all sorts of energy, chemicals, and industrial companies that are sensitive to the economy. These are the type of industries we have focused on

in the last few years and expect they will continue to outperform. We not only look at commodity plays but also those secondary and tertiary companies that can benefit from the primary commodity trends. We are less inclined to look for big tech companies, financials and other industries that we consider paper stocks. The eighties and nineties were great for paper stocks because they have operationally leveraged business models (high margins), had little need for financing and benefited from a twenty five year bull market in bonds (falling rates). We do however continue to research technology oriented companies that help improve the productivity of other firms. An outrageous example is Joy Global which makes coal mining equipment whose stock is up over four fold in the last two years. Another is Engelhard a specialty chemicals maker who has always possessed great science in catalysts that go into many things including automobile catalytic converters.

Recently there have been an increasing number of takeovers from both financial buyers and large corporate strategic buyers. With the huge amounts of excess cash many companies are generating the leveraged buyouts should continue. For example we have been a holder of Engelhard which is being pursued by BASF the largest chemical company in the world. Although BASF has offered a 25% premium Engelhard's management has been insisting that the company is worth even more. Pegasus Solutions (clients own either their stock or CV bonds), which processes hotel reservations, is being taken private by financial buyers who value Pegasus at more than the public markets had. Transmontaigne, another holding, is a petroleum products infrastructure company in the middle of a bidding war. Insiders along with financial backers had made an offer of $9.75 cash. More recently Morgan Stanley has made a higher bid of $10.50 in cash. The market is currently pricing the shares above $11.00 as apparently the hedge fund types are convinced that there will ultimately be an even higher bid. We would love to see a higher bid as our target had been the low teens.

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Index comparisons by company size

		Year by Year Returns for the last 8 Years								Q1	Compound	
		1998	1999	2000	2001	2002	2003	2004	2005	2006	Growth 3.25 years	Annualized
Large Caps	S & P 500	28.58%	21.04%	-9.10%	-11.89%	-22.10%	28.69%	10.88%	4.91%	4.21%	56.00%	14.66%
Mid Caps	S & P 400	19.12%	14.72%	17.50%	-0.61%	-14.52%	35.64%	16.50%	12.56%	7.63%	91.44%	22.12%
Small Caps	S & P 600	-1.30%	12.40%	11.80%	6.54%	-14.63%	38.80%	22.65%	7.68%	12.85%	106.87%	25.07%

	1998	1999	2000	2001	2002	2003	2004	2005
Corporate Profits change	-5.70%	21.20%	4.10%	-17.20%	11.40%	13.50%	17.40%	5.50%
Moody's AAA Corp Yield	6.5%	7.0%	7.6%	7.1%	6.5%	5.7%	5.6%	5.4%
PE Price Earnings Ratio	21.8	21.8	21.5	24.7	20	17.2	16.8	14.5
CPI Growth Rate:Inflation	1.60%	2.20%	3.40%	2.80%	1.60%	2.30%	2.70%	3.00%

Exchange does not provide volume data.