



## Third Quarter 2007 Performance Report

To describe the stock market's performance last quarter by just reporting that the S&P average was up 2% is like a driver who narrowly escaped a twenty-car pileup by skidding out of control and doing a three sixty across three lanes of traffic, describing his morning commute by saying he drove 15 miles and got to work on time.

July saw the stock market plummet over ten percent in a few days. Sub-prime mortgages were claiming victims all over the world, the economy was showing signs of slowing and the financial system was in turmoil. The market hit new lows in August but by September the panic was over and the market recovered most of its losses in three short days. Bernanke cut interest rates, the banks were wounded but solvent and even if the US slowed, it wouldn't stop world demand for US products...or so it seems until the next crises.

The market is trying to figure out if there will be a recession and if there is really a threat to the financial system but nobody has the answers yet. So, until the economic picture becomes clearer, we will probably see big swings in the market on minor events. We don't have a problem with that. We'll continue to hold a little extra cash, buy the dips and trade up to better growing companies when they get cheap. An occasional fire sale in stocks, however brief, is something we can use to our advantage.

But choppy markets make for inconsistent performance in the short-run as markets swing wildly and individual securities show even greater volatility. Last quarter mid and small-cap stocks were down over 1% while the S&P was barely up and technology stocks advanced by better than 5%. Those averages don't begin to account for the fact that a lot of financial stocks were down 30-50% and a lot of consumer stocks were down 15 -25% last quarter.

Little bombs went off in all our portfolios as some companies admitted to various forms of financial pain or warned of bad weather ahead. The negative surprises were mitigated to some extent by a handful of growth stocks that had great earnings and predicted nothing but clear skies ahead. Of course, ultimately if the economy falls into recession, nothing will be immune from the pain but the market prefers to believe that problems are company or industry specific until the headlines say otherwise.

Fears of a slowing economy weighted on the cyclical transportation and retail stocks but less so on energy and natural resource stocks. History shows that natural resource stocks are as cyclical as any retailer so we don't find many miners or drillers that are very attractive at today's prices. On the other hand, we think that transportation and retail stocks are attractively priced even if the economy slows.



We love cable TV companies but their stocks have been poor performers so far this year despite strong cash flow and no history of being effected by the economic cycle. We believe that we are just beginning to see the earnings boost that is coming from the HD/triple play (phone, cable and Internet). Given the HD upgrade cycle, these stocks are ridiculously cheap, at their lowest cash flow multiples in years.

Compare that to AT&T. Ma Bell faces a multi-billion dollar upgrade to its lines to begin to match cable's functionality but it was up over 6% last quarter while Comcast announced record earnings and broadband adds, but was down 14%. AT&T is wondering where it will get the money for all that new fiber, while Comcast is debating how to use the mountains of cash it will be generating over the next few years. Time-Warner has a jewel almost as valuable as Comcast, but it's masked by analysts' obsession with its AOL division. Our bet is that as the cash piles up in Time-Warner's coffers the market, or a raider, will appreciate T-W's undervalued cable business.

Preferring cable to Telco and retailers and transportation to mining and energy hurt our relative performance last quarter but we are pretty sure it will be the right call in the long run. Over the years, the market has been good to us when we bought stocks at reasonable valuations that were out of favor. We were always early and had to suffer a little pain first, but eventually better returns were realized by going against the crowd.

Unlike stocks, bonds continued to trade in a fairly narrow range, despite the market turmoil. The bond market anticipated the Fed's actions and rallied before the cut in short term rates. After the Fed's rate cut, bond yields rose slightly as the market saw less chance of a recession. It seems clear now that if the world economy is going to slow down significantly, interest rates will be going down. If the world economy stays strong, the bond market is probably overpriced and interest rates will be going up.

We lean toward the view that the bond market is pretty expensive given the consensus forecast of a 30% chance of recession, but we admit that our crystal ball is pretty hazy when it comes to economic forecasting. We'll buy bonds as soon the debt markets have a chance to stabilize but will keep average maturities on the short to medium side. When it comes to bonds, you have to take the yields you can get, not what you think you should get.

### Mortgage Meltdown

It's ironic that what brought down the hedge funds this time wasn't their exotic bets on foreign currencies or commodities futures trading. It was the residential mortgage market. They had been able to increase their risk by leveraging their bets and owning



piggy back and subprime loan pools but it was still just boring old single family homes and condos that brought the smartest guys on Wall Street to their knees.

The mortgage market isn't very exotic but it's big, about \$10 trillion. If housing loses 20-30% of its value, we are talking potential mortgage losses of \$100 billion to half a trillion dollars. Nobody knows how far down housing prices will go or how many loans are going into default. Worst yet, nobody knows who owns the bad loans because they were sold to everybody from hedge funds to German banks. Until we know how bad the problem is and who is affected, the market will be unnerved by seeing one dead body after another float to the surface and wonder who will be next.

We are shoring up the financial system by assuming the worst. We are marking down mortgage debt to levels that fully discount a collapse in the housing market. This flushes out the weak holders of the debt and gives us confidence in the future. This operation carries the risk that in removing the cancer we could injure the patient but it's better than doing nothing. So far, the fact that we have had just a 10% correction in stocks and we've spooked a few other overvalued markets, means the operation is going pretty well. In a few months, when it's over, we'll know that no matter how far the housing market falls, the people who own the mortgages can sustain the losses because they have already been forced to mark them down to levels well below what they will ultimately be worth.

What those mortgages will ultimately be worth will not be decided on Wall Street, it will be decided on Main St. The determining factors will be how many mortgage holders have jobs, how many default on their loans and what their houses are worth. The banks will be lucky to get 50% from the flippers and the nothing down speculators on their condos in Miami and Vegas but it's a little harder for the second home buyer to walk from his Naples vacation home, even if it is only worth 60% what he paid for it.

As the process unfolds there will be fear that everything will be brought down by the decline in the housing market but that's not likely. Our economy can easily absorb a hit in real estate prices. There is plenty of capital to finance good loans as soon as we sort out who's a good borrower and who's not. We just needed to bring things back to earth, not to bury investors.

### Getting Rich In A Bear Market

Bull markets are fun. Everybody is ecstatic while account values are soaring. Bear markets are terrifying. The pundits are sure we are falling off a financial cliff and every month your account statement proves them right.

The paradox is that profits are realized in bull markets but profits are made in bear markets. It's in bear markets that real bargains can be found that will reap exceptional



returns for years to come. If you want to get a bargain you have to buy when “there is blood in the streets.”

A 10% market correction doesn't qualify as a bear market, in fact it barely qualifies as a market correction but the principle is the same. It's a good opportunity to find some bargains. In a 10% correction there are always stocks that are down 25% or more because the market corrected but they got crushed.

We are using the market correction to find bargains. We'll use cash, if we are lucky enough to have some in our accounts. We'll sell bonds in balanced accounts to rebalance towards stocks. Finally, we'll be trading up. Trading up involves selling stocks for tax losses or stocks that are nearly fully valued and buying better growth opportunities that are inexpensive.

We will not assume that this is just a correction or that this is the beginning of a bear market. We don't know what the market will do next because no one can predict the future but we know that if we stay in the market and buy bargains, we'll do just fine.

We'd like to be able to say we could avoid bear markets by moving our clients into cash and just enjoy rising stock prices without the pain of corrections but the truth is we can't and we doubt anyone can. Lacking a crystal ball, we will stick with what we know works, perseverance.

10% corrections are perfectly normal events that can be caused by anything from a hiccup in the financial system to a temporary problem in the economy.

Bear markets are almost always associated with economic recessions. Economists are divided on whether or not recessions are necessary or if they are an avoidable event caused by a massive economic error. Recessions are very difficult to predict because they are almost always due to a surprise that triggers an economic shock. They are not caused by the stock market. So, don't look to stocks to tell you whether there will be a bear market recession. Look to the economy.

The process by which the stock market attempts to anticipate future economic events is hugely imperfect. It can be compared to watching a flock of birds migrating south. They go east, they go west, there is a lot of squawking and wing flapping, a group drops off to the south and the rest follow for a time. They eventually get where they are going but almost never go in a straight line.

Wall Street is full of squawking and people telling you to go every which way but that doesn't mean you should listen to them. Eventually the Street will get it right but if you follow every turn in the flock you'll waste a lot of energy and run the risk of getting lost.



Whether stocks will be a good investment depends on how the economy and the companies you own do over the next five, ten and twenty years, not on current events.

If the market goes down 10% or 20%, even 50%, it won't affect what companies will earn 5, 10 or 20 years from now when you'll need the money. But, if you buy stocks in a correction, you will make more money in the long run.

That's why we say that you make more money in bear markets than in bull markets. Market corrections give investors the opportunity to make extraordinary rates of return in the future. Much higher rates of return than would be possible if the market went up in a straight line.

Viewed that way, market volatility and irrational sector rotations are a long-term investor's friend. Over the past few years, much of the superior returns we had in our portfolios came from buying really great companies that were hammered in the 2001-2 bear market. We are able to identify relative value in any market but in market declines great values abound.

What constitutes a great value to us isn't a Wall Street darling that has a 30% correction after going up 300% in the last few years. The chances are that stocks like that are still overvalued and will have to spend a lot of time in glamour school before Wall Street cares about them again. We look for attractively priced, great companies that we've owned or wished we owned, for years.

Our favorite measure of value is to see where a stock is trading versus its historic cash flow multiple as shown in Value Line. When we can buy a company at ten or twelve times cash flow that has historically sold between ten and twenty times, we know we have improved our chances of making money. After that, all the company has to do is to keep growing earnings at something like their historic rate and the market will do the rest.

The same logic applies to the overall market. The time to be nervous is when it is going up every day and highly valued. The time to love the market is when it is falling and selling at a discount to its historic value. It would be nice if you could just have the market selling cheaply without a market correction but you can't. Corrections create values and buying good values will make you rich.

William Matthes

The information herein has been obtained from sources believed to be reliable, but we cannot guarantee its accuracy or completeness. Past performance is no guarantee of future results. Neither the information nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Westport Resources Management, a Registered Investment Advisor registered with the SEC.

315 Post Road West • P.O. Box 3089 • Westport, CT 06880 • (203) 226-0222 • Fax: (203) 454-4706  
WESTPORT RESOURCES MANAGEMENT, Inc an Investment Advisor, registered with the SEC and The State of Connecticut