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LESSONS FROM THE PAST 11 YEARS

In 1997, we handed in our resignations to Paine Webber and became investment advisors with Westport Resources. The choice to leave wasn't to distance ourselves from the relative safety of a big Wall Street firm, we were sure that if we were given half a chance, we could do better than what we had seen at the "wire houses." Paine Webber was later purchased by UBS but it is rumored to be for sale again, due to the need of the parent to raise capital. Like most of the other big firms, they made bad investments and suffered a series of scandals in the wealth management division. In retrospect, we had very little to fear from cutting our ties with a major broker.

But we didn't know that in 1997. The bull market looked like it had lost its legs in the second half of the year as the euphoria over the "Asian Tigers" turned into the financial plague called "The Asian Contagion." Markets were volatile, the risk to international financial system was real, and the country was being led by a president being threatened with impeachment. It was hardly the most auspicious time to change firms.

Thanks to the loyalty of our clients, the support of Westport Resources and a little luck, we got through that first year on plan. Assets under management grew substantially and were much happier working closer to home.

The startup problems that we worried about the most turned out to be the easiest to solve in making the transition from Wall Street to Main Street. Our information systems and access to research proved to be better than anything we had experienced at Dean Witter or Paine Webber. Our ability to find bonds and trading capabilities were a night and day improvement over what we had been used to allowing us to spend less time sweating the details of a trade and more time managing money. Our clients quickly understood that we were able to give them better service and at a lower price.

Lesson #1: A good small boat is better than a leaky yacht.

The 1997 stock market was all about what Paine Webber's chief market analyst Ed Kerschner had dubbed "Ruler Stocks," a term we later viewed with some derision. "Ruler Stocks" were companies whose earnings progression could be drawn with straight ascending lines. They actually passed out rulers with the stock symbols on them at one morning meeting. This supposed consistency of earnings justified the ever increasing stock prices and high valuations of Wall Street darlings like GE, Pfizer, P&G, and AIG.

At the peak of "big cap growth stock mania" Pfizer sold for over 50 times earnings, GE over 40 times and P&G over 30 times. All good companies, but all monsters whose long term growth was unlikely to outpace the growth of the overall economy. If you bought into the ruler stock story it would be seven years before you broke even on P&G, you'd still be down 50% on your GE investment and your Pfizer stock would be down about 70%.

Our lack of conviction for the research product of our old firm and preference for less expensive and faster growing mid and small cap stocks lead to our modest underperformance in 1997 and 1998 but after that the trajectory of the ruler stocks turned negative and for a very long time (yard stick) and we beat the market by a healthy margin. As usual, the market analysts had been able to identify a current trend just in time to get the last of sheep in the pen before the slaughter.

Lesson #2: It's easy to identify the current trend, but much more difficult to say when it will end, or what will be the next trend.

The bond market was an attractive alternative to equities for most of the late nineties, but nobody seemed to care. Bond yields of 6 to 8% seemed pretty boring when the big money was being made in the stock market. It was a classic case of investors getting used to the high yields of the eighties and early nineties, but not recognizing the good long-term value bonds offered. It's hard to believe, but one of the big stories of 1997, was that the federal budget was so close to being balanced that there was no need to float much government debt. With inflation running at less than 2%, bonds offered great real (after inflation) rates of return and good long-term appreciation potential.

Of course the Fed would finally be forced to raise short-term rates in 1999, but in what Alan Greenspan called "The Great Conundrum," long term interest rates continued to fall. By 2001, the conundrum was resolved as it became clear the economy was suffering a recession and the bond market had apparently correctly anticipated the slow down and lower interest rates.

We bought a lot of bonds for our clients while rates were still relatively high, but in retrospect, we wish we would have put a lot more money in bonds, both because it would have saved us some of the pain from the bear market after the turn of the century and because they offered good capital appreciation as long-term rates continued to fall for almost a decade.

Lesson #3: Bonds offer the best value when the economy is strong, the stock market is rising and investors don't care about them.

While the bond market was acting rationally during this period of time, the stock market was exhibiting the classic signs of a mania. 1998 to 2000 was the height of the great tech and telecom bubble, which at the time was not termed a bubble, it was called "The New Economy." Big cap was out, small cap was in, the tech revolution was in full force and fiber optics was the new cross country railroad. Everybody with an internet connection was an investment guru and it was assumed the good times would last forever.

These were truly depressing times for us. We were making money for our clients but not as much as if they'd followed the sage advice of one of teenagers that were touting tech stocks on the web. Day trading made waiting for long-term gains look old fashioned and we felt like silly old party poopers when we warned our clients that this would all end very badly.

In 1999, Kerschner was able to raise over a billion dollars for his new Paine Webber Strategic Fund, which poured into yesterdays' winners like Lucent, World-Com and Citrix. He promptly proved his market timing and stock picking prowess by losing 30% of his investor's money in his first year versus a market that was down about 16% from top to bottom.

In 2000, the world didn't end because the computers couldn't figure out what time it was the way the profits of doom and gloom said it would, but the tech and telecom bubble finally burst. While the Dow and the S&P big-cap averages were modest, the NASDAQ dropped 54%, a loss of \$3.3 trillion dollars.

The full effects of the ensuing bear market of 2000-2003 are hard to quantify. Some blamed the greedy CEOs who inflated their stock prices and ran with the money. Fifty CEOs cashed in \$100 million dollars or more from their stock options in the year and a half before the market crashed in 2000. Others sued their brokers. Mary Meeker, Jack Grubman and Henry Blodget, the pied pipers of the tech mania at Merrill Lynch, Salomon Smith Barney and Morgan Stanley got their wrists slapped for their shoddy research. Others blamed the Fed. Greenspan gave his famous "irrational exuberance" speech in December of 1996 but refused to take away the punch bowl from the party by raising interest rates until June of 1999.

In truth, they were all to blame but it wasn't their money they were playing with, it was "investors" who should have known better. Unfortunately, the same people who got burned on ruler stocks went on to buy tech stocks in 1999 because they had gone up 100% in the previous year. They sold their tech stocks after taking a brutal beating to get into a hot hedge fund. The hedge fund went bust and so they took what was left of their money and bought a condo in Florida because real estate prices had tripled in past few years. There is great comfort in following the crowd; unfortunately it can be disastrous to your financial health.

Lesson #4: Past performance IS indicative of future returns...it's an inverse relationship!

This being an election year we are often asked what effect the election will have on portfolio performance. We don't know, but a look at the last two presidents might be instructive. Bill Clinton was supposed to be a populist left winger who would bankrupt the country, tax us to death, kill world trade and get us into a war because of his total lack of foreign experience. We got the first balanced budget in decades and cut in the capital gains tax, open markets and peace. We didn't get universal health care or the clean government he promised but what we get is often different than the platforms politicians run on or the electorate assumes they will do.

George Bush was elected for this first term in 2000. We were supposed to be treated to a quick recovery from the developing recession, a foreign policy that would avoid foreign entanglements much less "nation building", balanced budgets and free market capitalism. Whether by plan or by chance, what we got was quite the opposite as the recession got deeper and our troops fought two wars in hostile countries while we tried build nations out of tribes. We ran record deficits and now have the largest expansion of government into private enterprise in history. We got the lower taxes and deregulation they promised, but it's hard to see how either party won't have to reverse course on those policies soon after the next election.

Anyone who is worried about the current campaign rhetoric should read the promises made in previous races and take it with a grain of salt with a stiff drink. What they promise is seldom what you get.

Lesson #5: Campaign promises are written in disappearing ink.

Even though the economy began to slow and the tech bubble burst in 2000 and 2001, they were good years for us. With very little exposure to tech and telecom and a healthy portfolio of stocks that actually had earnings instead of just web sites, we made money in the first two years of the bear market. We saw our value oriented stocks go up while tech and telecom tanked as we knew they had to. The world trade center got bombed, a new war raged on but it wasn't until the economy hit a brick wall in 2002 that the market left us no place to hide, and we experienced a significant decline in our stock portfolios.

The 2002 market hurt us badly, and not just because some of our accounts were down 20% or more. We didn't do any worse than the market in 2002 and we had two years of relatively good performance before that. Overall, we should have been pretty proud of ourselves but we couldn't get over the fact that maybe we should have known that the excesses of the nineties wouldn't be cured with just a pullback in tech and telecom, but had to spill over to the rest of the economy. Of course, if we followed our instincts, we would have sold every stock we owned in 1998, well before the chewing gum size bubble turned into a blimp way before the good times ended. At the end of the day, we made more money in 1998 -2003 by staying in the market than we would have if we pulled out, even with the bear market.

Lesson #6: Even if you are right, market timing is seldom a profitable game.

Truth be told, we compounded our “mistake” of being fully invested during most of the bear market in 2000-2003 by buying the beaten up tech and growth stocks on the assumption they were cheap and safe in 2000 and 2001, well before the bear market ended. Of course, they were cheap but hardly safe. Still, that “mistake” of early bottom fishing led to our best performance ever in both absolute and relative terms during the ensuing market recovery of 2003-06. We bought the stocks that everybody loved when they were trading at 100 times earnings in 1999, but we bought them when everybody hated them in 2001 and 2002 at ten to twenty times earnings. And guess what? Cisco still sold routers, Oracle still sold software and Scientific Atlanta got bought out by Motorola, so we made a lot of money for our clients when the market recovered in 2003 and 2006.

By October of 2002 the bear market had wiped out over 5 trillion dollars in investor wealth. The economy was staggering from a global recession. The default rates for junk bonds hit 18%, a level that hadn't been seen since the last recession. Sunbeam, Tyco, World-Com and Enron had made shambles of the investor's confidence in corporate America. The market had just dropped a terrifying 18% in the third quarter and the Congress had authorized George Bush to go to war in Iraq.

What followed was one of the steepest rebound in stock prices in US history. Over the next 26 months the S&P 500 would rise over 60% despite a war that quickly went bad, rising budget deficits, what appeared to be worldwide deflation, modest expectations for corporate earnings and declining real incomes of US workers. Why, because the market was too cheap. Things weren't perfect, but they were better than the market had anticipated.

Lesson #7: The real money is made by investing during bear markets, what follows may not be perfect but it is almost always better than what was predicted.

One of the best things we did during the 2002-3 market recovery was to buy oil refining stocks. Here is a great example of making money because we followed our discipline but for all the wrong reasons beyond that. In 2002-03 we knew energy stocks were cheap. We were in recession and that's what happens in recessions, commodities drop. Energy stocks had been out of favor for many years and we knew we had to buy them, if for no other reason than to keep our portfolios diversified.

That was the same discipline that led us to sell technology stocks when they mushroomed and buy them after their crash, so the discipline of buying low and selling high was fresh in our minds. The question was, what to buy? The big multinationals were cheap enough with yields that made them look more like bonds than stocks. The pure exploration and production stocks were good plays on the recovery of oil prices if we wanted to bet on that happening, but that seemed to risky to us. Instead, we had the foolish notion that the war in Iraq would be resolved quickly and we'd be able to pump the desert dry to pay for it.

We thought that the price of oil would stay low but the recovering economy would put pressure on refining capacity resulting in big profits for the refiners and not much of a move for the drillers. We got the part about big profits for the refiners, but that was about all. At first we looked pretty smart because refining stocks shot up much faster than the rest of the energy sector, thanks to industry consolidation and increased demand. Later, as the war dragged on, very little new supply hit the market and the ensuing economic recovery drove oil prices through the roof leading to the drillers catching up to the refiners.

We made a load of money in energy stocks but three out of four of the reasons we bought them were wrong. Still, the one thing we got right saved us. We knew that energy stocks were cheap. Why we bought them was less important than the fact that they were selling at rock bottom prices.

Lesson #8: Buy what is attractively priced because you can calculate that. How and why and if stocks will go up is unknowable.

The market recovery of 2003 through 2006 was marked by several trends. The relative outperformance of small and mid cap stocks, the recovery in tech and growth stocks, and the relative outperformance of financial stocks. We got all three pretty much right for once. We owned some smaller companies with a good deal of tech and growth stocks while staying light on financials.

We wrote in several newsletters beginning in 2005 that real estate looked like a bubble to us. Beginning in 2006 we began to reduce our holdings in mortgage originators, regional banks and brokers because we feared that the fallout from the bursting of the real estate bubble would spill over to the holders of mortgage related securities.

We went into the financial and real estate bubble with less exposure than the overall market but we still had a few real clunkers in places we never dreamed would be affected by the financial meltdown that ensued. We learned a long time ago that there is no such thing as a safe stock in a bear market. Between having underweighting in financials going into the great financial stock fire sale and the decline in value of what we owned, we have been busy buying the sector to get it back to a reasonable percentage of our portfolios. Why? Because they're cheap! We learned a long time ago that buying value is more important than timing the recovery.

WHAT ABOUT THE NEXT 11 YEARS?

We are sure we still have a lot learn but we must admit that we think it's getting easier to deal with the surprises the market always dishes out than it used to be. We've learned some great lessons that are serving us well but here are a few questions we still have.

Will there be a time when we should exit the US stock market?

We've always said that we would remain fully invested unless the world economy was so hostile to investors that corporations couldn't make money. Recessions, market crashes, and temporary financial crises are, in our opinion, buying opportunities unless the big one is out there. The big one is a world so dysfunctional; financial markets so broken; governments so hostile to capital formation that there will be no safe place to hide in a world wide depression.

That prospect has been raised continually by market gurus for a multitude of reasons since we started in this business over twenty-five years ago. It hasn't happened, but that's not to say it never will. How will we know when to cash in our chips avoid what could be decades of pain?

We are not sure what would cause us to buy gold or T-bills instead of stocks, but as it stands now, here are a few things that could turn us to pause.

1. The decline of capitalism world wide. The reason we have had one of greatest bull markets in history since 1982 is the growth of capitalism in expanding world markets from China to Brazil. What is happening in Russia now is clearly a break in what has been a steady drive towards capitalism. If China were to go the same route or Latin America started acting more like Venezuela and less like Chile, we could be persuaded to head for the hills. Nothing goes in a straight line, but the chances of a major reversal in what has been a steady march towards capitalism (in various forms) seems irreversible for now.
2. A hostile US investment climate. The US has benefitted greatly from laws that respect property rights, encourage the accumulation of wealth and allow free flows of trade across borders. If that reversed significantly, we would move our money elsewhere. If there were no better opportunities, we'd go to bonds or cash. So far, all we've seen are some proposals for increased in taxes and government regulation, but if we really started closing our boarders to world trade or made US companies uncompetitive, I'd go elsewhere with my investments.
3. A mania so vast that there was no value to be found. The first two scenarios involved disasters but if the news was so good that stocks failed to present a reasonable long-term return we'd be fools to wait for the panic to leave the playing field. Today the market is no where near euphoric pricing. In fact, it looks pretty cheap.

Has today's financial crises changed anything?

Yes, it is a crisis unlike anything that we have seen before, but so were all the others we went through. It's always different.

Is it more serious? All financial crises are serious in that they hold the potential to cripple the economy. When Russia, the Asian Tigers and Latin America looked like they would simultaneously default on trillions of dollars of debt, it was real problem that could have crippled the world economy for years.

Long Term Capital was so big and so leveraged that their failure could have spread to the failure of the entire US financial system. Today's housing bubble is not much different than the S&L mess of the late eighties but now instead of the RTC closing S&Ls, the Treasury is buying mortgage debt.

The question always is: Have we correctly identified the problem and will we fix it? The great depression wasn't caused by insurmountable problems; it was caused a series of blunders in addressing the problems. Most economists now agree that if the government had acted appropriately and our financial system had been organized properly the great depression would have been little more than a recession.

We acted appropriately in most of the recent financial crises and largely avoided severe damage to the economy. Will we do it again? Probably! We have certainly identified the problem. This is best publicized and most analyzed issue in modern times. In retrospect, we went into the S&L mess and LTC crisis blindly compared to the scrutiny we giving today's housing bubble and over leveraged balance sheets.

Are we administering the right medicine to the patient? It's hard to say, but it's pretty clear that the government and the industry are committed to spend what it takes and make the sacrifices necessary to stabilize markets and remake the system. We probably won't get it right the first time but we work at it until we fix the problem. And yes, like the S&L crises we will look back and say we overreacted, wrote more than we had to and closed good banks but that's a lot better than trying to sweep the problem under the rug the way the Japanese tried to do for most of the nineties.

Wall Street will most likely deleverage, which is a polite way of saying they will shrink until their diminished assets can support their debt but in the end we'll have far fewer banks and brokers who once again will vow to never take those kinds of risks again. Of course they will, but not for awhile.

But don't mistake deleveraging for financial Armageddon. We need to market down the value of bad real estate loans. A dollar of loss on a mortgage translates into twenty or thirty dollars in leveraged assets at a broker or bank but ultimately, it boils down to how much real estate and corporate debt will default and what the rate of recovery will be on the loan. The total losses probably won't be any more than that. And here's some good news. We sold a lot of that debt to banks and governments all over the world, which makes the hit to our economy a lot less than it might have been.

So here is the bottom line on the current financial crises. We can avoid a financial panic. After that, we will sort out the winners and losers in a game with a lot more players than chairs now that the music has stopped. It probably will be ugly. It probably will cause the recession last longer and be deeper than what it would have been without it, but most if not all of that is most likely already priced into the stock market.

Will value investing continue to be the preferred investment strategy?

Value investing has served us well for the past decade, but maybe things will change. Maybe they will finally invent a computer that will beat the markets and so many people will be value investors that there will be no advantage in doing what we do. Maybe, but we doubt it. The whole idea of value investing is that there is always some other strategy that outperforms us at any time, but their advantage will be short lived while value investing takes advantage of their irrational behavior. As for value investing becoming so pervasive that it took all the irrational behavior of day traders and trend followers out of the market, we doubt that will happen as long there is human nature involved in market movements. We doubt we will ever see a market that doesn't get overly euphoric or subject to the pure panic of herd. Until then, we can aim to take advantage of the market.

Will the next 11 years be as good as the past 11?

Probably, yes. The past eleven years have been marked by a stock market mania, two recessions, several international crises, the near impeachment of a president and a disputed election. That's about par for the course. The return for the S&P 500 from 9/30/1997 to 9/30/2008 has been about 7%, which is about 5% after inflation. That's about what the stock market is supposed to give you on a long-term basis.

Importantly, we are making this calculation after a pretty significant market correction, apparently not at the height of euphoria in a bull market. Most investors don't have the luxury of just needing their money at the end of bull markets. By making the long-term calculation now we are simulating an investor who put money in the market now that far from the 2000 top, suffered a big bad bear market, had a recovery and another setback. Sounds rough but it worked out just fine.

Thanks to the application of our value oriented investment strategy and a little luck we have done a little better than the S&P on average since 1997, but that's no guarantee we will in the future. We'd like to just match our past performance with periods of better performance and periods where the market beats us. If the market gets hideously overpriced again by taking one sector up to stratospheric levels we will be perfectly happy to leave those profits on the table while we underweight that market sector even if it means not beating the S&P for a year or two. Conversely, we should beat the market when those darlings turn to old maids in a market correction because we shouldn't have that much exposure to high flyers. If we can do those two things, underperform in soaring markets and protect our investor's portfolios in bear markets, our clients should enjoy a smoother ride and still get something like a market rate of return.

If we can do that, the next eleven years should be at least as good as the past eleven. If we really learned the lessons from the past, the next eleven years could be even better than the past.

Bill Matthes

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