

March 2009

**Executive Summary**

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**Market Update**

The Great Unwinding has turned into an enormous global meltdown. The collective failure of the many participants in our financial system, from investment banks to auditors to regulators to credit rating agencies, has been nothing short of astounding. We'll discuss that failure more in a future letter, but for the moment, we are in the bear market of a lifetime. This is not a cyclical event. There is a global deleveraging underway. Asset prices are under pressure as the world sells assets to pay down debt. And if many are deleveraging, something or someone needs to lever up. With the U.S. taking the lead, governments are leveraging up on an unprecedented scale in an attempt to stabilize both global asset prices and the global economy.

As Corey and I discuss below, this is a time for caution – to hunker down to assure one's staying power through this turmoil - and for opportunism - to review portfolios with an eye to maximizing opportunities for future returns.

**Credit Armageddon**

One of the greatest investment duos of the past three decades has been Ian Cumming and Joseph Steinberg of Leucadia National Corp. Under their tenure, Leucadia's per share book value grew from 11 cents in 1979 to \$25.03 at year-end 2007, a compounded annual growth rate of 21.4%. They saw the credit issues coming and spoke of them quite clearly in their 2007 annual report shareholder letter, written in the spring of 2008:

*"One of us has been mumbling about Credit Armageddon for years and it seemed earlier this*

*year that his fears were to be realized. At least for the time being, this nightmare has been avoided by strong government intervention.*

*Unfortunately, we suspect that the wizards of Wall Street have not only made mischief in the mortgage market, but in all other loan markets as well and the full effect of this is not yet visible. It seems that almost all financial institutions and investors have mispriced risk, and many financial institutions have found themselves carrying assets on their balance sheets at amounts considerably higher than market or their intrinsic worth. Recently, and often at the behest of regulators, financial institutions have been forced to sell these assets or to recognize the market to market losses, all of which erodes net worth, forcing them to raise new equity capital and/or to reduce leverage, a process that has come to be known as deleveraging. It may take quite a while for the scrubbing of balance sheets and the unwinding of leverage to come to an end, and we suspect that not all will survive.*

*We were not immune and have suffered some small damage in one of our investments. We are confident that the financial system will repair itself and learn to better distinguish who is a worthy borrower and what is a worthy loan. On the bright side, opportunities for courageous investors should abound. "*

Ian Cumming and Joseph Steinberg - exceptionally tough, brilliant, flexible, insightful. And here they called the credit debacle on the nose, even catching that "the wizards of Wall Street" made mischief in all loan markets, not just the mortgage market and that the mispricing of risk would lead to a process of deleveraging. So how did they do last year amidst "Credit Armageddon"? They still got socked.

At year-end 2008 Leucadia's per share net worth was \$11.22, a decline for 2008 of 55%. Ugh. With \$2.7 billion of equity (of which \$1.6 billion was in cash and investment securities) against \$2.1 billion of debt, the year-end balance sheet was far less solid than it was a year earlier. And those investments that are in equities are trading at lower market prices today.

This is the piece that has frustrated Corey and me the most. We, and others like the duo at Leucadia, saw the credit bubble. We stayed well away from mortgage brokers, home builders, etc. that were sure to get hit. We counseled clients to reduce debts and/or even be entirely debt free. But even the most enlightened among us did not foresee the meltdown that has ensued. In hindsight, Leucadia, like the vast majority of the investment world, has gotten whacked by the bear market, having invested a goodly portion of its handsome cash horde too soon.

To the extent misery loves company, we take a little solace that we are not alone. The entire world is down 50%, give or take, and that's the reality we must all deal with. On the other hand, we take little comfort that our value approach failed to protect our clients when we needed it most.

The S&P 500 is now at its lowest level since 1996 and of the 466 component companies that have reported earnings since Jan. 12, those earnings are down an average of 58%. The market is rapidly adjusting to today's harsh realities.

### **What Should We Do Now?**

Corey and I kick this question around daily. Related questions are "how bad could this get?" and "how much of today's prices already reflect current and future bad news?"

Corey and I are not clear about what is going to happen, so here is our two-pronged view on what to do.

1. **Ensure Staying Power** – How bad could this get? Assume the worst and review your balance sheet (just as corporations are doing) to survive that scenario. To the extent you have loans (including a mortgage) and you own stocks, you have borrowed to be in the stock market. Pare debt, raise cash, adjust finances to ensure living expenses are covered for the next several years. As the Indy car drivers say, "To finish first you must first finish."
2. **Invest with Entities that have Staying Power** – Isn't much of the bad news already in the price? Assume, on the other hand, that this is indeed the greatest buying opportunity of a generation (which, at some point, it most certainly is – however far or near that point may yet be). Upgrade if need be the portfolio with investments that

have unquestioned strength to stay the course. Here are a few categories that can profit from today's turmoil:

**800 pound gorillas.** Big companies with cash and boldness are getting bigger. Here are some examples. Coca Cola has long struggled to grow share in Russia (Khrushchev drank Pepsi). Now it sees opportunity as local bottlers and distributors are unable to get financing. Coke owns its own distribution system (including the delivery trucks) and has maintained its advertising, so it is Coke products that are filling the shelves of Russian grocery stores. GEICO is gobbling market share as other auto insurers struggle with investment losses and rising loss ratios. In just the past year GEICO's market share has vaulted from 7.2% to 7.7% and January was a record month for new policies. NetJets is out to up its service in Europe so it bought an AIRPORT in Germany! Meanwhile smaller fractional jet ownership companies are cancelling orders for planes. Clearly, NetJets is fast becoming the *1000 pound gorilla* in its field.

**Loan Sharks.** Debt markets are a mess, so Warren Buffett has become "Loan Shark to Corporate America". Within the past year, his Berkshire Hathaway has lent nearly \$20 billion, mostly at double digit rates and usually with an equity kicker. About \$16 billion of the total went to four companies: M&M Mars, Swiss Re, Goldman Sachs, and GE. In the case of Swiss Re, the note is for 12% and converts into equity at 25 francs per share after 3 years. Swiss Re was once one of the world's premier reinsurance companies (and should Berkshire choose to convert in three years, it may well become the dominant gorilla of reinsurance.) Other companies pleased to borrow at double digit interest rates from Berkshire included Tiffany, Harley Davidson, and Vulcan Materials.

**Blank Slates.** Wouldn't it be great if you could start all over right now? Yes, and so we like a new fund, IVA Worldwide, run by some old-hands, Charles DeVaulx and Chuck DeLardemelle (both formerly of First Eagle Global). After more than a decade mastering the global, well-diversified, all-weather, value approach developed by Jean-Marie Eveillard, these managers are poised to do well in this environment. It's new, so the fund is not under massive redemption like the rest of the fund industry. It's new, so the fund does not have legacy losing positions to wrestle with. It's new, so the managers have a clear, fresh mind toward bargain-shopping in a world replete with bargains. To date they have seen the best values in high yield debt (a la Mr. Buffett) and in Japanese equities.

## **Pecaut and Company**

Overall, we see all the seeds of an enormous rally: extreme fear, enormous cash positions (over \$9 trillion in cash, cd's, and money market accounts), insiders are buying at record levels (and, of course, have been dead wrong so far), universal negativity, low valuations. What will turn the tide? It could be something as simple as job losses are 400,000 instead of 600,000. As the boys at Leucadia noted,

"opportunities for courageous investors should abound".

***Dan Pecaut    Corey Wrenn***