Cambiar Investors

Cambiar Investors LLC
2007 Year End Investment Commentary

A volatile selloff that began in the summer gathered force in the fourth quarter, leading to a dispiriting decline in most indexes beginning in late October 2007 and continuing downwards explosively into the New Year. By the time you are in receipt of this letter, it is likely that a recounting of net stock market results in 2007 will matter far less than trying to figure out how to make sense of the markets going forward in 2008. However, it is our formal obligation to provide clients with such a summary, and it is also useful to understand how financial events have unraveled in the way that they have to understand how one might proceed intelligently from here.

On balance, we are constructive that there are some outstanding returns to be made from whatever lows the markets wind up probing this year. It is axiomatic, but the greatest long term gains do come from making capital commitments when markets are under greater levels of stress, and in having the fortitude to hold on with conviction through periods of evident difficulty. Indeed, the future trajectory of the business climate and the U.S. economy has not appeared so murky in years. The longer term consequences of a credit crunch and the need for a significant degree of consumer de-leveraging are likely to include years of sluggish growth and returns in many economic sectors. But much of this is reflected in financial valuations. As of mid-January, the U.S. equity market traded at a price-to-forward earnings multiple of just 14 times 2008 projections, a level not seen since the late 1980s and actually a good deal below the market multiple following the 1987 stock market crash! Expressed as an “earnings yield,” the stock market is trading at a yield of over 7%, a nearly 100% premium to the current 10-year bond yield of just 3.6%. Historically the market has traded at an earnings yield in line to a slight premium to the long term bond yield, ostensibly reflecting optimism that corporate earnings will grow in the future. The current relationship between bonds and stocks suggests profound pessimism that earnings will not merely stagnate but collapse in coming years.

While we are under no illusions that there will be significant pressure on corporate earnings as the U.S. economy lurches into a recession (or some degree of sluggishness that is awfully close to a recession), the disconnect between business prospects and implied valuations has seldom been this extreme at any point in my lifetime. Moreover, there are many business sectors whose fortunes are not closely linked to the overt issues that have triggered the recent market declines. As and when the markets do stabilize, it is quite likely that earnings multiples for those businesses capable of sustaining secular growth through a unique product, a unique value proposition, or an ability to address an increasingly global demand footprint, will expand. This is where we see the greatest opportunities and where we are committing capital.

2007 Q4 Market Commentary

After setting an all time record value early in the fourth quarter, the S&P 500 wound up with a decline of 3.4% for the quarter. Financial market discussions were dominated by fears about the extent and magnitude of credit problems in the financial sector specifically and the potential for these to cause the U.S. economy to experience either a significant economic slowdown or recession. Financials were the worst performing industry group in the overall market, with the NYSE financial

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index falling by 10.6% in the quarter and 13.1% for the year. As of December 2006, financial services represented the largest overall industry group by market capitalization so such declines damped market returns for the year. However, growth rates and economic vitality remained strong outside the U.S. As such, certain growth and defensive stocks as well as industrial-exporters enjoyed an oasis-like halo and performed well in spite of the well-publicized clouds elsewhere in the market, causing the blended average result to be less negative in the quarter. More growth-oriented investment styles performed better as a consequence of these market sensibilities and large caps held up better than small caps. While the Russell 1000 Value index (the most widely used large cap value index) declined by 5.8% in the quarter and the Russell 2000 index (a small cap index) fell 4.6%, the more technology and growth dominated Nasdaq Composite index declined by just 1.8% in the fourth quarter. International markets exhibited similarly mixed but generally declining performance.

These declines shaved off or eradicated most of the year's returns. The S&P 500 clung to a 5.5% annual gain while the Russell 1000 value declined by 0.2%. The Russell 2000 declined by 1.6%. The Nasdaq Composite registered a 10.7% gain. International markets fared much better as measured in U.S. dollars because of the prodigious decline in the dollar's value; the MSCI EAFE index gained 11.6% on the year. However, nearly all of the return was derived from dollar weakness; measured in local currency terms, returns were negative in both Europe and Japan. The Eurostoxx 600 (a similar index as the S&P 500) registered a slight (0.17%) decline in Euro terms. Japan experienced an outright bear market with the Nikkei and Topix indexes declining by over 20% from their midyear peaks to close the year with declines of over 11% each. Emerging market equities were the stellar outperformers, posting gains as high as 60% in China and 40% in India and Brazil, to name some notables. While the Emerging Markets story has garnered a deserved share of flowering financial press and the accompanying investor interest levels, value-propositions these are not, and would seem (to us) highly vulnerable to moderate shifts in sentiment or fundamentals.

Though financials as a group performed worst on a worldwide basis in 2007, other economically sensitive industries such as retailing, technology, transportation, and various heavy industrials saw grinding daily stock price declines as the fourth quarter progressed. The pattern of persistent stock price attrition and associated/projected earnings erosion of the last 90 days bore a distinct resemblance to the market action of the fourth quarter of 2000, the last time the U.S. entered a recession. Having managed Cambiar Investors LLC through that period and witnessed the patterns first hand, the stock price-action was so eerily similar that it is hard for me to conclude otherwise that the U.S. economy entered a mild recession in December. The statisticians that date recessions and expansions usually require years of statistical hindsight to pinpoint their exact starting point. Such tardiness does not help equity investors very much; my vote is December 2007.

End of the Cyclical Bull

The end of the economic cycle in 2007 likely marked the end of a cyclical bull market that began in late 2002 / early 2003. The bull market began as the U.S. and other major industrial countries pulled out of recession and as the onset of the military conflict in Iraq appeared to have little potential to engulf parties other than the immediate protagonists. Several broad economic sectors pulled the major and smaller economies back to a path of growth in the early years of this decade, such as

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housing, property development, travel and leisure, aided and abetted by a diverse and willing system of consumer and business credit that financed significant credit expansion. The champion growth industries of the 1990s, such as technology, telecommunications, media (known as "TMT"), remained rife with overcapacity and deflated tangible end market demand for their products. TMT was in no position to provide economic leadership at the time; rather these industries needed further retrenchment and rationalization. In the early years of this cyclical bull market, consumerism, finance, housing, property and leisure led not only the U.S. economy but the rest of the world in large degree. Beginning in 2005, market leadership shifted to a broader range of globally-geared sectors such as energy, metals, specialty finance, and industrial businesses.

The same sectors that brought the U.S. economy out of recession and that pulled the rest of the world up with them now appear poised to lead the economy to the downside. The housing market and financial services industry have already evidenced pronounced business deterioration or outright contraction. The consumerism wave that the property and financing markets helped foster appears poised to slide as well, as retail sales tailed off rapidly toward the end of the year in many broad categories. The knock-on effects in other utilization-rate sensitive industries such as transportation and commercial real estate, and in business-discretionary categories such as capital spending, have not yet begun to appear but seem more probable than not.

Recessions are often accompanied by stock market declines such as we are currently witnessing. These can be mild corrections or more substantial and destructive bear markets. There have been nine bear markets in the U.S. since 1950; should the current selloff be so-categorized, it would be the tenth. A bear market is defined as a decline in excess of 20% in broad equity indexes. Based on the waterfall decline of global equity indexes in early January (on the immediate heels of declines in the second half of 2007), many nations' stock markets have already entered technical bear markets. As of this writing, it would be a judgment call as to whether the U.S. had experienced a bear market already. The broadest U.S. equity indexes have teetered on but not actually hit full 20% declines. The S&P 500 had declined 19.4% top to bottom and the Dow Jones Industrial Average 18.0%, though the Nasdaq Composite and Russell 2000 indexes have each experienced declines by over 23% since their 2007 highs. The majority of prior bear markets have exhibited price declines of 20-28%, *meaning that most of the damage has already been done if this one proves to be of commensurate magnitude*. There have been two whoppers post-Depression, in 1973-74 and in 2000-2002, where declines exceeded 48% in each case. For a variety of reasons I doubt the current situation could produce such declines which I will argue for below.

The Anatomy of a Bear Market

The mere mention of a bear market ought to be chilling to investors. At a fundamental level, bear markets are destructive and few stocks emerge unscathed. They usually are rooted in one of two common phenomena: unsustainable valuations or broad cyclical earnings deterioration. In the former, the stock market, or some broad segments of it, become significantly overvalued, leading to a collapse in prices as business fundamentals fail to justify share prices. In the latter, share prices may not be especially expensive in terms of earnings multiples, but the conditions that businesses operate in deteriorate, causing earnings declines and stock price declines. As stock prices fall, the declines

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cause portfolios to become unbalanced with increasingly heavy weights in the less-negatively affected sectors, forcing many institutional investors to lighten up on these better performing areas, triggering more price declines. As markets fall, there is an emotional tendency by some participants to try to step out of harms' way by liquidating some portion of their portfolio holdings. Other more heavily leveraged players (and there are a lot of them out there) experience large losses forcing other sales to cover these losses, or alternatively shrink their balance sheets to reduce risk. Net, the lesson is simple: selling begets more selling, and all the more so when conditions become particularly ugly. But importantly, much of the later-stage selling is largely technical (or emotional) rather than fundamental. Though there may be a few "own island" situation stocks which hold together reasonably because of their own fundamental cheapness or internal developments, usually even the businesses that would seem quite remote from the problem areas experience price declines. For these reasons, the rate of decline and the amounts of volatility and stock market trading volume can become wildly inflated toward the end of the selloffs.

But as and when the market liquidation stops, the recovery phase can be very potent. When the technical factors driving selling abate, many stocks can and do rise quickly. An analogy is "letting a cork go underwater" – its natural buoyancy and the absence of anything impeding its ascent tends to cause it to float back to the surface (or to a more constructive valuation as a stock) rather quickly. As the markets begin to behave better, the same investors that seek to step out of harms' way step back in. Sectors that lag on the upside become underweighted in portfolios, necessitating more buying. More leveraged players' positions begin to appreciate, allowing them to afford more leverage again. In other words, the absence of selling begets buying and higher prices.

Since there have only been nine post-war bear markets, it is not easy to make definitive predictions about how things will develop from here. The 1990 bear market lasted just 101 days. Three other bear markets have lasted between 100 and 130 days. The interim bottom was reached 110 days into the current decline. However, the 2000-2002 bear market lasted for 939 days from top to bottom, and some of the other larger bear markets have lasted more than a year. Not surprisingly, the smaller, 20-28% declines have tended to bottom out in 100 to 150 days after the market peak, whereas the longer bear markets have generated more severe losses. It is worth noting that we are not starting from an inflated market valuation, as was the case eight years ago and as was the case in the early 1970s. As noted earlier, the trailing price / earnings multiple exclusive of the gigantic financial sector write down of bad debt stands at about 14x, with a few companies yet to report results. The stock market has not been this cheap statutorily in over 20 years, and not this cheap on an earnings yield basis since the 1960s. These factors all lead me to think that a bottom may be reached some time in the first half of 2008, if it has not already been seen.

If one could be so brilliant as to pinpoint the exact moment when bear markets cease, there is a lot of money to be made. Stock market recoveries have resulted in gains of at least 20% to as high as 60% in the ensuing 12 months following the end of a bear market. But this is not easy to time. There is no particular duration or magnitude to these affairs. Most recession-induced bear markets end well before the economic contraction ends. But some have gone on well past the end of the contraction. All this advocates that investors maintain or potentially add to equities and try to be patient.

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The anatomy of a bear market and that of an economic recession are remarkably similar. Recessions happen for very basic reasons. Though capitalist economies have a natural propensity to grow, some or several components of the economy experience business activity levels that are significantly in excess of the real ambient demand for their products and services and consequently need to contract. In other words, some form of excess needs to be "recessed". In the recessions of the 1950s through to the early 1980s, this generally meant that various forms of inventories had built up to unsustainable levels throughout the country, necessitating a huge drop in output in order to bring such inventories back in line with sell-through demand. As production and inventories contract, overall statistical GDP declines, and the loss of output winds up affecting other industries indirectly, such as transportation (less stuff to ship), banking (less stuff to finance, more credits go bad), and raw materials (less demand for them). Like a bear market, the output declines beget more output declines. Once inventories became lean enough, the resulting rise in output as unit production levels returned to normal tends to create a snapback to the national statistics; demand begets more demand. More recent recessions have been shallower statistically as the U.S. has become more of a service-led economy with much better inventory management technology and information for manufactured goods. This means the excesses take a different form and the explosive snapback feature following an inventory-led recession is blunted.

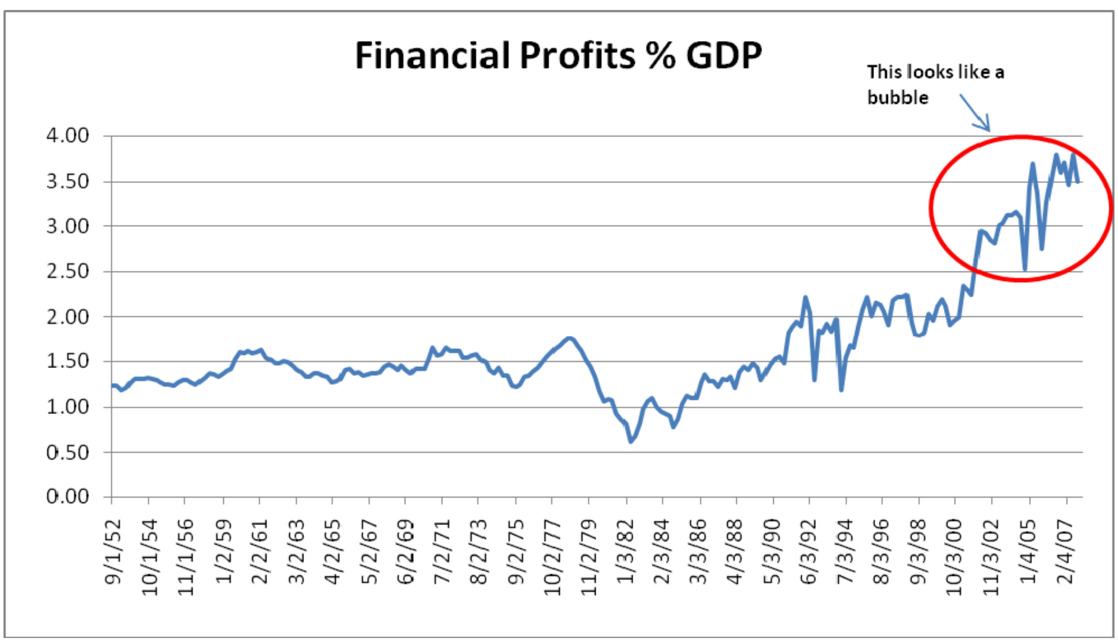
The 2000-2001 recession was caused principally by huge excesses in the information technology and telecommunications industries, where business capacities and associated overhead grew wildly in excess of legitimate end demand. Tech / Media / Telecom businesses have the peculiar characteristic of having either no physical inventory (telecommunications, software, movies, web pages…) or alternatively extremely rapid natural depreciation and obsolescence rates (computer hardware, semiconductor chips…). This meant that the businesses themselves needed to contract rather than the inventories as such. The rest of the economy was generally in good health in 2000-2001 and probably would have recovered more quickly but for the events of September 2001.

The problems today are centered in financial, residential construction, and consumer-facing businesses. Other than in commercial and residential housing (where the overcapacity is clear) these again are not factory production / inventory based businesses. As such, it is reasonable to believe that the statistical decline in GDP will be mild in 2008 but like the last recession, the recovery ought to be statistically sluggish as well. Unlike the 2000-2001 recession, the excess housing and commercial real estate inventory won't experience natural obsolescence; it rather is likely to contribute to further national home price declines until the excesses are absorbed, which can only be achieved through the passage of substantial amounts of time. Unlike servers, routers, and semiconductor chips, houses depreciate over 50 to75years as opposed to in just a few quarters.

The fly in the ointment as it were is the fact that the economy is being hit by a systemic credit collapse following an extended period of significant excess. Credit collapses caused most of the major financial calamities that transpired before World War II. Structurally they take a similar form as inventory-based recessions. Following a period of stability and general prosperity, economic agents take on increasing amounts of risk and debt in pursuit of returns. Lenders become overly complacent as well. At some point various losses occur, and it is essential that there is enough capital and liquidity at banks to absorb the losses. In the absence of sufficient liquidity, losses that might have been concentrated in a small number of institutions can become a systemic problem. This happened precisely 100 years ago in *The Panic of 1907* (which actually started in October 1907 and did not end until well into 1908), when the wheelings and dealings of a few speculators who tried to corner the copper market snowballed into a run on the entire banking sector. This episode led to the creation of the Federal Reserve Bank of the United States, which has the power to create or destroy an infinite supply of banking system reserves to combat such bank runs. At least in theory, if the Fed can supply enough liquidity in a credit collapse, the rest of the economy need not suffer unnecessarily if there are concentrated credit losses. The Fed has generally done its job in such circumstances save for the 1930s when it failed to provide liquidity.

Too Much Credit

The Fed was legitimately worried about the possibility of deflation and a credit collapse earlier this decade and took short term interest rates well below the rate of inflation for all of 2003-2005. This triggered an enormous expansion in credit to consumers and businesses and created what appears to be a clear bubble in the aggregate profitability level of the financial sector. Alan Greenspan will not be judged favorably for blowing this particular bubble. Though the economy has changed dramatically in its composition as compared to the 1950s and 1960s (when credit cards were not widely used, for example), it is hard not to conclude that credit-based activity got way out of line in the last 7-10 years.



Source: Hauer Associates

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The big expansion in credit, particularly consumer credit, was underway well before negative real interest rates emerged earlier this decade. Adjusted for inflation, consumer debt—including mortgages—rose an average 7.5% per year since 1997, far faster than the 4.2% rate of the previous 10 years. The last time debt rose so fast was the 1960s, as the postwar generation bought homes and autos. If Americans had kept borrowing at their pre-1997 pace, they would have had about $3 trillion less in debt. The extra debt also represents a formidable obstacle for banks and other financial institutions that might want to lend more to consumers – consumers need to de-leverage at this point.

There were many factors that drove this expansion in credit and seemingly disproportionate growth in the profits of the financial services sector. Technology and computer automation have clearly helped financial companies to process far more information and handle far more customers than in the old days of pushing paper. Financial services sector productivity growth has consistently been among the highest nationally since the early 1990s. But one particular innovation was key: securitization.

This process, by which pools of loans are bundled together and then sold in bunches to investors, has allowed banks and other old-line financial businesses to increase greatly the velocity of their businesses and capital efficiency. For example, banks' historic business model was to originate loans to customers, hold them until maturity, and hope they could match asset and liability maturities and costs well. They essentially had to sweat out returns on loans. But through securitization, banks could focus on origination and servicing by securitizing the majority of their loan production and selling it to investors for a profit, transforming a structurally low return on equity business (consumer lending) into a higher returns business because it could effectively be turned over multiple times per year. Because Wall Street demands consistent growth in profits, this created large incentives to securitize more and more stuff. Mortgages are the largest securitized asset class by a big margin, but just about every kind of loan that you could think of has been widely securitized over the last 10-20 years: credit card receivables, auto leases, commercial real estate loans, home equity lines of credit, aircraft leases… The market is huge.

Securitizations have a common structure. Once the pool of loans to be securitized is assembled, it is divided into senior and subordinated (junior) tranches. Assuming that there is real physical collateral behind each loan on the securitized pool, the senior tranche is likely to be rated AAA, with each more subordinated tranche rated AA, A, BBB and so forth. The idea is that in the event of delinquencies or outright defaults, the first losses are assigned to the more lowly rated tranches, such that all of the value of the low-rated tranches would need to be wiped out before the senior tranches would be impacted. This layering of potential losses obviates the need for risk reserves (like what a bank would carry) by the holders of the securitized paper because in effect the owners of the junior tranches bear the most plausible credit risk. This is illustrated on the following page:

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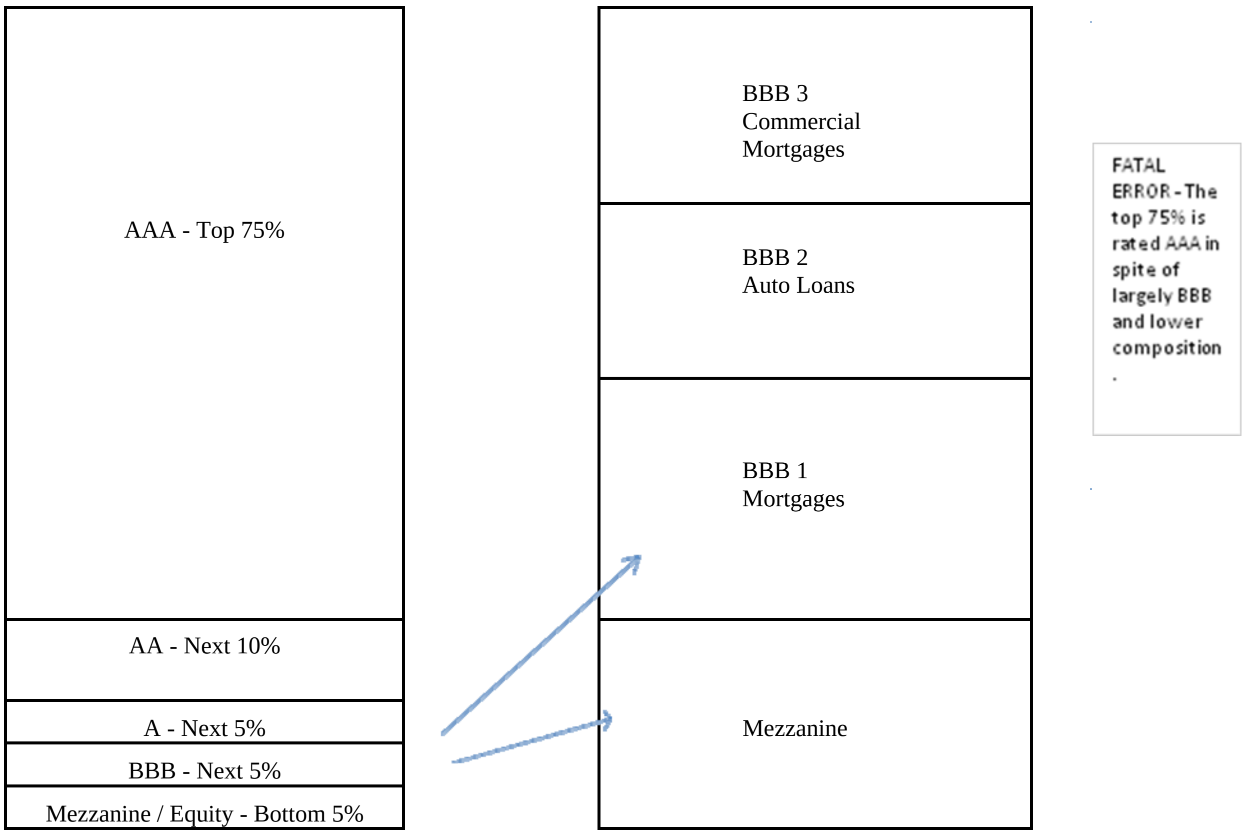
TYPICAL SECURITIZATION POOL STRUCTURES



Original Mortgage Backed Pool

CDO Pool of subordinated tranches

The big question in a securitization is: who will willingly hold the most subordinated tranches? In the event of a negative credit cycle, the junior tranches can quickly become worthless if defaults are high. (They are crudely referred to as *toxic waste* in the industry jargon.) The solution has been in many cases to package the subordinated tranches in with pools of other loans to effectively reduce the possibility of total losses. To my eye, it has been a bit of a *Where's Waldo* or *Hot Potato* exercise to bury the junior tranches somewhere that they might not be noticed too prominently by the buyers.

About five years ago, Wall Street began to package pools of junior tranches of different types of loans together, ie, mortgages plus autos plus credit card receivables… These mixed pools are called CDOs, short for *Collateralized Debt Obligations*. For reasons that seem highly implausible, ratings agencies were willing to assign AAA and AA ratings to the senior tranches of these CDO pools of junior tranches! The premise was that the underlying loans' performance would not be closely correlated, creating greater investor protection. What we are seeing today, however, is that ALL classes of consumer loans are deteriorating at the same time (auto, mortgage, credit card… have shown marked deterioration over the course of 2007). This means that the senior tranches of such CDOs are potentially worthless, and many formerly AAA rated CDOs have been downgraded to high default probability CCC ratings. The big headline write downs at banks and brokers that we are witnessing in the financial press are predominately these structured securitizations that have gone from the highest credit ratings to poor ones in a matter of months. Many of them got stuck holding $ billions of this paper as it became unsalable last summer.

All this is background to what is the $6.4 trillion dollar question going forwards: who exactly will buy the junior tranches of securitizations going forward? Clearly risks are high. *Unless there is a way to entice such buyers, the entire securitization process cannot go forward.* Obviously if some layers of protection can be added, there may be ways to restart this engine of finance. But I suspect that real securitization volumes outside of proven asset categories (like conforming mortgages) will fall by 40-80% going forward. And without securitization, banks must fall back on their old business model, which is a good deal less capital efficient than what has been the case for the recent history. This is the primary reason that we have elected to hold no banking stocks in our portfolios – despite the beating they have taken, the earnings power of most banks is probably a good deal lower than their earnings were in recent years.

For these reasons, the amount of monetary easing needed to cushion the blow from credit losses and to unclog the arteries of credit in the financial sector is dramatic. Part of the reason for the large stock market declines since early November is a gradual recognition by the market that the Fed did not seem to appreciate the gravity of this. It seems that the Fed is coming around, having lowered interest rates aggressively in between meetings in January after dawdling with hawkish inflation-fighter language in the fall. Clearly the credit collapse is a higher order problem than inflation being a percent or so outside the target range. In our view, the credit problem is a good deal deeper than what the Fed can do using a low short term interest rate. Much ink has been spilt bemoaning the excesses of the housing bubble and the catastrophically bad underwriting standards of lenders in recent years. But it is still worth noting that most of the aggressive mortgage products (that wound up sold into securitizations) had the common feature of allowing the borrower to take on far more debt and buy far more house than he or she could realistically afford. A borrower who took on a $500,000 mortgage but who can't afford the payments on even a $300,000 home cannot really be saved by the Fed's recent moves. While this is well understood by markets today, more problems are likely to emerge in commercial mortgages where overcapacity is rife and in other forms of consumer credit where default statistics have been flattered for years by the ease of refinance.

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Point of Discontinuity

It is likely to take years for the U.S. economy and for U.S. consumers to de-lever their respective balance sheets. The long term problems of grossly inflated real estate and a massive shift in the calculus of the banking sector bear more than a passing resemblance to the situation that faced Japan some 18 years ago when its real estate became wildly inflated following a credit bubble. Unlike Japan, the U.S. economy is substantially more flexible and through the efficiencies of markets and their pricing mechanisms, we should be able to absorb the credit losses and related bankruptcies in due course, allowing for resources to be better allocated. But to do this without demolishing our banking system will require a sustained period of very low interest rates so that the interest costs of the debt bulge can be serviced.

If interest rates are indeed structurally lower for an extended period of time, it would seem that future earnings streams would be more valuable and not less, in spite of the markets persistent multiple compression over the last 3 years. If one can find industries where there is sustainable growth and attractive returns on capital, the opportunities for significant capital appreciation are potentially very high as and when the economy turns and investors become more comfortable in the sustainability of earnings. Admittedly, the potential for the credit market problems in the U.S. to fester into a global economic problem cannot be overlooked or given short shrift. Nonetheless, we think it reasonable to believe that as stocks' earnings power becomes clear over the course of the year, we might actually start to see some multiple expansion. And hopefully much better returns.

Sources: Bloomberg & Hauer Associates

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