



## **Cambiar Investors LLC 2008 Q1 Investment Commentary**

Investment returns in the first quarter of 2008 were broadly negative on a global basis. A selloff that began in the summer of 2007, primarily in financial shares and various consumer-facing businesses, gathered force in the opening days of the New Year, leading to brutal declines in most world equity indexes. The United States fared comparatively “less bad” than many foreign Bourses, with the S&P 500 declining by 9.4% for the quarter versus declines of 19.0% for the German Dax, 10.4% for the UK FTSE 100 Index and 17.5% for the Japanese Nikkei Index. Last year’s supernova index was the Shanghai A Share Index in China, which gained 97%; it retraced two thirds of the gain due to an impressive 34% decline in the first quarter alone. The declines were broad and indiscriminate, with all of the statistical decline occurring within the first 12 business days of the quarter.

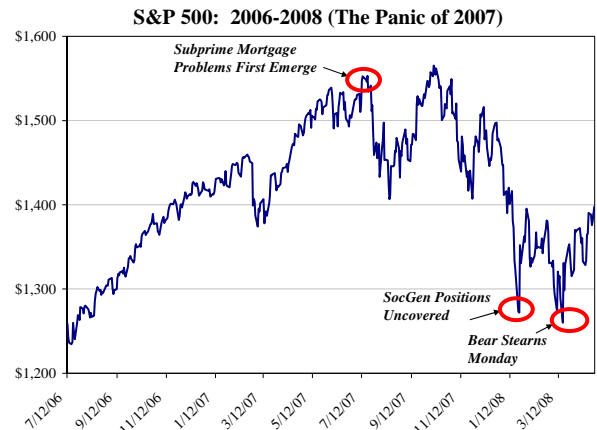
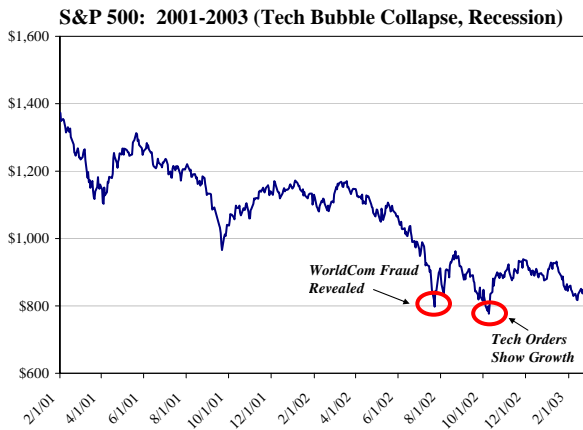
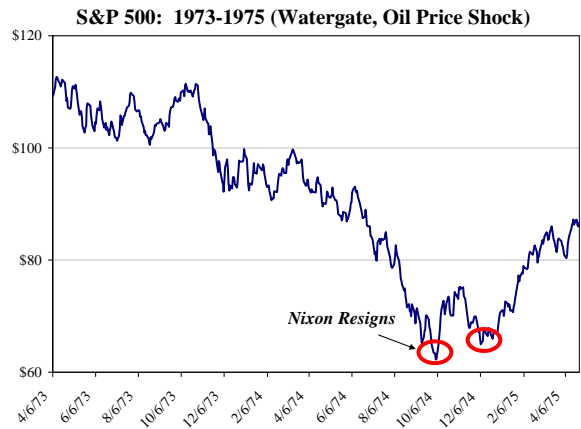
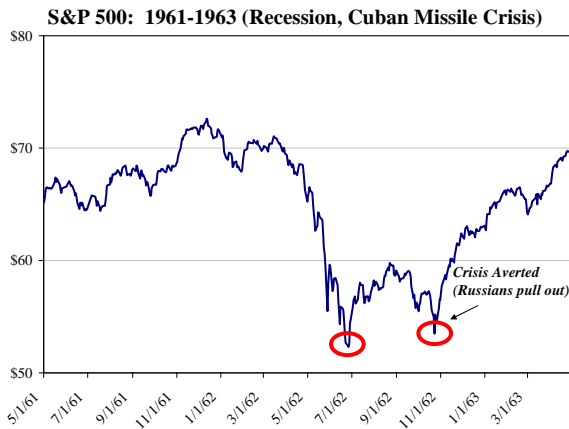
These equity market returns represented the worst single quarter returns since the third quarter of 2002 (when the S&P 500 declined 17% in the wake of the WorldCom and Enron bankruptcies) but in many respects, the first quarter of 2008 was more punishing - not a single broad sector registered a gain! No industry sector was spared; even those with the healthiest fundamentals (energy -6%), the least cyclicality (consumer staples -2%), the most predictability (utilities -10%), the most defensive (healthcare -12%), or the most contra-market trading propensities (metals -2%). In 2002, there were moderate returns to be found in healthcare and metals. Technology returns (-15%) were surprisingly the worst among major sectors in the U.S. market. Homebuilders as a subsector were up 15% following an eviscerating series of declines in 2006-7. The worst performing Dow component? Pharmaceutical giant Merck (-34%). How’s that for an entirely counter-intuitive and un-investable landscape!

The only good news is that the market did appear to put in some kind of bottom in the first quarter that looks technically similar to other major market lows. Following a waterfall decline in the first three weeks of the year, the market bounced sharply off lows first probed on January 22-23, only to revisit these lows in the middle weeks of March. This double bottom coincided respectively with problems at two major securities firms. A rogue trader at French investment bank Societe Generale hid billions of dollars in index-futures trading losses which were immediately blown out in January following their discovery. In March, the capital positions of many major U.S. financials and investment banks were under serious assault. Bear Stearns’ net capital-to-asset position was among the weaker and a run on the (investment) bank occurred in the middle of March. This led to an over-the-weekend Fed-brokered shotgun marriage between Bear Stearns and JP Morgan, who is among the few New York money center banks to have any identifiable excess capital right now and whose headquarters were 300 feet from Bear Stearns on Madison Avenue.

The irony of this sequence of events in March is hard to miss. The current panic in fixed income markets bears more than a passing resemblance to the *Panic of 1907*, which triggered a wave of bank runs following the collapse of a few speculators and banks that they were affiliated with following a failed attempt to corner the copper market. At the time it was JP Morgan (the man, not the bank) who called an emergency meeting among bank presidents at his residence on Madison Avenue in New York and bullied them to buy loans that were on sale with their reserves and stop the panic. 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.



Up until mid-January, I would say the Fed was not showing much evidence that it was up to this task or that it understood the sheer magnitude of the problem in financials which fanned the flames of panic. But by cutting interest rates aggressively as the quarter unfolded, opening the Fed discount window to a much greater range of collateral than had been allowed previously, and preventing the systemic damage that would have ensued from an abrupt failure of a major investment bank (which held several hundred billion dollars in counterparty risks through derivatives), a bad situation was contained. A crisis avoided is a crisis averted, and for this reason I think the low for the current market cycle may have occurred on “Bear Stearns Monday”, March 17<sup>th</sup>. Interestingly, the pattern of major bear market lows and “double bottom” formations has ample historic precedent, including bear market lows in 1932, 1962, 1974, and 2002. There is often wisdom in crowds oddly enough, and for whatever the reason, markets have regularly formed double bottoms at the most stressful points of major financial dislocations, as evidenced below:



**THE PATTERN IS THE SAME – DOUBLE BOTTOMS OFTEN MARK MAJOR MARKET LOWS**

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So with systemic failure *hopefully a negative option that is no longer on the table*, we can go back to the business of investing with an eye toward the future. What might that future hold? The U.S. appears to be skirting the edges of a mild recession based on various data. Europe looks to be following us into recession with a lag of about 100 days. East Asia continues to grow rapidly but with overt signs of growing pains. Agricultural product and energy shortages are creating a variety of societal and economic limitations to breakneck growth. Moreover, the export-led development model in Asia, which has been highly successful, now faces a saturated and overly-extended major customer in the U.S., which means that Asian growth will of necessity, need to be more inward facing. All of these developments serve to create a greater than average degree of uncertainty about exactly where the world will be in a couple of years' time. The premium on having some sort of financial and economic vision is very high.

We have worked very hard internally to develop a broad as well as a nuanced view of the future range of opportunities and challenges in various sectors. The two that are the most interesting and impactful are the outlook for credit and the outlook for energy.

**Financials** – Much ink has been spilled on the financial crisis of 2007-8. It started in an arcane corner of the market, namely securitized subprime mortgages and similarly structured credit pools of lower-quality loans, and has spread into almost every asset class. We will not add much more ink to the flood here other than to articulate its broad parameters. Credit was, for varying reasons, systematically mispriced for the last 5 to 10 years in our estimation. This led to an excess of lending which recent events and stratospheric losses by lenders are now beginning to reverse. This process will take years, not a few months. It is becoming a consensus that there will be at least \$1 trillion in credit losses, primarily in mortgages, but extending into car loans, credit card loans, corporate debt, and so forth. So far estimates of this sort have tended to spiral upwards since the crisis began last summer. If at least half of these losses are concentrated in the banking system, this means that the nation's lending capacity has shrunk by anywhere from \$4 trillion to as much as \$8 trillion dollars. The typical bank operates with a capital-to-asset ratio of between 4% and 8%. Taking the midpoint, the negative multiplier of \$500 billion in lost capital is >\$8 trillion in lost capacity to hold risk assets. Banks, securities firms, GSE's, and other credit specialists have been and will continue to raise capital at potentially highly dilutive prices because they cannot possibly sell this quantity of loans to maintain regulatory compliance. Net, the loan shrinkage will likely not be as draconian as \$8 trillion because of the capital raises, but it is hard to comprehend how it will not become much more restrictive. This means that the nation will lurch quickly from a credit feast to a credit famine and that recessionary conditions may linger well into 2009.

Speaking of regulations, how hard will the hammer fall on the banking sector and Wall Street's "Creature from the Black Lagoon" securitization? Pretty hard in our estimation. Net, just after our banking system falls from well capitalized to uncapitalized, a new layer of capital requirements will be added. What does this all mean? More capital raises, lower earnings per share (because there are a lot more shares) and more restrictive lending (perhaps more appropriate in the long run).

These capital raising and dilution exercises are absolutely deadly. Ultimately Bear Stearns shareholders were wiped out, or at least very close to it, with a merger price of \$10 per Bear Stearns share, down from \$170 in early 2007. We had mentioned Countrywide Financial as another possible system-breaker in prior



letters. It is to be wed to Bank of America for about \$5 per share, down from \$45 in early 2007. Any number of other financial companies more heavily exposed to housing and mortgage lending have seen similarly horrific losses of value as a price of survival in some form.

For these reasons, we believe that on balance the risk/reward is not very favorable in banking and other credit-related businesses for holders of publicly traded shares, even after the massive declines. There has been a nice bounce in percentage terms off the mid-March lows. We expected this, but feel that many if not most large cap banks will lurch sideways to down for the balance of the year, as the nauseating reality of a post-credit bubble world becomes more evident. The market has (correctly) been unable to go up until the banks stopped going down due to systemic risk concerns. But that does not mean that banks must be a leadership sector. Unless one is a very clever shorter-term stock trader, we see far better opportunities elsewhere.

**The peaking of global oil supplies** – Ask yourself this question: how can the U.S., as the world's largest economy and consumer of 23% of the world's daily production of oil be nearing recession, yet oil prices average \$97 per barrel in the first quarter of 2008 and are now pushing toward \$120 per barrel? How can this be? Is it speculation? It is hard to argue that speculators alone could push oil prices up nearly five-fold since 2002. Instead, we think there are larger factors at work, with the crux of the answers to the posed questions that the world's daily production of crude oil is simply not growing to meet demand that continues to push upward globally. Millions of new customers are added each month in emerging markets, each incrementally sipping at the world's thinning reserves. In other words, the oil price and supply/demand equations are no longer weighted as heavily toward American driving habits and the broader U.S. economy. The idea of fundamentally exhausted global production growth, or Peak Oil, is an absolutely fascinating and simultaneously horrifying concept to contemplate. We may explore it in greater detail in future letters. In the interim, we think many energy stocks fail to fully price in both current and expected future oil and natural gas realities. Our exposure in client accounts is substantial and we expect it to remain so for the future.

Here are the broad dimensions: In 2007, the world produced and consumed about 86 million barrels per day (mbpd) of oil and natural gas liquid (NGL) equivalents (81 mbpd oil, 5 mbpd of NGLs). The U.S. accounts for about 20 mbpd of that demand, and all industrialized OECD countries demand about 49 mbpd. Most of that oil is used for transportation, where despite much hoopla about alternative forms of energy, electric cars, and so forth, there are to date no functional equivalents for gasoline, jet fuel, and diesel fuel. If one strips out the production of NGL condensates, there has been very little (if any) net increase in global production, in spite of the high prices and exploding emerging market demand. Over the next three years the view is remarkably similar to the past three years – based on known projects and known decline curves for aged oilfields, production may reach 89 mbpd of oil and perhaps another incremental 1 mbpd of NGLs. This is totally incompatible with growing emerging market demand. Whereas in the 2000-2004 time period the increased output of Russian “brownfield” oil fields (resuscitated USSR fields in Western Siberia mostly) production was able to grow world oil supplies in line with mushrooming emerging markets demand (mainly China, India, Eastern Europe, and the Middle East), this appears to have topped out in the last two years. Almost all the growth since 2004 is NGLs, not oil.

This is more alarming than it sounds at first blush. Much of the world's natural gas is “associated gas” – it is found together with oil. As an oil field matures, the resulting loss of reservoir pressure releases the dissolved



gases, which often forms a cap over more mature oil fields. This causes the ratio of natural gas to oil to rise when reserves are pumped out or when production is increased. In other words, a rising NGL ratio is a sure sign of reservoir aging. About 4% of oil output was NGLs in the 1970s; this may rise to about 10% by 2012. Familiar NGLs include benzene, butane, and propane. This may be welcome news for companies that produce cigarette lighters or outdoor barbeques, but does not help with the growing world auto and jet fleet.

Oil fields are, in an odd way, a lot like people. They are most physically productive when they are young and the effects of aging are both persistent and irreversible. As they get older, more “stimulation” is needed to achieve the same physical output. Eventually the output is of lower quality (i.e. more NGLs as a percent of total physical output), followed by an outright physical decline (fewer barrels per day no matter what one does). Once the signs of aging are visible – the decline phase is not far ahead. The growing percentage of NGLs is a fairly clear indication of the aging of global oilfields.

In the last 30 years, oilfield services companies (primarily U.S.-based) have perfected many ways of accelerating oil production and stimulating underground reservoirs. Through techniques including horizontal and diagonal drilling, they can now tap formations that previously were impossible to achieve reasonable recovery rates on. They can push oil out of the ground using artificial lifting techniques, rather than merely flooding the reservoirs with water or recreating pressure with natural gas or nitrogen injection. Less porous rocks can be fractured with pressure pumping, allowing oil or gas reserves to flow where otherwise they could not. All of these technologies have allowed oil producers to recover more oil more quickly from oil fields than was possible years ago. But, as oil is by definition a depleting resource, these accelerated recovery methods *ultimately just deplete it faster* – meaning that once an oil field truly starts to decline, the rate at which production falls is quite spectacular.

There are tangible current examples of the deadly math of accelerating decline rates around the world. Mexico’s giant Canterell field, which today supplies the U.S. with ~1.5 mbpd of high quality crude is in free fall, with production expected to decline at a 15-20% annual rate. Barring the development of new oilfields in Mexico (mostly far offshore, and years away from scale production in any case), Mexico will be a net oil importer by 2011-2012. The north slope of Alaska is experiencing similar declines (hence the great interest by oil companies to drill in ANWAR, in spite of the politics). It is not just a North American phenomenon – accelerating decline rates are happening in the Russian brownfields, in Iran, in Kuwait, and in the UAE. There are some big projects coming on stream this year and next in the Caspian Sea, in the Gulf of Mexico, and even in Saudi Arabia, but net of the decline rates, it is about a wash! Major new discoveries, mainly in deepwater offshore Brazil, will not produce meaningfully until well into the next decade, and will again only keep total world production flattish net of decline rates elsewhere.

The implications are broad and far reaching. Oil prices must go high enough to kill demand – which means that the price deck for producers is potentially vastly higher than anyone might have dreamed at the onset of this decade when Asia was in deep recession and Russia still desperate for cash. We are seeing real demand destruction today in the U.S. Maybe \$4.00 at the pump gets Americans out of their SUVs for good. But Peak Oil is not a problem that goes away quietly into the night.

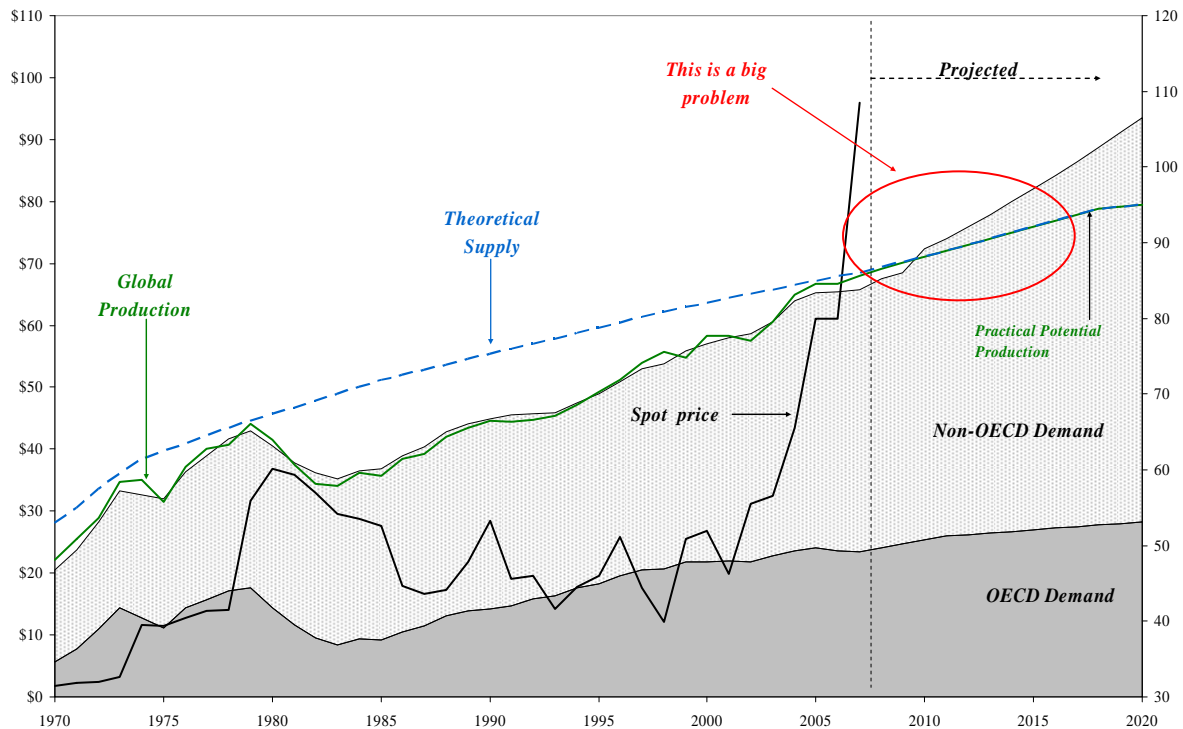
We have been using the chart below since the beginning of the year to show pictorially our thoughts on the energy sector. The key factors are the dashed blue line (potential supply) and the persistent growth of non-OECD demand (grey area), which will of its own accord push demand above supply in the not-so-distant



future. Obviously, that is not physically possible, hence prices must ration the available supply, and they go parabolic as the curves threaten to cross. Take a good look at this and think about what it means. Though it is impossible to be exactly precise about such a globally diffuse industry, if this is on balance an accurate representation of the fundamentals (we think so), the implications are very large.

The picture below was the house view as recently as February. Increasingly, there is evidence that our (Cambiar's) estimated supply curve, which flattens out at ~94-95 mbpd in 2015, *may be optimistic* due to the higher percentage of NGLs in production, and accelerating decline rates at so many major fields. Production above 90 mbpd may functionally never happen. This may substantially explain this year's rapid move upwards in oil prices.

### World Oil Supply and Demand



Figures in millions of BOE per day

***If global oil supply is functionally capped at ~95 mbpd, oil prices become a royalty on global growth.  
If capped at ~90 mbpd, it's the same but sooner...***

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There are many investment opportunities in spite of some of the clearly unpleasant ramifications of Peak Oil. Energy stocks become uniquely valuable with turbocharged earnings and cash flows. Technologies that allow for greater energy savings also become very valuable. The automobile needs to be completely rethought (smaller and fewer). Infrastructure requirements and the urban footprint become much different longer term. Trains operate with an immense cost advantage over trucks despite their point to point delivery advantages. Agricultural commodities, which require a lot of hydrocarbon energy to produce using mechanized methods, become more expensive (this is part of the big price squeeze in agriculture though that issue has many complexities similar to oil). Can paper currencies be trusted to hold their purchasing power in the face of growing scarcity? Gold and other precious metals may map over better to real purchasing power. Big emerging markets like China and India would seem to be more than a bit late to the party to propagate an automobile-centric future to their nation. Does global outsourcing become too expensive (to transport the goods), leading to a domestic manufacturing renaissance? As the Age of Petroleum itself grows old, these are very interesting and potentially disturbing issues to consider.

Hopefully our ruminations can help explain some of the volatility we have witnessed so far this year. Having some vision about where to find value and where it may be elusive is particularly critical. We will share more of our thoughts on these topics in future quarterly letters.

My personal favorite statistic: In the first quarter, the stock market was statistically the most volatile it has been since 1938 (!) with intraday moves of greater than 1% on 52% of all trading days. In 1938, as the threat of World War and a global Depression weighed on the markets, the market moved by more than 1% on 57% of trading days. Considering the substantial institutionalization of equity markets, the rapid dissemination of financial information by electronics and the ease of electronic trading... as compared to information via ticker tape and paper-based trading in the 1930s, the mere fact that volatility could even be proximate to that of 1938 is amazing.

Thank you for your continued confidence in us.

Sincerely,

Brian M. Barish  
President  
Cambiar Investors LLC

*Data Source: Bloomberg*

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