Cambiar Investors LLC
Q1 2009 Market Discussion/Outlook

To our clients,

The first quarter of 2009 began with a continuation of the extreme volatility and general downward trajectory of equity markets that prevailed in 2008. Q1 2009 was not any pleasure to sit through, but after nearly two years of deteriorating economic and financial conditions, glaring economic policy errors, and waterfall stock market declines, a number of leading financial variables that have pointed persistently downward over the last two to three years turned up sharply. As of this writing, stocks have taken some notice of this. After a fierce selloff that saw the S&P 500 Index shed 28% of its value between early January and early March, markets recovered more than half of the loss, resulting in an 11% decline for the quarter. As has been the case since the troubles in the financial sector began almost two years ago, the pain was worst in the value indexes which declined 17%-19% depending on the capitalization range. The first quarter of 2009 marked the *sixth* consecutive quarterly loss in the U.S. stock market. As an historical reference, only one other bear market has produced six consecutive quarterly losses (1969-1970) – the worst the Great Depression could muster was five consecutive quarterly losses in 1930-31.

We are well aware that there is a persistent drumbeat of negativity and gloom in the financial media and by commentators and that any bouts of optimism since the credit bubble began to pop in the summer of 2007 have proven to be false dawns. Markets react on seemingly an hourly basis to the trials and tribulations of the banking sector whose egregiously poor loan underwriting and business leverage have threatened the whole system. There is a palpable and understandable fear that in their breakdown, forces have been unleashed by the financial crash of the last two years that may be difficult to contain or envisage their upcoming course. In prior letters we have chronicled the numerous financial and economic challenges and would till no new ground restating these discussions or rehashing the negatives. And clearly the systemic de-leveraging of the U.S. economy and banking system reset will just take a long time. Nonetheless, this bear market is getting old by historical standards (602 days to the March 2009 low from the broad market peak in July 2007), the magnitude of it globally (-57% to -65%, depending on one's choice of measurement) has now substantially exceeded all postwar declines, the market was oversold on a technical basis by 4 to 5 standard deviations from "normal", and light at the end of the tunnel is emerging. Increasingly, the banking stocks seem mired in their own structural issues, while the band goes on in the many parts of the economy not intimately tied to credit. The case for a fresh round of pessimism and gloom is not altogether strong.

Those are subjective perceptions. There are several objective positives that we identify below:

1) The Yield Curve – Starting in the second quarter of 2006, the U.S. Treasury yield curve inverted and remained in some form of inversion until the beginning of 2009. It is now positively sloped at all successive maturities. An inverted yield curve is a consistent negative harbinger for the economy and financial returns, implying that fundamentals and risk considerations that underpin the normal term structure of debt (getting higher yields as one lends longer term) are obviated by an imminent economic downcycle. Following the *Bear Stearns* and *Lehman Brothers* failures the yield curve became altogether cockeyed due to severe risk-averse behavior by market participants, implying that interest rate policy and market health remained dysfunctional. Today's positively sloped curve is an unambiguous indicator of greater forward expectations for financial returns and orderly market function.

2) Stock Market Breadth - A stock market dominated by a few winners and a preponderance of losers is not a healthy one, and such was the case from late 2006 through the end of 2008, making active management particularly challenging. Despite posting the worst stock market returns since the Great Depression, the most commonly referenced averages actually *understated* the damage, which was even more pervasive for the average stock.

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Breadth has been a good deal better since the last few weeks of 2008, and while the most prominent stock indexes probed significant new bear market lows in February and early March, the bulk of the losses were more narrowly concentrated in financials and interest-sensitive industrial businesses, making the overall damage less severe than the averages would suggest.

3) Funding is available - Alongside the significant improvement in stock market breadth, corporate bond issuance has risen dramatically, corporate yield spreads have compressed in varying degrees, and mortgage refinancing activity picked up significantly. The interbank lending markets have also calmed to pre-crisis levels. Funding is not available to everybody on cheap, easy terms – but loose credit lies at the heart of what caused the problems in the first place. It would be foolish to believe such conditions could return. A resumption in the ability of businesses and individuals to fund basic activities, rather than mindless liquidation of all financial contracts and obligations notwithstanding the viability of counterparties, is surely a prerequisite to recovery.

4) The probability of a (new) system-busting failure appears remote - It is clear that the deepening of the recession and of financial losses is a direct consequence of the mis-handling of the crux of the financial crisis in September, when *Lehman Brothers* went into an uncontrolled bankruptcy and various financial intermediaries teetered on the razor's edge of a similar fate. This created the massive forced-selling vortex that engulfed the markets in late Q3 2008. It is abundantly clear from the actions of various government agencies that there is widespread recognition that such system-busting failures cannot be tolerated, in spite of the unseemly political consequences of "bailouts" and the like. Moreover, at least among financial companies, most potential *Chernobyls* have already been sniffed out and contained. A significant part of the valuation compression in all stocks can be traced to the inflation of equity-risk premiums, which rose in the last six months to levels only witnessed briefly during the worst phases of the Great Depression. As fears of another *Lehman*-type episode abate, stocks can rise - in many cases appreciably - because the embedded risk-premiums are simply too high.

All of these directional changes are positive and point toward expectations in financial markets of an improved business climate in the future. Since the onset of the banking system crisis that began in mid-2007, NONE of these financial variables have suggested this until now, individually or collectively. While GDP and corporate profits in the first half of 2009 will register material declines (we crudely estimate a 6% contraction in Q1 GDP and a 1-3% contraction in Q2 GDP, on the heels of -7% for Q4 2008), it seems reasonable to us to forecast an end to the economic recession some time in the second half of 2009. Enough data is turning positive as of this writing to think that the recession may just end in May, but 3Q 2009 looks the more likely date.

Whether the bear market of 2007-2009 ended in March is hard to say. My own prior efforts at predicting a low have proven poor. For what it's worth, I would not have ever predicted that, given the financial circumstances that were in plain evidence one year ago at this time (namely the failure of *Bear Stearns* and obvious problems in securitized asset quality and liquidity globally), Government and Central Bank resources would **not** have been marshaled aggressively to contain the next likely wave of systemic pressures or a system-busting failure. But they weren't, at least not in a timely manner, and all hell broke loose. And rather than a long and tortuous process by which the U.S. and the rest of the world could learn to operate on a whole lot less credit, we instead got a brief taste of Depressionary forces of systemic collapse that had been locked away in the deep recesses of history. Those 1930s demons may have been put to rest through a series of extraordinary government actions, and for this we can be a little bit thankful, but at an immense expense that will have to be reckoned with down the road.

If the Depressionary forces have been put at bay and there is some recovery in the economy for the simple reason that it's been clubbed to death, our expectations remains that the market will end the year without a huge change in its overall value (The S&P 500 started the year at 903) but with a lot of interim volatility. That prediction is looking pretty good. If we are off, it may be a little bit to the too conservative side.

Technical curiosities - Since topping out in 2007, the S&P 500 Index has lost 57% top to bottom, reaching an easy-to-remember for posterity low tick of 666 on March 6th, a 13-year market low. The top is a less easy-to-recall 1,576 in October 2007. The Value Line Arithmetic Mean Index (an equal weighted index) lost 62% top to bottom, but it

topped a little more memorably on Friday, July 13th 2007. The Russell 1000 Value Index has lost 64%. At the low point in March 2009, the S&P 500 had retraced 62% of the stock market advance that began in Ronald Reagan's first term. For market technical fans, that would be a 5/8th or 62% Fibonacci sequence retracement and the fact that the market bottomed there is considered significant for people into that sort of thing. Personally, I have been drawing charts of the market going back to the depths of the Great Depression of the 1930s to get the maximum historical perspective. Interestingly, the trend line generated by the major lows dating back *all the way* to the Depression low in 1932, which picks up the second Depression low in 1937, the 1942 WWII low, the 1949 postwar recession low, the 1974 post-Watergate low, and the 1981-82 20%+ interest rates recession low – that line crosses March 2009 at 664 for the S&P 500. The other indexes cited above had yet to be invented. It is possible that this turn and a turn in the economic cycle may coincide neatly with each other. This stuff is the stock market equivalent of a voodoo doll, and there are lots of non-comparability issues from one era to the next, but it nonetheless is a very interesting picture.

The S&P 500 Index – Inception to Present

Source: Bloomberg

Echoes of a Different Market Extreme – A day before the 666 on March 6th market low, I sat in a San Francisco hotel room incapable of paying much attention to the technology stock conference ongoing in the lobby as rain poured down from the sky outside, contemplating what exactly lay in the future for equity market functionaries such as myself. Ironically, nine years earlier in March of 2000, a couple days before the tip-top of the technology bubble that raged at the time, I attended the same technology conference at the same hotel imbued with a similar sense of personal dejection as Cambiar's clients exited in droves to pile into technology stocks and growthier mutual fund offerings. Within days, the markets turned. In 2000, there were reasons to be smug after the insanity peaked out. This time around, those discouraging feelings will endure a lot longer.

What stings to this day, both as regards to the despondent 2009 lows and the insane technology stock 2000 peaks, is how glaringly ineffectual the capital markets have been for over fifteen years now in allocating capital to the appropriate resources. How else can one explain a market that makes nobody any money in 13 years with immense interim volatility? It is a stark reality that has bothered me immensely. Maybe the answer is a simple one – stocks

got overdone in the 1990s and were due to wander through the desert for years. It may be just that simple, but I think there is a bit more to it.

When one looks at the great economic triumph of the 20th century, namely capitalism over socialism and other forms of statism, it is universally agreed that capitalism's winning feature is the pricing mechanism of the marketplace which creates efficient resource allocation and quickly reveals winning and losing business strategies and structures. And capital markets sit at the center of such systems, or at least are supposed to. Their lack of function is certainly capable of bringing the whole system down as we have seen.

My opinion is that capital markets (capital markets specifically, and not ordinary goods and services markets) have been focused on the wrong variables for all too long and it has finally caught up to them. Rather than generating superior market-based outcomes like they are supposed to, they are generating poor pricing signals and we are all suffering for it in varying degrees.

Properly functioning markets have this wonderful feature – they self-correct. Too much of a good or service, and the price falls until enough buyers buy or the producers stop making it. Too little of a good or service, and the price rises, reducing demand and increasing the profitability of production, thereby increasing supply. It is brilliantly simple. Yet capital markets have been anything but simple in the last 20 to 30 years. With the explosion in derivatives, stock options, securitized loans, credit swaps, and other forms of financial novelty, pricing signals are often one if not several steps removed from the underlying fundamental marketplace elements that they are supposed to relate to. In this loss of simplicity, in favor of complexity and subtlety, there has been a decided degradation in the quality of pricing signals. When pricing signals are indeed poor or deeply misstated, what is "desired" by the marketplace in terms of business capital allocation, corporate governance, and the like becomes distorted from what real world realities would dictate. Instead, the imagination and in many cases the fictional beliefs of the capital markets can run amok, with a comparatively limited ability of the market's normal self-correcting character to express itself properly, or in time, to avoid devastatingly mistaken outcomes.

This loss of pricing efficiency and pricing signal quality is plainly visible in the housing market and in the mortgages that attach to them. Not all that long ago, if an individual wanted to buy a home, there were but two possible funding options: 20% down in cash, and either a 15-year straight mortgage, or a 30-year straight mortgage. No option ARMs, no Interest-only's, no negative amortization options existed, nor did complex CDOs or structured packages of interest-only and principal-only strips for banks to hold. In that simple old-school payment structure, mortgages did a great job of enforcing personal savings rates (to make the down payment, one had to be thrifty for years in advance), high equity to loan value ratios (because home equity started high and went higher with each payment), rational home prices and supply (because getting to a 20% down payment wasn't easy for many people), and low default risk. And they were easy for banks to value on their books, too. But introduce all these funky payment mechanisms, and the relationships between home supply, home prices, mortgage payment capacity, borrower risk, loan quality, and so forth become contorted. Were too many people enticed to buy homes because it was too easy to do? Absolutely, and yet home prices kept rising because rather than it becoming prohibitively difficult to make the down payment, "creative" financing allowed buyers to circumvent this particular inconvenience to living the big life. As this efficient pricing model became wildly distorted, our banking system has very neatly wrecked itself.

A similarly convoluted twisting of market-based pricing signals has occurred in equity markets, but the gestation has been very long in the making. A long time ago, in the 1950s and earlier, common stock was viewed a good deal differently than today. Back then, common stock was just one of several classes of corporate capital, alongside bonds and various forms of preferred stock, which underpinned business capital structures. Common stock and preferred stock were owned because they paid cash dividends. Shareholders expected a yield, and the notion of owning a stock that did not pay out a decent component of earnings as dividends was seen as being quite odd. Common stock had one unique feature however – the dividend could be varied. It could grow as dividend payout capacity grew and also could be reduced or scuttled in difficult times. In exchange for this optionality, investors got a vote. That was the simple bargain. Regarded in such a fashion, the business of valuing stocks was pretty easy. A

5% dividend yield was good, while a 6% yield was better. A 5% yielding stock with some obvious capacity to grow the yield because of a high coverage ratio of earnings and good business prospects might be more attractive yet.

The simple promise of a regular stock dividend and return of capital to shareholders kept market pricing rather efficient. Companies with excess cash flow could afford large dividends. Companies without excess cash flow could not and had to keep their ambitions in check. Capital efficiency was assured by the ongoing capital cost associated with the yield. Companies that raised their dividend raised their stock prices, but at an obvious cash cost that could only be incurred if management was pretty certain of itself. Dividend cuts could not be taken lightly. As for the cyclicality of the business cycle and specific industries, near-term earnings trends were not so critical provided the dividend remained well covered. Given the sanctity of the dividend, longer-term business planning horizons were critical. Like the humble fixed-payment mortgage, a market-insistence of a straightforward dividend policy insured a remarkable degree of overall discipline.

Starting in the 1960s, the investing world began to change. A more diverse range of business characteristics other than yield took precedence. Subsequently, the dividend yield of stocks fell below corresponding corporate bond yields because of the promise of growth. The inflation of the 1970s devalued the worth of a consistent dividend stream. The tax policies of the 1980s and onwards treated dividends punitively relative to capital gains, which created no tax liability until they were realized. Capital appreciation began to be valued over and above yield. In fact, capital appreciation could arguably occur faster by not paying out any dividends at all! Businesses could leverage up with no explicit equity cost of capital or buy back a lot of stock and shrink their share counts. M&A-based growth strategies could be pursued. Corporations with inflated stock valuations could use their own stock as currency to buy other businesses. Armed with an expensive currency, corporations could manufacture an inflated growth rate, and provided they did not pay a material dividend, such growth occurred often at little identifiable cost to corporate coffers. With no dividends to pay, companies could offer outrageous quantities of stock options to employees and officers, with no tangible cost either.

Importantly, the basis for capital appreciation in stocks to this day does have something to do with real business growth and profits, but it's a loose association at best. When capital appreciation rather than yield becomes the market's primary focus, the result is more akin to a beauty contest; yet in this contest investors are asked to identify not the most beautiful contestant but rather the one that will be judged the most beautiful by all the other judges, who themselves are engaged in the same exercise. As a result, a number of transitory standards of beauty emerge that are not altogether in sync with the normally self-correcting discipline of markets. In the early 1990s, price earnings to growth rate (or PEG ratios) were held in very high esteem, and one spent a lot of time identifying anomalies in PEG ratios. As PEG ratio analysis descended in importance and non-sensical outcomes, the "beating" of Wall Street analyst estimates became in vogue. But this was rather easy stuff for the average corporate CFO to engineer, so by the late 1990s the key metric to focus on was the beating of "whisper" numbers that somehow were less mutable. Once the tech bubble popped, whisper numbers gave way to margin and operating leverage-related trends, with stocks reacting more strongly to basis-point variances in reported gross margin trends than to absolute earnings levels. As private equity and easy lending boomed in the mid-2000s, "optimal" capital structure and theoretical private market value (basically a measure of how much covenant-light debt can be piled on to available cash flows) rose to favor. Well, that's out now. More recently, capital appreciation has been driven by trends in analysts' estimate revisions, such that individual stocks rise and fall based on Wall Street analysts marking up or down their (evidently inaccurate) forward profit estimates. Managers are apparently supposed to anticipate these revisions and manage around them. I suppose trends based on "whisper" estimate revisions are next.

Don't hate the player, hate the game - The foolishness of these ever-changing standards would be comical were it not so tragic. Investment managers have little choice but to heed prevailing capital market definitions of beauty, at least to some extent -or risk losing the annual performance sweepstakes that managers are vetted against and risk a declining client base. It's a poor bargain at best. It is my personal view, but these ever-mutating criteria of capital appreciation have a great deal to do with the astonishingly erratic pricing of stocks, culminating in their rise and collapse in the 1990s, and the more extreme version that has taken place this decade. Alongside this volatility has been an unambiguously poor allocation of capital by the markets. Without a doubt, a ton of money has been poured

into debatable businesses and business management strategies at inflated valuations because they were trendy at the moment.

Many of the more humdrum dividend payers have held up to some extent in the debacle of the last two years, but these companies represent a small and generally stodgier subset of the marketplace. A strong portfolio management commitment to owning such businesses exclusively would have entailed an inordinate concentration in banks and other financial companies in the last two years which would have generated catastrophic results. Business schools still teach the dividend discount model of stock valuation, but along with the slide-rule, it is snickered at as more of a historical curiosity than something to be taken seriously.

We are taking the above line of reasoning seriously, at least to the extent that we can. While historic valuation trends and relationships are still relevant, we have increased our bias towards investments that possess higher sustainable payout capacities. For companies with strong excess cash flow generation and no dividend policy, we are urging their managements to get more serious about paying one. Some companies are responding, or at least making the right noises about it, though the prevailing capital appreciation-oriented religion is difficult to cut through. Admittedly, to confine oneself to high-yielding stocks exclusively would be more than a bit limiting right now, as one would cut off a dangerously large set of market opportunities. I recognize that a wistful longing for the days when stocks were valued according to their yield and yield-growth capacity may be akin to a yearning for the days of the set shot in basketball and leather football helmets. The game has just moved on, the world is different, and some companies are better off hoarding capital to develop their businesses. But we do see this simple yet efficient form of shareholder return as probably increasing in popularity again, just as the simple fixed-rate mortgage may regain much of its unfairly lost popularity. Certainly, the financial “creativity” unleashed in recent years deserves more than just a bit of derision and contempt. Perhaps when stocks (on balance) return to the form of which they were once conceived, then the markets may get back to improving economic outcomes rather than distorting them.

Thank you for your continued confidence in us.

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