



CAMBIAR INVESTORS: MID YEAR INVESTMENT COMMENTARY

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Introduction

During the second quarter, equities globally continued an advance that began off what may prove to have been an epic market bottom broached in early March. The S&P 500 advanced 16% in the quarter; other indices around the world generally fared a good deal better, as anecdotal evidence mounted in many sectors and geographies that the horrific pace of economic contraction of the preceding six months was abating, if not turning around altogether. There was a high degree of autocorrelation of returns among risk-asset classes. Large cap value and growth equity indices in the U.S. performed almost identically in the second quarter (16%+ for each), while smaller cap and high yield indices increased more (20%+ each). By early June, the S&P 500 Index had rallied over 40% off the low tick of 666 reached on March 6th to about 950, which symmetrically equated to a 40% loss from the all-time high reached in October 2007. At that point, the rally cooled off and markets have shown no particular direction since, leaving the S&P 500 up approximately 3% at the mid-year mark.

Outside the U.S. – particularly in commodity-centric countries such as Russia, Brazil, Australia, and Canada – equity markets rallied sharply, as several primary industrial commodities such as oil, copper, and iron ore experienced rapid price recoveries from their lows reached in late 2008. The growth story in China and India remains very strong, and both of these countries already appear to have “turned the corner” toward economic recovery, resulting in almost implausible year-to-date gains of 62% and 50%, respectively. The venerable Dow Jones Industrial Average was, in fact, the worst performing major index in the world for the first half of 2009, in part because of its odd price-weighted formulation, as well as heavy representation by rather troubled U.S. business sectors (such as financials, autos, and other credit-sensitive industrials). The Dow registered a -5% first-half return.

The liquidity issues and structure of capital markets have improved markedly since the end of 2008 and continued to improve in the second quarter. Much of the recent improvement in stock prices is the consequence of a significant decrease in implied risk premiums – essentially, the long-term outlook is what it is and though stock prices reflect a difficult economy, they also reflect the perception of risk and relevant financial conditions. For the better part of 2007-2008 and into early 2009, a constructive view of financial markets or of the economy was hopelessly unrealistic, owing to the severe asset quality and liquidity problems resident in the banking sector and within the core of the global capital markets’ system.

These issues devastated the pricing mechanism for risk assets (stocks, non-government bonds, commodities, etc.) as market functions wholly broke down during this period. There can be no doubt that the capital markets’ conditions which inflated risk premiums in the prior two years have improved in 2009. We have detailed these considerations in prior letters. The four critical factors that point to such health are: 1) a positively sloped yield curve, 2) active corporate credit issuance with reasonable yield spreads, 3) greater stock market breadth, and 4) a clear reduction in the probability of a system-busting failure, as can be ascertained by the very low (25 basis points) interbank funding rate. With these improvements in the financial ecology in place, a strong case can be made to incrementally increase exposure to risk assets, rather than shy away from them. Realistically, further progress may be more difficult until global and U.S. economic growth becomes decidedly positive and not negative. This next step in the healing process appears likely to emerge in the second half of 2009.

Our in-house economic call is that the recession of 2007-2009 is more like a “Dececession”, a noxious mixture of Depressionary and conventional recessionary forces. There is no question it will rank as the most severe postwar recession in terms of duration, job losses, wealth destruction, and the rate of nominal GDP contraction. Similar to a conventional recession, the parts of the economy that were overdone in the 2000s and needed repressing (housing, financial services, and some of the more indulgent forms of consumerism) were contracting significantly by early 2008, while other parts of the economy more remote from these excesses slowed but did not contract. Statistically, the first part of 2008 was not altogether different from the recessions of 1990 or 2001. Unfortunately, the global financial system was far more highly leveraged than in prior recessions and entered the downturn unreasonably overconfident in various models of risk control and containment. These models ultimately proved to be poorly constructed, as critically they could not withstand the abrupt failure of key counterparties. An orderly unwinding of leverage was essential to end the recession, a process whose necessity somehow failed to be recognized by policy makers. Hence, when Lehman Brothers went into an uncontrolled failure in September 2008, the modern-day equivalent of the Depressionary demons from the 1930s suddenly leapt from the box in the attic where they had laid dormant for nearly 3 generations. The Great Depression stemmed from a series of uncontrolled and cascading financial failures that laid waste to our economic and financial systems for nearly 40 months without abatement. We unfortunately endured a six-month dose of those same forces. Thankfully, we do appear to have learned at least a little from history, and

those 1930s demons may have been put to rest through a series of extraordinary government and central bank actions. For these policy actions we can be appreciative, but must simultaneously recognize the immense expense that will have to be reckoned with down the road.

The Medium-Term View

If we look at the events of the last 12 months through this lens, a few non-consensus conclusions emerge about the shape of the next 12 months:

First, there may be a larger than expected statistical recovery in the economy and in financial markets than one might expect, simply because the drawdown in business activity and financial conditions from September 2008 through March 2009 was so extreme. The scope for a “big bounce” in procurement-type orders is substantial given a nearly 15% contraction in the non-public sector/non-personal necessities components of the economy. The big bounce might run out of gas sometime in 2010 or 2011 - then many of the unavoidable realities of the post-credit bubble economy such as chronic overcapacity and disquietingly high unemployment levels may assert themselves more prominently.

Second, while it has become popular to discuss a “new normal,” consisting of lower equity returns because of lower structural economic growth in the U.S., it is also true that as a consequence of the Depressionary forces that exploded onto the scene in September 2008, the risk premiums assigned to stocks similarly blew out to Depression-like levels. Current equity prices embed generationally high-equity risk premiums (we calculate such premiums at 4-5%, vs. longer-term averages of 2-3% and negligible risk premiums for most of the last 20 years). There is ample scope for higher-risk assets such as stocks to outperform low-risk assets such as government bonds, given their current pricing. As for the structural challenges facing the U.S. economy, a lower-growth environment seems unavoidable. But, remember that an increasing number of both large and small capitalization U.S. domiciled companies have substantial non-North American sources of revenue and profit, such that an analysis focused solely on the U.S. economy is inherently an incomplete analysis. Ultimately, the most important determinant to equity performance is the entry valuation one pays; GDP growth and unemployment trends help or hinder performance at the margin.

Third, we see risk-spread compression as in fact being part of “the plan.” By taking the Fed Funds rate to 0% and purchasing large quantities of Treasury bonds and high quality mortgage-backed bonds, the U.S. Federal Reserve is overtly engaged in a financial squeeze play. The Fed will squeeze the returns out of non-risk assets, to the point where most pensions and investors are forced to take active portfolio risks or else violate actuarial return assumptions. Improved asset pricing, whether it be houses, stocks, or business assets, is an essential ingredient to a durable economic recovery. Individual investors are not bound by such actuarial constraints and may elect to keep inordinate sums of money in checking accounts or under mattresses

owing to the (understandable) fear generated by the events of the last 24 months. Yet just as common stocks’ extraordinary run from 1982 to 1999 enticed many individuals to disregard risk and the importance of valuation and quality corporate governance, we sense the opposite sentiment today. Namely, the outperformance of bonds and cash, in tandem with the desultory performance of equities in the 2000s, has created an inflated reverence for the security of cash and risk aversion that is similarly unhealthy. At some point, the inflated risk-asset premiums and the deficient yields on low-risk assets are bound to converge; until then, equity returns may surprise on the upside. This is in all probability apt to be a multi-year phenomenon.

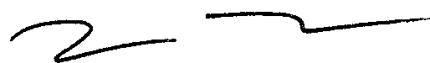
Last, the role of government will continue to be hard to account for fully. Leadership is critical in times of stress and does influence ultimate outcomes. Our leadership has been doggedly hard to handicap and has, on balance, been reactive rather than proactive. Things have needed to get really bad before appropriate measures have been undertaken. For example, the most baffling factor in my mind behind the collapse in 2008 was the U.S. government and monetary authorities’ collective failure to get ahead of the curve in contending with liquidity and capital problems among major financial sector participants in the event that things just mushroomed, which is exactly what happened. The Bush administration was politically weak in 2008 - even by conventional lame duck standards - complicating matters gravely. It took the legitimate threat of a bona fide modern Depression to focus the mind. In 2009, the most baffling factor so far for the Obama administration is the lack of cohesion in fostering a pro-employment/greater business confidence mind-set. Consumers don’t spend and businesses don’t hire unless they are reasonably confident about the future and the rules under which they are asked to play. While there is ample scope for any number of structural reforms that might sensibly be pursued by the Obama administration, the current top legislative proposals (global warming and universal healthcare access) appear very costly and invasive, at a time when consumer and business confidence are at the lowest levels since records have been kept. These priorities may be a consequence of the commanding political majorities Obama enjoys for the moment. Whatever the reader’s political persuasion, it is seldom possible to succeed with such an agenda in the face of profound economic hardship. The current recession/decession is highly structural - many large centers of employment were beneficiaries of expansive sources of credit and, with these credit spigots turned down more or less permanently, a great many Americans need to find something new to do. These challenges necessitate an increased focus on fostering entrepreneurialism and business confidence. My personal forecast is that as unemployment soon breaches the 10% level (and it is a coin flip in my mind whether the postwar high of 10.8% will be exceeded in 2010), our President will of necessity reconsider various priorities and the associated rhetorical flourish.

Apart from the strange stage that is American politics, this movie has been seen before. It is often the case that when a financial earthquake erupts of the magnitude that was

witnessed in the last 12 months, markets overshoot badly on the downside and eventually recoup about half of their losses in 12 to 24 months before the bleak long-term reality bogs down further recovery. I have seen this pattern repeatedly as an investment professional following international markets over the last 20 years. The overshoot is a consequence of a poor fundamental backdrop and quickly rising risk premiums. Whether the U.S. market can regain so much lost capitalization remains to be seen (the S&P 500 would need to get back to a level of about 1,120 for a 50% retracement of its losses, or an additional 22% gain from June 30 levels). This would return the value of the U.S. stock market to late September 2008 levels; things were not exactly peachy then. Skepticism abounds, and I am unsure myself because the credit problems run so deep, but that is the typical pattern. The recovery process normally has two distinct phases. We just passed through phase 1, the sharp decrease in risk premiums from horrific levels, which were pricing in a modern Depression and briefly contemplated en masse bank nationalizations. We are entering phase 2, a more fundamentally driven recovery in risk-asset prices caused by economic improvement that few would have believed could materialize in 2009 when the calendar turned.

At the beginning of 2009, we forecast little net stock market change with high volatility - which proved to be an excellent forecast for the first half of the year. Essentially, I thought phase 1 would consume the whole year. But a lot of things have gone much better than one could have hoped for in January. Interbank credit markets have compressed to pre-crisis levels, a number of banks succeeded in raising substantial amounts of capital, and Asia has outright turned the corner. The bankruptcy of Chrysler and General Motors did not crash the system; the ripples were barely noticeable outside the more affected geographies (give team Obama some credit for that - no comment on the costs). With the recession/decession likely to end in the third quarter, with various statistical recoveries likely to be sharp, and with multiples still very low, it would be surprising not to see some advance in the U.S. market by year's end and into 2010. And it would fit the pattern perfectly. So, outside of political developments that are just tough to imagine actually becoming U.S. policy, our forecast is for stocks to make further advances as evidence of a big bounce mounts and as risk premiums moderate a bit more. As we move further into recovery in 2010, the structural headwinds that an over-leveraged economy must carry will likely weigh back in on matters. For now we are fairly constructive on the medium-term (next 9-12 months) potential for stocks. At the very least, short-sellers will find life difficult.

Thank you for your continued confidence in us.



Brian M. Barish

President

Cambiar Investors LLC

Appendix - Further Ruminations on the Efficacy of Capital Markets

We have received a great deal of reaction and commentary about our first quarter letter which offered an open critique of modern stock-pricing trends and generally accepted wisdoms that have proven fallible. Clearly, we hit a nerve. Anyone with even a modest affiliation or interest in capital markets can see that something has gone very profoundly wrong with the whole enterprise - not just in recent years, but over an extensive timeframe. Intellectually balanced answers have not been easy to come by in the politically and emotionally charged atmosphere that has prevailed amid the devastating losses.

The following is a more technical expansion of that discussion. It describes enhancements to our investment process that we believe will markedly improve the accuracy of our valuation conclusions.

To summarize our critique first - It is hard to dispute that stock market prices have not only proven to be weak indicators of future company-specific performance, but that the pricing mechanisms for a wide variety of capital markets' instruments (not just stocks) have in many glaring cases generated such uniquely poor pricing signals as to damage our economy and prosperity broadly. This contrasts greatly with academic arguments praising the efficiency of market-pricing mechanisms, and is utterly counterintuitive given the vast array of intellectualism, technology, and financial creativity that has been lavished onto capital markets since the 1980s. But perhaps that is the root of the problem. Our contention is that stock pricing and associated paradigms of value increasingly lost touch with the role that they were originally conceived to serve, as this creativity was pressed into financial market mechanics.

Common stocks' original premise was very simple: to provide a long-term dividend stream. That is what investors owned them for in days of yore. The basic promise of a regular stock dividend and return of capital to shareholders kept market pricing rather efficient by imposing a number of generally positive disciplines and limitations on corporate behavior and strategy. But as stocks began to be venerated for their capital appreciation potential in lieu of their capacity to fund a stable or growing dividend stream, they became untethered in varying degrees from the self-correcting discipline and feedback loop of real-world business markets that an ongoing cash dividend requirement tended to impose. Any number of unfortunate consequences have resulted.

We have historically relied upon a "Relative Value" investment philosophy to identify investment targets and parse through the many variances in business characteristics. This approach entails appraising individual companies' historic valuation ranges and/or peer group valuations on traditional accounting measures (P/E, P/B, Yield, P/Sales, etc.) and using this appraisal to project future valuation ranges. A relative value philosophy places a good deal of faith in historic market valuations as a sensible point of reference

that, more likely than not, will continue to hold sway, assuming business trends and catalysts come together constructively with some analyst-led feel for what may or may not be reasonable valuations in a current market context. Put more compactly, we make forward multiple projections based on prior patterns, combined with extensive analysis of business and industry fundamentals. When it works, it can be remarkably effective in identifying buy and sell points and even today, there are many current portfolio holdings and stocks we are eyeballing where this approach appears entirely sensible. But – what if you have begun to question the market’s ability to get the basics right? How much reliance on forward multiple projections and peer group analysis can one be secure in?

A few years ago (in late 2006, to be precise), I began to harbor nagging questions about this issue. If one considers the intellectual foundation of relative value - that historic valuation patterns ought to correspond to returns on assets, growth rates and so forth - forward multiple projection implicitly contemplates many simultaneous *ceteris paribus* (all things held equal) conditions. While projecting forward multiples based on historic valuation patterns certainly isn’t crazy, can we safely assume that we can effectively hold neutral 20-30 different relevant business analytical considerations over multiple business cycles? It is reasonable to conclude that some of these factors trend towards certain normalized levels and/or may be self-cancelling (some improve while others deteriorate). But, if indeed the current mega-recession is “structural” as it relates to a large swathe of global industries, if the model for the allocation and pricing of credit may be permanently altered, and if we can expect a reversal of the path of deregulation in Western economies, then using valuation patterns and ranges from the 1985-2006 time period to project future valuation ranges does seem intellectually challenged for a number of industries and subsectors.

Our solution is to run our traditional relative value-based conclusions related to individual stock analysis through an additional dividend-colored lens. What does such a lens look like exactly? A return to a 1950s-type world of simple dividend payers and reciprocal stock valuation may be a hopelessly nostalgic and unrealistic basis for portfolio construction today. To make this exercise work, we need a uniform valuation tool that places companies with variable growth rates, capital intensity levels, and payout percentages on the same scale. Variances in the financial landscape don’t make this analysis easy. Obviously, many companies today do not pay a material component of their earnings out as dividends. And those that do are often older-line businesses such as regulated utilities, integrated oil companies, food companies, and (up until recent events made dividend payments impossible) banks and other financials. What these companies all have in common besides longevity is that they do not grow very quickly based on the number of units of “stuff” that they sell per annum - whether that is refined barrels of oil, kilowatts of electricity, boxes of cereal, or insurance policies. Out of a combination of tradition and necessity to keep investors interested, they generally pay out material dividends. It is not uncommon to look at the valuation of these more mature businesses in terms of the net present value of the dividend stream alone, with any growth potential added as some kind of bonus.

Companies that grow more rapidly in terms of unit sales may distribute no dividend (or a token dividend) because most of their operating cash flows are needed to grow their facilities. Internal capital requirements for rapid business growth should be the primary reason for a low or non-existent payout. But in a marketplace biased to favor capital appreciation over stable dividend payments, this is not the only reason for minimal payouts. Companies in industries such as healthcare and information technology that came of age in the late 1980s or 1990s pay out few dividends because there is no tradition or apparent demand that they do so, even though they tend to generate prodigious excess cash flows. A number of other quasi-service sector businesses also seem allergic to the concept of a payout. Even among the businesses that normally pay dividends, there are large variances in the percentages that actually get paid out, with such businesses in many cases eschewing dividends to focus on stock buybacks or M&A as drivers of value. Not surprisingly, total shareholder returns in these areas are highly inconsistent over longer stretches of time.

Our solution borrows heavily from the analysis of subscription-based media businesses, which admittedly was not the first place that we started, but it works best on a cross-industry basis. It has been standard practice for analysts following subscription-based media to value their earnings and cash flows not on the basis of reported figures, but rather on the basis of a theoretical “steady-state” analysis. This is because each customer that a cable television business adds for example, incurs substantial up-front costs such as a truck roll for the install, the cable set top box itself, and various customer service issues. As a result, the cable company may lose money for the first 6-12 months on each new customer, only to make up for that in future years. If said cable company grows particularly quickly, this dynamic can weigh heavily on reported GAAP earnings and cash flows, to the point where these reported bottom-line figures may generate entirely unusable financial conclusions. As such, cable and other subscription-type media businesses typically break out their subscriber acquisition costs per quarter. These can be excised from financial statements to determine what profits and cash flows would have been had there been no net subscriber growth. This residual calculation is known as “steady-state cash flow” (SSCF), which as the name suggests determines how much cash flow would be generated if the underlying business were neither growing nor contracting in terms of customers. Admittedly, SSCF is an abstraction and is not entirely separable from actual financial results. But it does show what the business would look like if it were to turn into a low-growth, utility-like cash flow stream, or alternatively if it looked and operated like the above-mentioned mature companies in terms of unit growth that would be traditional dividend payers. It consequently works well as a universal yardstick.

To augment and cross-check our relative value-based conclusions for a structurally evolving financial landscape, we now layer on a SSCF-type analysis to all of our current and prospective individual stocks, not just subscription-based media companies, and irrespective of a company’s growth rate or dividend policy. The SSCF is approximately equal to the company’s payable dividend capacity if it were to maximize its payout, with some component of this cash flow likely nonetheless to be held

back to fund various business expansion. So as not to penalize companies that are growing or undertaking sizable cash-consuming projects, it is necessary to project dividend capacity out over the next three to five years and not focus excessively on near-term prospects. The end result is the “Dividend Capacity Model” or DCM for short. The model’s dividend capacity projection is expressed as a yield for consistent comparability across a range of stocks; the higher the implied yield of course, the more attractive the stock as judged by this methodology.

Some notable points regarding the DCM:

- The model places emphasis on determining not just earnings per share, but cash from operations and capital expenditures needed both to sustain the business in a steady-state (maintenance capex) and deployed to grow assets and thereby revenue (growth capex).
- The model does not work as intended if we are overly conservative or naively optimistic, and therefore great care is taken to derive a “mid-cycle” set of margin and related ROIC/ROE figures that can be applied to our out-year projections. Additional adjustments are made to the model to account for relevant positive or negative company/industry characteristics (i.e., balance sheet composition, corporate governance, etc.).
- In select out-years, we then break out an operating cash flow estimate that excludes growth capex from the net calculation thereby isolating the implied steady-state cash flow (SSCF) that could be generated if the company opted to cease growth at that time – i.e., as if the company turned into a utility.
- We then assume that a percentage of the SSCF can be distributed as a common stock dividend on a going-forward basis (the Dividend Capacity), notwithstanding the company’s current policy or payout level. The distributable percentage of SSCF is a somewhat subjective figure and may be influenced by factors such as the volatility of the earnings, the variability of capital requirements, the degree of competition, etc.
- The Dividend Capacity expressed as an out-year yield should exceed a hurdle rate of at least 10%. The DCM also serves as an effective price- target mechanism for trimming and exiting positions as the DCM yield declines to 4-5% which we would view as full/fair value.

The value of the DCM will inevitably vary by industry, with exceptionally cyclical or capital-intensive businesses with highly indeterminate payout capacities more difficult to model with a substantive degree of accuracy. In addition, companies that have shown little propensity to pay dividends or that cling to more of a 1990s style of capital management (heavy on stock buybacks, M&A, and aggressive stock option issuance) may need to be withheld from client portfolios altogether in spite of demonstrable dividend capacity, because free cash flow under any set of adjustments is unlikely to accrete to minority shareholders without an unforeseen change in corporate behavior.

Cambiar has historically, and will continue, to seek companies with the potential for a 50%+ total return hurdle over a forward 18-month time horizon to clear new investment ideas. The DCM does not compromise this return hurdle nor does it substitute for the bottom-up fundamental research that has underpinned our performance for decades. Stocks purchased and sold as additionally guided by internally-designated DCM yields should generate a similar internal rate of return – as we have back tested we have found that the DCM largely corroborates GAAP multiple ranges in a majority of cases. There are situations where, because of particularly low or high ongoing capital retention requirements, historic multiple ranges and the valuation potential that our DCM model produces do not concur; in such instances we have to apply some thought and common sense.

The DCM is simply an additional valuation tool; it requires reliable forward forecasts to work properly. It is not a quantitative screening or trading formula. However, the DCM addresses head-on the intellectual challenges that we see embedded in a traditional relative value-based multiple projection approach to stock valuation: namely the comparability of historic financial conditions and the general quality of market pricing signals in a forward financial world that may prove structurally quite different from that we have seen in recent years. Like the SSCF approach to media stocks, the DCM makes intuitive sense, but it is an abstraction and is not to be relied upon exclusively. Owing to the severe valuation compression in stocks globally, we are not having a difficult time finding candidates that meet both traditional relative-value upside potential or that appear attractive on a DCM approach.

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