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Investment Newsletter – February 2005

The Berkeley Investment Advisors' Special Situations Portfolio

In my January 2005 newsletter, "Introducing Separately Managed Accounts: Investing in Securities", I explained in general terms the strategies I've used to consistently beat the market over the last 6 years. I briefly introduced clients to four risk tailored portfolios. Now I will fill in the details about construction of one of the four risk profile portfolios. Then I will provide further background on the two trading strategies used for this portfolio, including example trades that contributed to my performance record.

The Special Situations portfolio is meant for clients with a long term investing horizon who are willing to take market level[1] risk in pursuit of market beating returns. The objective is to exceed returns on the S&P 500 index by at least 4% per year. This portfolio will invest in individual stocks and REITs based on the **Market Over-Reaction Contrarian Investing** strategy and the **Opportunistic Liquidity Provision** strategy. (The January 2005 newsletter has detailed strategy descriptions). Both of these strategies involve buying stocks as they are declining (counter to downward momentum). This portfolio will probably take losses over short periods when entering a position. As I will describe in more detail below, it is only appropriate for clients who believe in the strategies and know they will have the patience and discipline to stay in the portfolio until time proves the strategies correct.

In the Opportunistic Liquidity Provision strategy we are buying on a drop in a stock price where there is no news that would explain the drop. This is symptomatic of liquidity driven trading and if we provide that liquidity we are betting that eventually the buyers will show up and bid the price back up to our estimate of intrinsic value. This could take some time and we need patience to wait for our payoff. In the meantime, we are exposed to further technical selling as well as the possibility of market moving news. Of course the news could be in

[1] Meaning 12 month returns on this portfolio will fluctuate as much as a broad based index fund.

our favor and result in a big payday as investors pile into a relatively thinly traded stock.

In the Over-Reaction strategy we are analyzing the news that moved the stock and concluding that the market price reflects much worse results than the actual news that came out. There are two risks here. One is that more bad news is coming that confirms the worst case and the market value is correct. If this happens we won't make excess returns. The other risk is in the timing of the low and the turnaround. The timing of each depends on both subsequent news and market psychology – both of which are very hard to predict using fundamental analysis. As a result, the portfolio may get into a stock early and it will continue to fall. If this happens without any new news, and our analysis of the stock's intrinsic value is correct, then we will actually want to buy more shares because this will boost our returns going forward when the stock recovers. Such recovery may take quite a long time and therefore the key to this strategy is patience and discipline. If you do not believe in the strategy, you will be tempted to sell at the worst possible time. Thus I recommend against clients allocating money to this portfolio unless they are sure they can hold the position for at least a year.

My Investment Education – Theory and Practice

In the MBA program at Berkeley, the finance curriculum included a heavy dose of Efficient Markets Theory which basically says that investors cannot beat the market consistently. Based on this, and my lack of time to research stocks, I invested in mutual funds with an emphasis on index funds. When I started working on Wall Street and focusing on what actually happened in the market day-to-day, I realized that the Efficient Markets Theory was not true. I saw the short-term herd mentality of professional money managers, and the lack of in-depth analysis, as opportunities to make easy money and I took advantage of them. (Only my lack of big money to work with prevented me from making a living this way).

A word of caution. My trading history may not be viewed as a guarantee that my future trading will produce similar results.

Example Trades to Illustrate Trading Strategies and Results

My story starts with the Russian domestic debt default in late 1998. The turmoil that hit emerging markets trading in 1997-98 was referred to as contagion. Trouble in one market led to trouble in others. The reason for this is complicated but I will boil it down to two factors: 1) the trader herd mentality, and 2) collateral calls on hedge funds that use a lot of borrowed money to trade across all the markets. Both of these factors impacted trading in the shares of Cemex. This company, one of the 3 largest cement companies in the world, is based in Mexico but has operations all over the world – including Europe and the U.S. This company has very strong Harvard educated management that has built a world class company by buying underperforming assets and turning them around with the Cemex system. While this company also fits my Long Term Value strategy, I will use it to illustrate the Over-Reaction Contrarian and Opportunistic Liquidity strategies.

After the Russian default in August 1998, traders reasoned that there would be a general sell-off of emerging market shares because the bad news coming from some markets would taint investor views of all emerging market securities. They also correctly concluded that emerging market hedge funds would need to sell off positions of even the best emerging market companies to raise money to meet margin calls on other depressed and less liquid positions.

Even though Cemex (NYSE: CX) is one of the biggest emerging market stocks, its liquidity (the number of shares that can normally trade without affecting the price) is relatively low. The result was a huge fall in the stock price with no fundamental change in the economics of the underlying business. This stock dropped to a value ($12.50) equal to just 4 times its earnings per share. I concluded that I would earn big returns for providing "liquidity" in the face of the short term selling pressure. Within 7 months of buying, the shares returned to a more normal valuation – up 86%.

After the stock made its post crisis move back up to its true value, it traded in a relatively wide range $20-$26**.** As I mentioned earlier, this stock is worth holding under the Long Term Value strategy. Thus the regular price fluctuations caused by liquidity motivated trading presents an opportunity to boost returns using the **Opportunistic Liquidity** strategy. I therefore added to my existing position when Cemex hit $20.25 per share and sold the additional shares when it got to $25. This roundtrip happened twice in a year – each time earning 23% after trading costs. The first roundtrip took just 4 weeks (6/7/00 – 7/5/00); the second took 7 months (10/12/2000 – 5/21/2001). This stock closed at 38.87 on Feb 10, 2005.

Now, we'll turn to an event in the U.S. market. The first trading day after 9/11/2001 the market sold off insurance companies and real estate companies with holdings in downtown Manhattan. The insurance company stocks declined 20% even though most had quantified their potential losses at just 1-2% of their capitalizations. In fact, this event was bullish for insurance companies because the reduction in capital triggered huge increases in insurance prices and therefore profits going forward. If you bought Everest Re (NYSE: RE) insurance (for example) on this drop, as I did, you would have made quick gains. Although I sold for a quick 16% gain just 9 days later, this stock rose

57% in the month following my trade. When I sold this stock I moved the money into ACE (NYSE: ACE) insurance company. I picked up that additional 41% gain (that I had missed by selling Everest Re) by buying ACE insurance at $28.97 in September 2001 and selling at $40.97 in February 2002.

The Real Estate Investment Trust with downtown Manhattan holdings was Brookfield Properties (NYSE: BPO). A quick read of their financial statements showed that a) they were well insured, and b) they had locked in revenues for many years with long term leases. On that first day of trading, 9/17/01, I bought this stock at $17.31 and it actually declined further – hitting a low of $15.98 in November. This stock took much longer to recover. I sold in September 2002 at $20.08 for a gain of 16%. (Since then this stock has continued to rise. If I had held it till the end of 2004 the annualized return on this stock would have been more than 30%).

These trades illustrate how and why the big market players leave easy money on the table when big events happen. The message is that there are big payoffs to clear-headed analysis coupled with a willingness to go against the herd to provide liquidity to the market (i.e. buy when others are selling), and patience. More recent opportunities include the Freddie Mac accounting scandal and the insurance industry scandal.

Conclusion

The Special Situations portfolio offers patient disciplined investors the potential for market beating returns. Since, however, the Special Situations portfolio requires opportunity events in the market; it will tend to be concentrated in a few investments at a time and may occasionally have no positions at all. Consequently investors will generally allocate most of their assets to one or more of the other Risk Tailored Portfolios: Long-Term Value, Long-Term Income, or Parked Money. These portfolios will be explained in more depth in subsequent newsletters or you can request a brochure which covers all the details of investing in our separately managed accounts.

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