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January 2010 Market Commentary

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Choppy start to earnings season

The first few days of 2010 started off impressively with equity markets broadly rallying. However, this past week earnings season started in earnest with results from highly followed companies such as Alcoa ("AA") and JP Morgan ("JPM") demonstrating that market valuations may have gotten ahead of business fundamentals. AA's report demonstrated that demand remains tepid and the miss relative to Street expectations indicates investors may have gotten a bit enthusiastic with regards to the economic recovery. In the case of JPM, investors were expecting news that credit troubles for JPM and the broader banking sector may be improving. Unfortunately, Q4 09 results showed just a mild drop in provisioning levels relative to Q3 09, suggesting the banking sector could still face troubles well into 2010.

Results from AA and JPM demonstrate that there are a number of persistent problems which make the underpinnings of the current equity market shaky. What investors generally observed in 2009 were a number of positive economic surprises, particularly in areas like GDP figures. For example, in Q2 09, reported GDP was -1.0%. As bad an absolute number as this was, the expectation was for -1.5% and as a result, markets continued to rally. In addition, the -1.0% was the Advance GDP figure and by the time the Third GDP figure was released, the Bureau of Economic Analysis ("BEA") found that Q2 09 GDP was actually even better than the Advance report, with growth of -0.7%.

The BEA releases three sets of GDP figures, refining them over time. The Third Report, which is released around the end of the following quarter (so for Q2 2009, the Third Report would be released in September 2009), is the most accurate but the market seems to emphasize the Advance Report, which is released in the first month after the quarter ends, the most. As a result, the least accurate figure can have the largest market impact.

While Q2 09 GDP came in much better than expectations, Q3 09 GDP figures exhibited considerable choppiness. Q3 09 GDP figures initially came in at 3.5%, which was a stunning surprise to many investors and encouraged them to extrapolate a potentially stronger recovery in 2010. The "V-Shapers" would be proven right. Unfortunately, the Second Report of Q3 09 was revised down to 2.8% while the Third (and final) Q3 09 GDP report was revised down even further to just 2.2%. However, as bad as this revision was, a large driver of Q3 09 weakness was due to timing of inventory destocking so Q4 09 GDP could come in at 4% or higher.

However, 2010 could pose a big challenge in keeping this momentum going. A lot of the current GDP performance has been due to changes in inventory liquidation. Early on during the economic crisis, businesses aggressively liquidated inventory. That pace of liquidation should have slowed markedly by Q4 09 and should start to pick up which is why GDP growth in the second half of 2009 is expected to be fairly strong. This is typical of most business recoveries but with a crippled financial sector and hobbled consumer, the pace of recovery after inventory levels are stabilized could be anemic.

Q4 09 could be the high water mark for GDP growth as unemployment continues to rise. While unemployment appears to be holding steady at 10%, investors should note that U-6, which is the broadest definition of unemployment, continues to rise. What this means is that marginally attached workers, who are not represented in the official unemployment figure (U-3), will return as the economy recovers, making it difficult to experience a meaningful drop in unemployment. Persistently high unemployment combined with a leveraged consumer and crippled financial sector makes the prospects for a broad market rally in 2010 more dubious. Nonetheless, there are still opportunities available to investors and managers that can reconcile economic conditions with fundamental, company-specific factors.

Don't Miss the Obvious

The financial media all too often emphasize economic news and its impact on the markets. Even the format and presentation of the shows are designed to create casino-like excitement with the colors and flashing news alerts that encourage viewers to trade themselves silly. While I believe today's markets lend themselves to a higher degree of active trading, there are still attractive long-term opportunities for investors who let their fund managers stretch their legs

(provided they are real active managers and not closet-indexers) and can endure some degree of tracking error in exchange for a higher internal rate of return ("IRR").

Emphasizing tracking error, or deviation from the benchmark, can lead investors and managers into stupid decisions because of fear of falling behind their benchmark. As a result, a stock may have rallied 50% off its historical lows and a fund manager may sell it, following typical advice of "taking some chips off the table" because he/she does not want to risk having the stock roll back a bit and negatively impact his/her results. However, those that did that in recent months missed out on much larger gains as many stocks went up three-fold or more.

Because I run a fairly concentrated portfolio in my hedge fund and managed accounts, I tell my partners that I focus on IRR. This is in part due to the concentrated portfolio as well as my preference to at times emphasize specific companies and sectors. As a result, some companies may offer an astounding bargain but remain undervalued for a period of time while the broader markets rally. I can personally attest that this can be excruciating for a fund manager and often times can lead them to deviate from the best values to stay close to their benchmark. However, if an investor is with a fund manager that can really analyze a company and conduct serious research, then exchanging the mental and emotional hangover of lagging the market in the short-term can lead to superior IRRs.

For example, while the broader market is fair to richly valued on a number of metrics, certain sectors are trading at very cheap levels, particularly on a price to tangible and liquid book value. One can look at the balance sheets of some companies within the refiner and independent power producers, run a liquidation analysis whereby assets are aggressively written down and netted against liabilities, and still have book equity values that are above current share prices. In addition, prices are near historical lows as these sectors did not participate in the 2009 rally.

The obvious bear case is that the economy is struggling and a recovery will be very weak so utilization of energy and power will be very low. That, however, is not really relevant at this point as the prices more than reflect this concern. The stocks in this sector were worth in some cases five times their current value just two years ago. Right now, these sectors are still expecting the worst so even marginal improvements can have outsized impacts on the stock performance.

The challenge, however, is being disciplined and focusing on IRRs rather than tracking error. If a fund manager held a portfolio consisting mainly of power and refinery companies, there's a possibility he/she could lag the markets for 1-2 years. Perhaps the markets increased by 9% for both years one and two while the fund manager was flat. But if in the third year, if the market was up 9%, perhaps the fund manager's concentrated holdings in power and refinery companies were up 100%. In this case, the fund manager's annualized return would be 26%. This is in part why some legendary value investors like Seth Klarman recommend that investors take a three year view on stocks.

Clearly, most managers will have exposure to more than two sectors but the point is that if a stock is currently trading close to its valuation floor while the upper end of its valuation suggests the possibility of a 100+% return, holding the stock for a longer period of time can make sense. The problem is most fund managers won't hold a position for this long for the rightful realization that most investors would pull the plug after 1-2 years of underperformance. What makes it even more challenging is that the securities that present the possibility of large returns are at times the most hated.

This discussion is mainly to present a different way of evaluating some fund managers, particularly those that run active, concentrated portfolios, but also to establish a framework – using IRRs – to evaluate some potential investment opportunities. One specific investment that could be incredibly attractive from this perspective is Citigroup ("C").

C is hated and ridiculed by the financial media and investors alike as illustrated by its languishing stock price. The current banking crisis and economic issues present considerable headline risk and given what occurred in 2008, investors are snake bitten by many well established financial companies which collapsed. This psychological aspect is in part what contributes to C's attractive current price and investors that can endure some volatility for the next year could do extremely well over the next three to five years. The activities by the Federal Reserve and Treasury established C as Too Big to Fail ("TBTF") and while it is the worst of TBTF entities from an operational aspect, the spread between other TBTF entities and C appears unreasonably wide.

C recently repaid $20B in TARP and its timing – during the slow holiday period in December 2009 – led to a weakly priced offering. While this offering diluted existing equity holders, shares are still well under diluted book value of $5. Right now, shares are trading close to tangible book value but as the crisis ebbs, shares should be valued closer to book value. This makes sense because some of C's components of Tier I Equity include items such as deferred tax assets that may be subject to further writedowns. In addition, as JPM's earnings report illustrated, consumer credit is still a problem and C has significant exposure due to its credit card and home equity loan books.

However, these items are widely known and reflected in C’s share price at this point. Another item that is widely known, or should be, is the impact of FAS 166/167. This will require C to bring off-balance sheet items onto its books and may impact Tier I capital by 50-80 basis points. More importantly, when C management elected to repay TARP, management must have felt comfortable about the impact of FAS 167/166 and the overall quality of their assets and potential writedowns whereby C could survive without the government’s equity interest. Under TARP, C also had $250B in assets that were ring-fenced in terms of the impact on C’s capital position so management’s willingness to exit TARP and the corresponding ring-fence agreement shows a level of confidence with respect to C's assets. Credit deterioration is possible but it’s important to note that while investors and financial media are focused on all the potential negatives, current valuation imposes a bit of a floor in C prices. More so, there are a number of positive catalysts that may not be given an appropriate weight.

For example, the current steepness in the yield curve makes it easy for banks to make money and replenish capital. C also has a number of impressive franchises such as Banamex and a basic sum of the parts analysis can support a share price far higher than the current $3.40 per share. Also, with expectations so low with respect to credit quality, even slight improvements in results could propel shares. In addition, C does not currently pay a dividend but as credit conditions improve in 2011, C could reinstate its dividend, further supporting a higher valuation.

Ultimately, it’s difficult to envision C remaining at these levels for an extended period of time. In two years a case for $8-12 per share could easily be realized. If C reaches the midpoint of $8-12 by the end of 2011, investors that buy C here would enjoy a 73% annualized return. The challenge for investors is taking the initial exposure to a stock that is reviled and possibly missing out on short-term rallies in other parts of the market while C lags in the near-term. While the broader markets do not appear to hold tremendous value, there are some attractive and obvious opportunities available to patient and analytical investors who are not dissuaded by fear of the unknown.

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