



January 12, 2010

Quarterly Commentary

4th Quarter 2009

Back in the day (to use the parlance of today's younger set), mom used to occasionally trick us into taking a bath by bringing home a box of bubble bath from the store. The suds would get so thick that we couldn't find the soap bar underneath, and thus probably didn't end up with a real good cleansing.

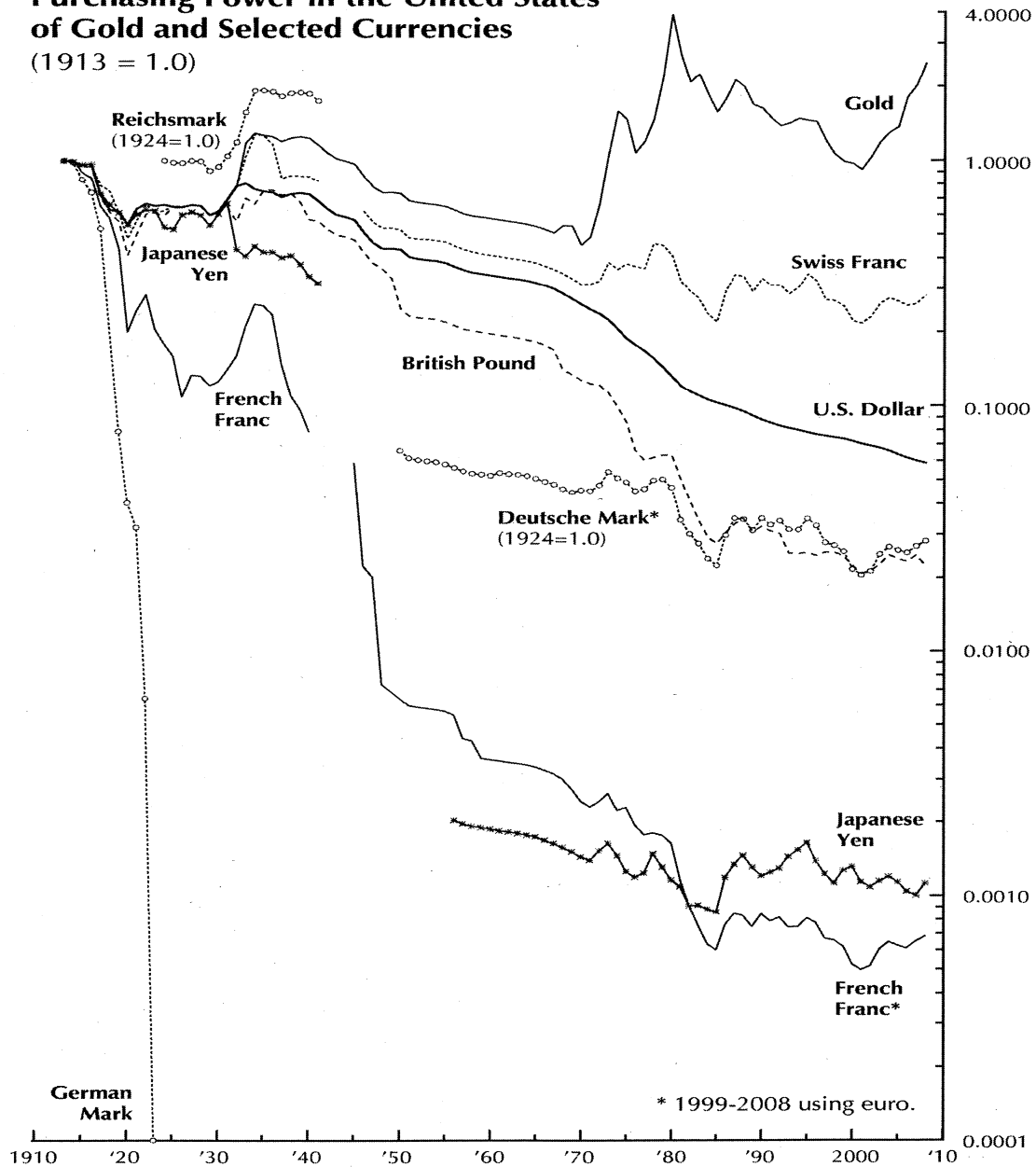
In much the same way, the flood of dollar liquidity into our economy over the last two decades has fostered so many bubbles that it is hard to find the true value of assets. The generally recognized bubbles in technology stocks and real estate (we would also currently add U.S. Treasury bonds) of the last decade have spawned the recognition that asset inflation is occurring and probably is not fully measured in the Consumer Price Index. We read many declarations that this asset class or that asset class is reaching bubble proportions. One of the most public debates currently is whether gold has reached bubble status. A rather personal and heated disagreement on this topic rages between investor, media personality and author, Jim Rogers, and NYU economist Nouriel Roubini, with Rogers in gold's camp and Roubini declaring a bubble.

As we enter the first year of the new decade, our job in security analysis will be even more involved with the discerning of intrinsic value from inflated prices and speculative bubbles. You might think of this as separating the wheat from the chaff. Because the Fed's reaction to every major crisis of the last twenty years, be it real or perceived, has been to create more money, the job of separating the wheat from the chaff has become more difficult.

Historically, the purchasing power of fiat currencies has been debased over time. The chart at the top of the next page is a great representation of how some of the world's major currencies have performed vis-à-vis gold in retaining their purchasing power. Gold is a good asset class when making this comparison because it has had a monetary role of some form for thousands of years and is relatively finite. As you can see, gold has maintained its purchasing power, while the world's currencies have eroded at various rates. This fact is ever present in our minds as we go about our work. For us, having the intuitive head start that assets, particularly tangible assets like gold and others, have the ability to help us maintain our purchasing power, gives us major direction.

We believe that there is some evidence that the public recognizes this, particularly the investing public. We have always felt that the willingness of many growth investors to project into the future about growth rates, profit margins and other fundamentals was,

**Purchasing Power in the United States
of Gold and Selected Currencies**
(1913 = 1.0)



Note: Purchasing power calculated from the implicit price deflator for U.S. GDP and the exchange rates of foreign currencies for U.S. dollars.

Source: American Institute for Economic Research, <http://www.aier.org/>

in many cases, an effort to project future inflation in order to keep up with the purchasing power treadmill. As a reminder, FRM is not a growth style investor, but a fundamental value investor.

One example of investors' willingness to project into the future (and beyond current fundamentals) that we have observed, though not expertly, over the years is farmland. For at least the last thirty years, or ever since the last major inflation of the late 1970's, farmland prices have traded at levels above a price warranted by the underlying fundamentals. In other words, we are not aware of any significant transactions in our area that have taken place in farmland over this period where the buyer could take the prevailing agricultural

results of inflation, and we anticipate that the worse inflation becomes, the more price distortion and bubbles we will experience in all markets.

One specific stock where we readily admit that we have followed a similar tack to farm land investors is **Newmont Mining**. While we do not see gold or gold stocks in a bubble at this time, gold stocks have been and continue to be inflated relative to current fundamentals. There is no doubt a premium built into the price that buyers are willing to pay for future inflation protection, as it is anticipated that gold would follow its historical pattern of increasing in price during inflationary times. One aspect of Newmont that warrants paying a somewhat inflated price is its operating leverage. With the current reserve base and cost structure, we anticipate that earnings per share will increase at a rate that significantly exceeds a given rate of increase in the price of gold.

Let's go back to the question of whether gold is currently in a bubble. This question additionally impacts other commodities, because commodity investors watch the gold price as an indicator of inflation. While the current price of gold might be somewhat inflated, on an inflation adjusted basis (see the chart below), gold is nowhere near the inflation adjusted high reached in January of 1980. Gold reached a high at that time of \$850/ounce, which is \$2,358 on an inflation adjusted basis. A hindsight view of the chart shows that the gold spike at that time was probably a bubble, but it also reflected inflation expectations at that time. We have seen one estimate that says that if the government were using the same inflation measurement methodology in use during the 1980s, the inflation adjusted high reached in 1980 would be over \$7,000/ounce! While we have not verified that number, we do believe it to be much higher than the \$2,358 reflected on this chart.



Source: <http://www.ritholtz.com/blog/2009/10/gold-inflation-adjusted/>
Courtesy of Bianco Research

With the Federal Reserve's announcement on November 4 that it plans to keep the targeted overnight funds rate near zero "for an extended period," one thing is for sure: the cost of

foregone interest income from owning gold is no longer a big factor when compared to the interest to be earned by holding U.S. dollar deposits.

Fannie and Freddie Redux

Our 2004 article “It’s Time to Bust Up Fannie and Freddie” warned of the moral hazard of continued implied backing from the U.S. government. Now that the reality of that has hit home, there seems to be no end in sight. The Treasury Department announced on Christmas Eve that it would back the obligations of both entities beyond the \$400 billion it had set as a maximum. This clearly usurps the authority of Congress in this matter, which had set a maximum of \$200 billion. The true cost won’t be known for years. Maybe it is not too late to bust ‘em up!

2009 Performance Review and 4th Quarter Activity

Our 2009 composite equity performance exceeded the S&P 500 and the Russell 1000 Value by a significant margin. As always, your individual results are contained within your quarterly statement. Our performance was greatly aided by many of the newer stocks in the portfolio that we had averaged down in during the debacle of late 2008 and early 2009. Our training and experience says to add to existing positions when prices are plummeting if fundamentals are unchanged. This is easier to talk about than it is to act on, and that can sure be said for the period referenced above. We stuck to our training discipline and continued buying as prices declined. Our largest positions in energy and pharmaceuticals produced mixed results. Energy was a drag on our overall performance, which was disappointing. Likewise, the large pharmaceutical stocks did very little with the exception of **Sanofi-Aventis**. With many of our largest positions not producing great results, this makes us hopeful for good performance in 2010.

Fixed income performance was mixed. While we were able to capitalize late in '08 and early in '09 on attractive spreads in corporate and municipal bonds, we were limited in our regulated portfolios by quality constraints and reinvestment opportunities. With over half of the investment grade universe of corporate bonds now between BBB+ to BBB-, we are, in many cases, restricted from weighting our portfolios to the same degree. We continue to want to err on the side of conservatism in fixed income with regard to maturities.