

SmartMoney

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ANNUAL
INVESTOR
ROUNDTABLE

Tough Calls for Tough Times

The difficult days might not be over, but our four panelists are finding some buys amid the rubble.

By Dyan Machan and Russell Pearlman

WILL PRESIDENT OBAMA BE GOOD for investors? Steven Romick has his doubts. The manager of the \$1.3 billion First Pacific Advisors Crescent fund fears there will be too much regulation; too much spending on roads, bridges and other giant projects; and, well, too many Democrats. “I’m scared of big government. Period,” says Romick.

Too much government wasn’t the only thing troubling the four money managers who gathered for lunch at New York’s ‘21’ Club for our seventh annual investors roundtable. They also fretted that economic recovery might be many months away, the stock market might be headed even lower, and financial companies, after all their recent woes, still might have further to fall.

Who can blame them for being anxious? Samuel Lieber, whose Alpine funds specialize in real estate and dividend-paying com-

panies, compares 2008’s financial distress to a 100-year flood. “We’ve had the worst economic experience that any of us have gone through,” he says. Things got so bad in the fall that Alpine started buying back shares of its Global Premier Properties and Total Dynamic Dividend closed-end mutual funds—both at steep discounts to their net asset values. Lieber, 51, says the past year has taught him to double-check the advice of nearly everyone, particularly rating agencies and brokerage firms, but even his company’s own analysts at times.

If our panelists didn’t exactly spread holiday cheer, it wasn’t all gloom and doom. Romick, for all his worries, thinks there’s a chance that President Obama will be more centrist than Candidate Obama and sees the appointment of Rahm Emanuel to White House chief of staff as a sign of such pragmatism. Gerald Jordan, a growth-fund manager and the most bullish of the bunch, pointed



Charles de Vault
 PARTNER,
 INTERNATIONAL
 VALUE ADVISERS

to a good omen amid the bad news: He says that in the last half century, the stock market bottomed within a month of when the unemployment rate passed 6 percent. The difference, he cautions, is that this time around the Federal Reserve has already sharply cut interest rates. Even the bears came armed with investment ideas, and by the end of the two-hour discussion, some found a little more room for optimism. (Maybe the wine helped.)

Jordan, 42, who runs the \$70 million Jordan Opportunity fund, likes to place big bets on big companies. Lately, that's meant health care and energy, two areas that promise long-term growth. The fund was down 30 percent in the first 10 months of the year, though it still managed to beat other funds in its category by nearly six percentage points. Charles de Vault, 47, comanager of the newly launched IVA International and IVA Worldwide funds, has just a small portion of his portfolio in the U.S. He sees more value overseas, particularly in cash-rich companies in Japan.

Romick, 45, started preaching the virtues of cash in 2004, when he and his firm grew worried about the increasing amount of leverage in the financial system. A healthy cash position helped him avoid the worst of the market's crash, but the FPA Crescent fund was still down 19 percent in the first 10 months of 2008. Romick thinks corporate bonds are a far better value than most stocks, but he still managed to find a stock or two worth buying. "You've got to invest when there's fear," he says. "And there's fear right now."

SMARTMONEY: *What lessons have you learned during the market meltdown?*

GERALD JORDAN: Know who owns your stocks. You've got massive liquidation in a lot of the stocks that I've owned. There are hedge funds that are highly leveraged, creating these unbelievable waves of selling. Take U.S. Steel. I bought it in the mid-\$90s and sold most of it in the high \$160s to \$170s. The stock got down to \$120, and I started to nibble on it and bought a little bit more at \$90. Yesterday it's at \$30! At one point in the month of October, I said, "I can't take this anymore," and sold it all. I do think the steel sector looking out three to five years is fine, but it's going to be sloppy.

CHARLES DE VAULT: What has been happening is a gradual realization that there were real and traumatic things happening in the real economy. To me it's not a matter of supply and demand of stocks and short sellers; it's people realizing that there had been an obscene credit bubble going back years, if not decades. People were fed stories of "Yes, the U.S. will slow down, but the rest of the world, especially China and Russia, will be okay." These stories were myths.

STEVEN ROMICK: I agree with Charles in that there was this sense of denial about what was coming, and I think there's still a sense of denial about what's here. The banks are wildly undercapitalized. The government's bailout package was a complete joke. There's about \$850 billion in tangible equity in the banking system against \$13 trillion in assets. Banks are technically insolvent. This impairment is going to be much deeper and broader than anything we've experienced in all of our lifetimes. I will tell you what is wildly mispriced: corporate debt. Either corporate debt is ridiculously cheap, or stocks are ridiculously expensive. There are things I'm seeing that I have never seen in my career. I've never seen disconnect in debt versus equity like what you see today. **SAMUEL LIEBER:** This is a unique period in one's investing life, and you have to be selective. You can't rely on the rating agencies to tell you what to buy; you can't rely on Wall Street. You even have to have a little skepticism about your own analysts and what they like. You can't look at things on a relative basis, and I think that has been an important lesson.

SM: *Will 2009 be better?*

DE VAULT: I am optimistic about Japan. Japan had its bubble in the 1980s and not one since then. Japanese companies are grossly

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—GERALD JORDAN

overcapitalized, unlike in the U.S. or Europe. Companies until now paid no attention to shareholders. But increasing numbers of Japanese companies are increasing their dividends. Makita and Canon, two companies whose stock we started buying recently, just announced pretty significant stock buybacks.

ROMICK: There are opportunities. I'm beginning to deploy capital, but I believe we're going to end up with an overcorrection. You're going to have these rolling troughs, with certain sectors—at one point steel, at one point energy—getting hit at different times. I would argue that financials haven't come close to hitting their bottoms.

LIEBER: I think looking at the market's price/earnings ratio is sort of a silly dance. I think that we have to be cognizant that the market's multiples are based on projections of where we are expected to be in years hence.

JORDAN: My outlook is a little more positive. With the exception of the Great Depression, most bear markets are 40 percent to 50 percent declines, and that's about where we are. You have to start buying. Period.

SM: *What do you expect out of the Obama administration, and what are the implications for investments?*

ROMICK: I wrote a speech in May called "The New Deal," and I crossed out *New* and called it "The Raw Deal." I'm worried about taxes going up as it impacts the middle class and smaller companies. And I'm worried about excess regulation. I'm worried about bringing so much to the government that it's really a disincentive to private industry.

LIEBER: There are limits to how much things change. The country went a good distance to the right over the last 20 or so years, and we're going to gradually move to the left. We're also going to see more infrastructure building, especially if we see 9 percent unemployment. We're going to see a modern version of the Works Progress Administration approach. We're going to see taxes tilted against corporations, especially loopholes that allow them to shift [income] overseas.

JORDAN: I'm not all that worried about Congress. History has shown that Democrat-controlled Congresses have a hard time getting along with each other.

DE VAULX: I think what Americans in particular, as well as the English, Irish and Spanish, should understand is that it's not normal to spend more money than your income. It's an absurdity, and I think politicians should have the guts to tell people that they have no business living beyond their means.

SM: *We understand that the broad picture is cloudy, but what stocks look good?*

LIEBER: Centex, the home builder, is a well-capitalized company trading below its net tangible assets. There's going to be an initial push to restimulate the housing market here. It's trading at \$9, and you've got to look at a two- to three-year view to see it around \$30 to \$35. Though not cheap, because it's seen as a safe play, Kroger is a good bet. Everybody needs food, and it's an efficient large-scale operator. Another company in infrastructure and housing is gypsum wallboard maker Eagle Materials, which is earning about \$1 a share. If they can get back to normalized earnings of about \$3.50 a share, we think this stock can go from the high teens to the low to mid-\$30s. A different theme is Nintendo. The stock, at \$40, has lost half its value over the past year but could gain 50 percent as we get closer to a new high-definition game-console launch in 2011.

ROMICK: Individuals can buy bonds of CIT Group, a high-quality middle-market lender, at 60 to 70 cents on the dollar. I don't understand why anybody would want to buy stocks when you can buy this kind of stuff. Some of these CIT bonds that mature in 2011 yield more than 20 percent. The only way I lose money with CIT Group is if 50 percent of the assets are written down to zero.

SM: *What else do you like?*

ROMICK: I think Sallie Mae debt is very good, with yields in the high teens for a one-year bond trading at 80 to 90 cents on the dollar. We don't believe we can lose money on Sallie Mae, because most of their loans are government-guaranteed. I also like the energy complex. Oil driller Ensco International is trading at 40 percent of its replacement value—the same discount-to-replacement value today it had in 2001, when oil was \$26 a barrel. I see the stock

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—SAMUEL LIEBER


ultimately settling above \$100. In health care, managed-care provider WellPoint is trading at about six times earnings and will benefit as the country addresses the uninsured market. It could earn \$7 a share and could double.

DE VAULX: We have 7.5 percent invested in U.S. equities, which is remarkably low in a global fund. We see better values elsewhere. In the U.S. we do like Cintas, the uniform renter. It's best in class, and we think we know where that business will be in 10 to 20 years. At \$21, it sells at seven to eight times operating income, and we value it at low to mid-\$40s. In Japan, Makita is a cash-rich power-tool maker with competitive advantages over Black & Decker. We are mindful that operating earnings will decline, but we think it will still make money in the trough. Also in Japan, Secom is an electronics security company. Makita and Secom are trading at roughly 40 percent discounts to their intrinsic values. When oil started falling below \$80, we started investing in some plain-vanilla names. One is Total—it's unusually well managed for a big French oil company.

JORDAN: We look for secular themes, and we've been bullish in energy for a long time. Diamond Offshore is the second-largest global offshore deepwater driller, with ginormous cash, no debt, and looks like they'll have a \$7.50 dividend per year including their special dividend. It's in business with national oil companies, so there's probably not a lot of credit risk there. It could rise to \$120 to \$160 based on a reasonable multiple in a new up-cycle. Peabody Energy is a big coal producer in the U.S. Even if you take 2010 numbers and cut them in half, it's trading at nine times 2010 earnings—pretty darn low for this industry. We mainly own commodities stocks and health care. Abbott Labs covers the waterfront in terms of products. The stock's trading at about 15 times 2009 earnings, and I think in a slow economic environment it can still easily trade at 20 to 25 times, for a 20 to 40 percent upside. I don't think it's got a 20 percent downside. It's a safer name to own as you wait through this decline. Another company off the beaten track is CACI International, an information-technology outsourcer. When the government needs new programs on the technology side, they hire these folks. The stock's cheap at \$42. I think this is one where you can make 40 to 50 percent over 18 to 24 months.

SM: *Market prediction, anyone?*

DE VAULX: If the U.S. market falls another 20 percent, that could bring about a faster recovery—it will have discounted the next three or four years. If the market doesn't fall but stabilizes, it will be flat for a few years. The pain in the U.S. could last five years.

LIEBER: We think we are in for two to three dull years in the U.S. and Europe. During those years we think China will absorb its inventories and high-priced raw materials. Then it will turn around in a low-priced world to lower the cost of its production. In doing so, it will be able to export more deflation to the rest of the world via low-priced goods. That will be just in time for people who have been stretched and are maybe trying to save a few more bucks than they used to. 



Charles de Vault,
International Value Advisers

I wrote a speech in May called
“The New Deal,” and I crossed out
New and called it “The Raw Deal.”

—STEVEN ROMICK

Their Picks

Here's what our roundtable panelists like, and why.

STEVEN ROMICK:

FPA Crescent fund

EnSCO International (ESV, \$32)

Hit hard by falling oil prices, offshore contract driller is debt-free and trades at a fraction of the replacement cost of its rigs.

WellPoint (WLP, \$35)

Managed-care provider has low price/earnings ratio and could get a boost as the government begins to address the huge uninsured market.

CIT Group bonds (2011 maturity)

Shares of this commercial lender have been hammered, but Romick sees bargains in some of its bonds.

SLM bonds (2010 maturity)

Romick says some soon-to-mature bonds of this student lender, known as Sallie Mae, offer attractive yields.

SAMUEL LIEBER:

Alpine Total Dynamic Dividend fund

Centex (CTX, \$9)

Once home building picks up, Lieber says the company could earn \$4 a share and trade in the low to mid-\$30s.

Eagle Materials (EXP, \$19)

This maker of cement, wallboard and recycled paperboard could benefit from a construction industry rebound.

Kroger (KR, \$28)

Efficiently run grocery-store chain isn't supercheap, but it has a booming private-label business. It's also safe: People will always have to eat.

Nintendo (NTDOY, \$39)

Japanese video-game maker has high margins because of low R&D costs and has a new HD game console on the way.

GERALD JORDAN:

Jordan Opportunity fund

Abbott Labs (ABT, \$55)

Diversified offering of health care products includes the fast-growing medicated-stent business.

CACI International (CAI, \$42)

The government goes to this Arlington, Va., company for some of its information technology needs.

Diamond Offshore (DO, \$73)

Deepwater offshore oil driller is generous with dividends and does business with national oil companies.

Peabody Energy (BTU, \$27)

This big U.S. coal producer recently started exporting to China. Even with slowed growth, Jordan says, Peabody should remain profitable.

CHARLES DE VAULX:

IVA Worldwide fund

Cintas (CTAS, \$21)

Cincinnati-based company has a reliable business selling and renting uniforms to workplaces.

Makita (MKTAY, \$19)

De Vaulx expects operating earnings of this Japanese power-tool maker to "collapse" in the downturn, but says it has lots of cash and should still be profitable.

Secom (SOMLY, \$90)

Japanese electronic security firm has a stable business and a dividend, and it trades at about 40 percent of its intrinsic value.

Total (TOT, \$52)

A casualty of declining energy prices, but the French oil giant trades at a low price/earnings ratio and pays a big dividend.

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Holdings are as of December 31, 2008 and subject to change. The funds held the following: Canon Inc. (1.1% of the International Fund, 0.9% of the Worldwide Fund), Cintas Corp. (1.6% of the Worldwide fund), Makita Corp. (1.6% of the International Fund, 1.1% of the Worldwide Fund), Secom Co. Ltd. (1.6% of the International Fund, 1.1% of the Worldwide Fund), Total S.A. (0.0% of the portfolio).

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