



# SIZEMORE CAPITAL MANAGEMENT

## 2009 First Quarter Investment Outlook and Commentary

To Our Investors,

2009 has certainly gotten off to a rocky start for the world's capital markets. Those of us who believed the worst of the bear market was behind us in the fourth quarter of 2008 were sorely disappointed in January and February. The S&P 500 was down by as much as 27% for the quarter before recovering markedly. The index finished the quarter down 11% on a total return basis.

We are proud to say that Sizemore Capital Management's portfolios weathered the storm well. Our actively-managed Tactical Portfolio lost only 3.9% for the quarter, benefiting from strength in its bond holdings, Asian equities, and infrastructure positions. Likewise, we were pleased with the performance of our strategic asset allocation portfolios. In 2008, much of the diversification benefit was lost due to the broad nature of the panic (more on that below). In 2009, under negative but more "normal" conditions, the benefits of diversification reasserted themselves, and our exposure to asset classes such as master limited partnerships and bonds enabled us to post satisfactory risk-adjusted returns.

Our model total returns for the quarter were the following:

Preservation of Capital	0.14%
Conservative Income	(7.46%)
Growth and Income	(9.84%)
Growth	(10.57%)
Aggressive	(13.06%)

The Preservation of Capital portfolio did exactly what its name implies: it finished the quarter flat, preserving capital. The Conservative Income and Growth and Income portfolios slightly outperformed the S&P 500, though their returns suffered from their exposure to the real estate investment trust ("REIT") sector, which has been one of the worst sectors since the bear market began in late 2007. The Growth portfolio more or less matched the performance of the S&P 500, and the Aggressive portfolio mildly underperformed the index.

### The Quarter in Review

We would like to start our review of the events of the quarter with an excerpt from Berkshire Hathaway's 2008 annual report, penned by the great Warren Buffet himself.

*The investment world has gone from underpricing risk to overpricing it. This change has not been minor; the pendulum has covered an extraordinary arc. A few years ago, it would have seemed unthinkable that yields like today's could have been obtained on **good-grade municipal or corporate bonds** even while risk-free governments offered near-zero returns on short-term bonds and no better than a pittance on long-terms.*

It should be reassuring to know that the world's greatest investor sees value in sectors in which we have significant positions. We continue to believe that the municipal and high-grade corporate bond sectors represent excellent value, and we intend to hold them in the portfolio for as long as this pricing anomaly exists. Some municipal bonds now sport tax-adjusted yields approaching 10%. This simply does not happen under normal market conditions.

Mr. Buffet continues his comments with a real gem on the value of a contrarian mind:

*Approval, though, is not the goal of investing. In fact, approval is often counter-productive because it sedates the brain and makes it less receptive to new facts or a re-examination of conclusions formed earlier. Beware the investment activity that produces applause; the great moves are usually greeted by yawns.*

Well said, Mr. Buffet.

Despite all of his wisdom and his long history of investment success, not even Warrant Buffet escaped 2008 and early 2009 unscathed. His Berkshire Hathaway stock declined by more than 50% peak to trough, mostly on fears of the company's exposure to the financial sector. Berkshire's net income dropped 59% in fiscal year 2008 and an incredible 96% in the fourth quarter

But Mr. Buffet is not the only famous name to run into difficulties. General Electric, the pride of corporate America, slashed its dividend in February. The company needed the cash to deleverage GE Capital, reducing its debt load and providing a cash cushion for potential future losses. In a move that was widely expected, General Electric also lost one of its most prized assets—its AAA credit rating.

The first quarter also brought us a presidential proposal for a \$1.7 trillion budget deficit labeled, almost unbelievably, "A New Era of Responsibility." It also brought us new chapter in the AIG debacle, including a polarizing bonus scandal, and several major steps toward greater levels of government control of the economy and over private transactions. Bill Clinton told us during his presidency that "the era of big government is over." Sadly, it now appears to be back with a vengeance.

We consider the decisions being taken by the president and congress today to be very significant risks to the long-term health of our economy. Though it is impossible to measure, we suspect that future GDP growth and stock returns will be lower than they otherwise would have been. That said, we do not recommend being overly cautious. The United States government has acted wantonly irresponsibly at various times in the past, and it will no doubt make similar mistakes in the future. **Regardless, investments purchased at reasonable prices and held for a sufficient time frame should continue to be reliable builders of wealth.** Stock returns may end up being lower than what they could have been, but given today's pricing we still see enormous potential for long-term capital gains.

We are not long-term "buy-and-hold" investors who believe stocks are always a good buy at any time, any price. Clearly, there are times to be out of the market, or at least under-weighted to it, and there are other times when an aggressive allocation is warranted.

The events of the past 18 months should have proved once and for all that the markets are not efficient. The Efficient Market Hypothesis, so beloved by finance academics, is patently false because it rests on several unrealistic expectations. The theory assumes that investors base their buying and selling decisions on a rational assessment of future prospects based on all currently available information. Investors are presumed to be completely emotionless, like millions of Spocks from Star Trek. This is ridiculous, of course. Investor decisions are motivated by alternating swings of fear and greed. This is not a criticism; it is simply a fact of life.

Another major flaw in the theory is that it also assumes that the market is completely liquid and that the investors themselves do not affect it. In other words, all investors are sufficiently small so as not to single-handedly move the market with their trading activity.

Anyone familiar with a "short squeeze" would know that this too is a ridiculous presumption. During a short-squeeze, a short-seller is required to buy back the shares of stock he sold—at virtually any price. This is one of the reasons that some of the biggest one-day rallies are in the midst of horrid bear markets in which stocks are in a very clear downtrend. It also explains much of the unusual pricing we see in today's stock and bond markets.

During this bear market, every major Wall Street bank failed, was forced into a merger, or was forced to reorganize into a traditional bank holding company (as opposed to an investment bank). There is literally

not a single major “old school” investment bank left on the Street. What is left of Wall Street has been forced to adopt a much more conservative business model, and as a result risk tolerance has significantly waned. Much of the aggressive trading has stopped altogether.

While we believe that the “animal spirits” will eventually return to Wall Street, right now they are noticeably absent.

The failure and retreat of the major banks could rather colorfully be compared to a fat man getting out of a bath tub. When he gets out, the water level quickly falls across the entire tub. Likewise, when a major source of demand for stocks, bonds, and other assets suddenly disappears—as happened in 2008 with the widespread failure of the Street’s banks—the value of virtually everything falls faster than the water level of the aforementioned bath tub. This is why diversification and traditional asset allocation fared so poorly in 2008. With the loss of several big players, the market simply stopped functioning and everything fell simultaneously. The major tenets of the efficient market hypothesis did not hold. This is why we have the bargains today in corporate and municipal bonds.

The good news is that the dust is finally settling. Goldman Sachs and a handful of other financial institutions are already giving their “TARP” funds back to the government. Make no mistake; the fallout from this crisis will be with us for years, if not decades. But the worst part of it does appear to be behind us.

## Portfolio Review

A full review of every position is not necessary at this time. Our basic investment rationale has not changed since the end of the fourth quarter. That said, we feel it is necessary to update our comments on some of the positions.

We will start with PXR, our emerging markets infrastructure investment. We were disappointed midway through the quarter to find that PXR was more or less falling in lockstep with the S&P 500. Starting in March, however, PXR began to significantly outpace the S&P 500 to the upside. We continue to see a lot of value in this investment. Regardless of what happens to the United States and Europe, there are significant infrastructure needs in the developing world that need to be met. We remain very optimistic about this position.

We also remain optimistic about MFD, our global infrastructure and utilities fund. We found that MFD’s management reached many of the same conclusions as ourselves about the performance of the sector and of the fund. Consider these notes from MFD’s 2008 Annual Report on the “Disconnection Between Operational and Share Price Performance”:

*One of the market’s key and persistent concerns over the Period was the deterioration in the pricing and availability of corporate debt. These concerns intensified following the collapse of Lehman Brothers in September 2008, after which credit market liquidity reduced significantly and credit spreads widened sharply. Credit market issues throughout 2008 led stocks to with above-average levels of debt, including those in the infrastructure sector, to underperform despite typically sound operational performance.... Notwithstanding the credit-related concerns and the significant macroeconomic headwinds, **we believe that the operational performance of the underlying infrastructure assets of MFD’s holdings was generally sound and in line with our expectations....***

*Despite this, MFD’s performance was negative during the Period in part because listed infrastructure securities were unable to decouple from the sell-off in the broad equity markets resulting from the credit market dislocation and the economic slowdown.*

MFD’s underlying portfolio of loans and infrastructure stocks is solid. Unfortunately, the fund was forced to sell assets at depressed prices in order to raise cash. Though hard to measure, this no doubt destroyed value.

Regardless, we still like the exposure that MFD gives us, and at current prices we consider the security a steal. The fund trades at a 22% discount to its net asset value at time of writing (close to an all-time record), and it yields close to 8%. At these levels, we believe MFD represents real value. The fund's underlying holding should continue to rebound, and the fund's discount to net asset value should continue to narrow. As the credit markets continue to normalize, we would expect the dividend to rise as well. All things considered, we expect MFD to be one of our best-performing positions in 2009.

The luxury sector is more of a mixed bag. We remain wildly enthusiastic about the sector and continue to consider it the most undervalued contrarian investment available today. Unfortunately, we are less enthusiastic about the security we choose to capitalize on this investment theme. We love the ROB ETF; it has exactly the mix of luxury-related companies that we want to own. The problem is that no one else seems to like it. More accurately, no one else seems to notice it is there. Trading volume on the ETF has fallen to a level that makes us uncomfortable. Trading volume can be as low as a few hundred shares on any given day. For this reason, we cannot allocate any new funds to this ETF. We will hold our existing positions, but for new monies we will have to explore other options. A broader consumer discretionary ETF would be a possible, though imperfect, substitute. Alternatively, a higher weighting could be given to the S&P 500 ETF.

On a positive note, we were please to see *The Financial Times* report on March 9 that French fashion house Yves Saint Laurent reversed ten years of losses to post a profit—in 2008 of all years, the “worst luxury market in living memory.” ([See FT article.](#)) Luxury remains a high-margin, highly profitable business, even if top-line sales growth continued to stay slow for the next several quarters. What we saw in late 2008 was inventory liquidation. Retailers are likely to keep inventories lower than in past years to avoid a repeat of the 2008 luxury fire sale, which means slower growth for the brands. But it also means that the brands will be in better position to keep their prices strong, preserving their margins.

Finally, in an unexpected twist, the exporting countries of Asia have actually been hit harder than the United States—where this global crisis began. [The Economist](#) reports that Taiwan has suffered the most out of the 55 countries that the magazine covered. Industrial output fell by 32% in the 12 months to December and an almost unbelievable 62% in the fourth quarter.

Interestingly, the market appears to believe that the worst has already happened. Since the beginning of 2009, our position in EWT has outperformed the S&P 500 by almost 20%. This is the beauty of contrarian value investing. When you buy assets cheaply enough, your downside is limited. Bad news stops driving the investment lower, and even marginally good news sends it higher. We are quite satisfied with EWT's performance thus far in 2009, and we will likely hold this position for the duration of 2009.

## Looking Ahead

We remain wildly bullish on our portfolio prospects for the remainder of the year. Our major investment themes—corporate and municipal bonds, infrastructure, luxury, and Asian shares—appear to be appropriate for this environment.

Here's looking forward to another quarter,



Charles Lewis Sizemore, CFA  
Chief Investment Officer, Sizemore Capital Management, LLC