



SIZEMORE CAPITAL MANAGEMENT

Sizemore Capital Management, LLC 2010 First Quarter Investment Outlook and Commentary

To Our Investors,

So far, so good. The first quarter of 2010 is off to a great start. After a very mild correction, equities and virtually all risky assets continued to drift higher, though at a slower rate than in 2009. Bond yields rose slightly on fears that high levels of government spending and a recovering economy would lead to high inflation—a view that Sizemore Capital Management does not share. In fact, our portfolios continue to be positioned for a low-inflation scenario with heavy emphasis on income.

Our actively-managed Tactical Portfolio returned 3.34% for the quarter, compared to 5.30% for the S&P 500 Total Return. Our short position in the euro and our long positions in pipeline infrastructure and luxury goods contributed most to our returns, while our positions in bonds added income and stability. Our short position in gold and our long position in utilities were a drag on performance for the quarter.

Our returns for 2010 on our passive Strategic Portfolio Allocation models were the following:

Preservation of Capital	0.75'
Conservative Income	2.98'
Growth and Income	3.85'
Growth	4.25'
Aggressive	5.10'

Portfolio Review

SCM Tactical Portfolio

In the first quarter, we made several significant moves. We sold out of all direct emerging market positions—specifically emerging market infrastructure (PXR) and Brazil (EWZ)—and initiated a short position in gold via the Proshares Ultrashort Gold Fund (GLL). We will explain our rationale below.

On January 8, in an internal investment memo we wrote:

After enjoying gains of nearly 100% in just over one calendar year, we decided that the time was right to sell our position in emerging market infrastructure (PXR). As we wrote in our 4th Quarter 2009 letter to investors, this is a move we have been considering for quite some time. Our growing concern is that China is in the midst of an unsustainable capital spending and infrastructure bubble. While we cannot know when this bubble will burst, we believe the safe and easy money has already been made. Holding this position at this point would constitute chasing returns, which is something we consider dangerous. In our view, it makes sense to take some money “off the table” so that we will be in position to move quickly should new opportunities present themselves.

PXR's market cap is 15% China, 12% Brazil, 9.1% South Africa, 8.9% Indonesia, and 8.2% Russia. With the exception of Brazil—which we continue to have exposure to via our position in EWZ—we consider all of these countries to be high risk at current levels. Should emerging markets in general come under strain, our position in EWZ will also be under review.

We have been growing skeptical of emerging markets for several months, but our recent caution was triggered by a number of factors:

1. The view is nearly unanimous on the Street that emerging markets are the place to be invested in 2010. The “themes” that have been appearing with increasing frequency are the relative decline of the developed world (US, Europe, Japan) and the rise of emerging market giants like China, India, and Brazil. We actually agree with this macro theme—over the long term.

Technology and globalization have made it possible for poorer and less-developed countries to leapfrog many of the stages of development that today’s rich countries experienced. India doesn’t even have adequate paved roads, but the country’s cities have world-class internet infrastructure. Similarly, many countries are bypassing the expensive step of laying communications wires and are going directly to cheaper wireless infrastructure. We view this as a major positive; it is clearly good for the world economy if living standards rise in the developing world.

Still, it is unclear why this beneficial long-term trend would automatically mean higher stock prices today, particularly when emerging market stocks tend to be geared towards exports to the West, not domestic consumption. Given that all major emerging market indices are dominated by such stocks, we believe the boom in emerging markets is based on false premises.

2. [The Pragmatic Capitalist](#) did an excellent job of aggregating the 2010 forecasts from the major Wall Street banks. The overwhelming consensus on the Street was for U.S. stocks to finish the year positive, though not wildly so. This is not something we pay a lot of heed to, as this is fairly standard. In bull markets, Wall Street strategists consistently underestimate the indexes’ performance, while in bear markets they overestimate it. This is not to say that the strategists are ill-informed or unintelligent; they have access to some of the sharpest minds and the most expansive data in the world. But for lack of better forecasting tool (because none exists), they fall into the common forecaster trap of “anchoring and adjustment.”

At any rate, while we do not take market forecasts seriously, we do like to read them for common themes. And it seems that every bank on Wall Street—even those that are bearish—seem to have a positive view on emerging markets. As natural contrarians, we would view this as a signal to bet the other way. When “everyone” is bullish on a given asset class, there is no one left to buy.

3. China is starting to draw the attention of some significant contrarian short-sellers. James Chanos, who made a name for himself by shorting Enron and Tyco before their respective implosions, is actively betting against China. And he is doing so specifically by targeting infrastructure stocks, which he sees as being the most vulnerable. While Chanos’s comments alone would not be sufficient for us to take action, we do believe that it is only prudent to take the views of such a successful contrarian seriously.

4. Pivot Capital Management published an [excellent report](#) outlining how truly excessive China’s capital spending boom has been. We will refrain from summarizing the entire report, but these facts warrant repeating.

- Investment accounted for 70% of GDP growth in 2008
- Investment accounting for 90% of GDP growth in the first half of 2009
- China’s investment rates far exceed those of even post-WWII Germany and Japan
- China is experiencing declining marginal returns on its investment spending (i.e. getting less “bang for the buck” for every dollar invested in capital spending). Decreasing returns are an indication of overcapacity.

- China's urbanization rate is massively understated due to the definitions that China uses (by China's definition Houston, Texas is not considered "urban" despite being one of the largest cities in America. Its population density is too low). Pivot estimates that China's true urbanization rate is 20% higher than the quoted 45%. What this means is that continued urbanization will not be the economic boon that many China bulls believe it will be.

Anecdotal stories abound of China having a real estate bubble, with prices driven to uneconomical levels by speculators. We take these stories with a grain of salt due to the lack of quality data, but evidence is mounting that prices are rising faster than incomes. According to Pivot, price-to-income ratios are higher in China's major cities than they were in Los Angeles or London at their mid-2000s peaks.

All of these factors indicate to us that the time is right to exit this position. Could China's investment boom continue for months or even years? Absolutely. The U.S. housing boom certainly proved that overpriced markets can get even *more* overpriced before they crash. But we feel that prudence dictates we make this reallocation now, while we still have a handsome profit. We will also closely monitor our position in Brazil (EWZ) in the event that weakness in emerging Asia spreads to Latin America.

On January 21, our fear turned out to be true. In response, we wrote:

Brazil and emerging markets in general came under incredible stress over the past two days. EWZ finished today down nearly 5%.

We have grown increasingly skeptical of emerging markets over the past 3-6 months. We maintained our position in EWZ as a way of hedging out bets; just in case we were wrong about emerging markets being at risk, we wanted to have some amount of exposure, and EWZ appeared to us to be a reasonable vehicle to accomplish this. So long as the security continued to rise in value, we were content to hold. Now, it appears that our skepticism was warranted, so we believe it makes sense to liquidate this position while we still have a healthy profit in it. In roughly four months, we earned a 10% return, plus dividends. There is no reason to get greedy here and chase returns.

This brings us to our second portfolio move today, the purchase of the Proshares Ultrashort Gold Fund. **If there is anything we were more skeptical of than emerging markets, it would certainly be gold.** None of the bullish arguments for the "barbarous relic" made sense to us. Yes, gold has some value as an inflation hedge. But we are currently experiencing deflation, and **the experience of Japan shows that deflation can continue even with massive monetary and fiscal stimulus when the private sector is deleveraging.** Yes, gold has traditionally been a "crisis hedge" during uncertain times. But when the financial sector collapsed in 2008 and it appeared that the world as we knew it was ending, gold actually *fell*. Yes, gold offers protection from a falling dollar—if you bought it ten years ago. But how will gold perform in the event of a bull market in the dollar? We firmly believe that a stronger dollar will be the reality over the coming 1-3 years; it is difficult to see gold performing well in this environment.

Finally, for us to believe the gold story we would like to see confirmation from another asset class, such as bonds. The bond market is generally considered to be more sophisticated than the stock and commodities markets because it is dominated by large institutional investors. And right now, the much feared "bond vigilantes" are showing no signs of fear. Yes, yields have risen in recent months. But they are still very low by historical standards and hardly indicative of impending hyperinflation or a dollar collapse.

To us, the bull market in gold is a trend based on false premises. It's also become a "popular" investment among both retail investors and some money managers. As contrarians, this makes us highly skeptical.

The problem with making a contrarian call is that you can be "right" but still lose a lot of money if you are too early. Just ask anyone who tried to short the Nasdaq during the 1990s bubble. With this in mind, we find it necessary to use strict risk control on this trade. We are implementing a 25% stop loss. On a 10% portfolio position, this limits the total risk to the portfolio to a tolerable 2.5%.

Should gold continue to break down as we expect, we would look to exit this position in roughly six months or after a profit of 30-40%.

The January 16 issue of the *Economist* attempted to refute many of the China bear arguments made by Pivot and by Chanos (see "Not Just Another Fake"). It's not to say the *Economist* is bullish on China; it's just that they believe it's "not that bad," and that the country is actually in better shape than Japan prior to its implosion two decades ago. The *Economist* does make some valid points:

- "Chinese share prices are nowhere near as giddy as Japan's were in the late 1980s. In 1989 Tokyo's stockmarket had a price-earnings ratio of almost 70; today's figure for Shanghai A shares is 28, well below its long-run average of 37."
- Despite the bubble in some markets, "Average home prices nationally...cannot yet be called a bubble. On January 14th the National Development and Reform Commission reported that average prices in 70 cities had climbed by 8% in the year to December, the fastest pace for 18 months; other measures suggest a bigger rise. But this followed a fall in prices in 2008. By most measures average prices have fallen relative to incomes in the past decade."
- "The most cited evidence of a bubble—and hence of impending collapse—is the ratio of average home prices to average annual household incomes. This is almost ten in China; in most developed economies it is only four or five. However, Tao Wang, an economist at UBS, argues that this rich-world yardstick is misleading. Chinese homebuyers do not have average incomes but come largely from the richest 20-30% of the urban population. Using this group's average income, the ratio falls to rich-world levels. In Japan the price-income ratio hit 18 in 1990, obliging some buyers to take out 100-year mortgages."

These points may technically be true, but the *Economist* misses the point. China's bubble doesn't have to be as big as Japan's in order for it to burst. And the fact remains that China has overcapacity in its industrial sector that it continues to add to with new capital spending. The *Economist* also makes a critical error in comparing China today to the United States 100 years ago. The United States had a booming population in those days due to both immigration and high native birth rates. The United States was building infrastructure for its burgeoning population and for the settlement of the West. Due to the One Child Policy, China's population growth rate is negligible. China's migrants also move primarily from the countryside to the already populated coastal regions. Yes, this requires construction on a massive scale. But no, China is not conquering an untamed continent.

We believe that China's infrastructure building has, at a minimum, gotten ahead of itself. China is currently building roads that may not be utilized for ten or twenty years. At the very least, we would expect the growth rate in China's commodities usage to moderate in the coming months and years. In any event, we continue to believe that selling PXR and EWZ was the right move to make.

Update on the Luxury Sector

Coach sent the luxury sector into a tailspin when the company released its earnings on January 20. The company's stock price then proceeded to fall more than 10% in two days. So, is the rebound in the luxury sector over? We don't think so. We read the earnings release and found nothing objectionable in it. Year over year growth was strong. It just wasn't quite as strong as Wall Street had hoped, and the stock got punished. We don't view this as indicative of a larger setback for the industry, and in fact, the stock more than recovered from its fall throughout the rest of the quarter and currently sits near its 52-week high.

The Financial Times appears to agree with us. The day after the Coach release, the FT wrote,

These may still be early days but there are increasing signs of a revival in the luxury goods industry. Tiffany, Richemont and Burberry have all been reporting an encouraging recovery in sales during the second half of last year that appears to have accelerated in December....

Luxury goods groups all expect demand to continue growing strongly in Asia but they are also banking on the recovery of their mature markets compounding the Asia-Pacific region's double-digit growth.

Well said. The FT essentially made the same points that we have used over the past 18 months. **The luxury sector is primarily a play on the rising affluent class in the developing world and secondarily a play on the recovery of America's wealthy.** It's also a play on the rise of the American Echo Boomer young woman. As America's enormous population of college students (currently at the highest levels in history) graduate and join the workforce, they will need work-appropriate clothes and accessories. This should be a big boon for Coach and other entry-levels luxury manufacturers and retailers. *Every* college girl will not run out and buy a new Coach purse upon getting that first job offer. But given the size of the Echo Boomer generation, there should be enough of them to make a noticeable impact on luxury sales going forward.

Still, sentiment toward the sector remains skeptical. We like this. It tells us that the sector most likely has at least a few more months of outperformance left in it.

High-Yield Bonds

The Financial Times published an article on March 29 that summarized many of our thoughts on our position in high-yield bonds (see "[Junk Bonds Sell in Record Volumes](#)"). The FT wrote,

Global issuance of bonds with ratings below investment grade, known as high-yield or "junk", totalled \$67.8bn (£45.3bn) at the end of the first quarter - an all-time high for the first three months of the year, according to Thomson Reuters...

Persistently low official rates have driven yield-hungry investors out of money market funds into higher yielding investments such as junk bonds.

Meanwhile, economic growth and receptive capital markets have improved the prospects of lower rated companies. Default rates are expected to drop under 5 per cent this year from a peak of 14 per cent globally in 2009, says Moody's Investors Service...

But the sharp gains and the wave of supply over the past year have led to warnings that investors are chasing performance and that the rally may run out of steam soon. The torrid pace of issuance follows \$176bn last year, the second highest annual tally, Thomson Reuters says.

So, we have two opposing forces affecting this market. On the bullish side, we have an improving global economy and a decline in risk aversion. All else equal, these factors should point to lower yields and higher bond prices.

But on the bearish side, we have a massive influx of new supply that is outstripping demand, keeping yields relatively high. On balance, we are still mildly bullish on the sector. We concede that rising supply should put a limit on capital gains potential, though we don't see it depressing prices much further. At present, we believe the high yield we enjoy from this sector to be adequate compensation for the risk. We have no immediate plans to sell, though we will continue to monitor the sector for signs of weakness.

Looking Ahead

Going forward, we are most hopeful on the prospects for our short sales of gold and the euro. The euro trade is performing as expected. While gold has not yet joined the euro in its decline, we believe that it is only a matter of time for the reasons discussed above. Ideally, we would like to close these positions within the next 1-2 quarters, but our decision will be based on the performance of these two positions over that time period. Our biggest disappointment in 2010 has been the performance of the utilities sector. To us, utilities remain the most attractive industrial sector—they enjoy a high yield and conservative pricing relative to the S&P 500, which is increasingly looking extended. Given current pricing levels, we consider ourselves already compensated for any regulatory risk due to new government “green” initiatives or other risks.

Here's looking forward to a great 2010,

A handwritten signature in blue ink that reads "Charles Sizemore". The signature is fluid and cursive, with a long horizontal stroke at the end.

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