Lebed Asset Management LLC

Investment Commentary—July 2009

If you've received our client communications over the last six months, you know we've consistently predicted a weak and protracted economic recovery. The financial crisis resulted largely from an explosion in debt, most notably consumer debt. Some of the excess borrowing—trillions of dollars worth—will be written off. But most of the debt will be repaid. Money devoted to debt repayment is money that won't flow into the economy, which is why the recovery will be weak. The scope of the debt is such that it will take several years of pinching pennies to get it back to a sustainable level, which is why the recovery will be protracted.

Of course, considering how desperate things looked four or five months ago, when many perfectly sane observers warned of a looming depression, any kind of recovery, even a very long one, might sound pretty good. And, indeed it does. What's more, economic data increasingly suggest that the economy will be growing by some time in the fourth quarter, perhaps even earlier. So, if a very long recovery doesn't sound so bad (all things considered), and if it's just around the corner, what's to worry about? Well, in the long term there's inflation and deficits. But we have a more immediate concern. Namely, that the recovery scheduled to arrive later this year could be nipped in the bud in 2010.

If you put your mind to it, you could come up with any number of problems that could derail a nascent recovery. For us two stand out: state fiscal crises and further waves of mortgage defaults.[1]

California, with its $26 billion (and counting) shortfall and history of budget stalemates is the poster child for state fiscal crises. Unfortunately the Golden State is not alone. The Center on Budget and Policy Priorities estimates that collectively state governments face a $350 billion shortfall in fiscal years 2009 and 2010. And the timing couldn't be worse, as states' efforts to balance budgets will probably take full effect just as the federal fiscal stimulus is beginning to wear off. Columnist and economist Paul Krugman captured the problem well, if depressingly, when he referred to "fifty little Hoovers." A federal bailout may well be justified, but would be politically perilous and hence somewhat unlikely.

The subject of mortgage defaults is complex, but in a nutshell, while subprime defaults have probably peaked, troubles in other parts of the mortgage market

[1] Not too far behind on our list would be commercial real estate and the upward pressure on interest rates exerted by massive federal debt issuance.

are yet to come. The biggest problem is with Option ARMs, the product that allows for flexible payments, including payments so low they don't even fully cover interest, never mind principal. Of course, all good things must come to an end, and borrowers who opt for low payments eventually have their monthly installments automatically "recast" to a much higher level. Data from Credit Suisse suggests that a surge of Option ARM recasts will begin in the middle of 2010 and crest some time in 2011. This will inevitably lead to a new wave of defaults and foreclosures. To make matters worse, while subprime defaults have peaked, subprime foreclosures are progressing very slowly and may not peak until next year. Meanwhile, the Obama plan to ameliorate foreclosures is proving inadequate. This rising tide of foreclosures won't take the mortgage industry or policymakers by surprise. For example, it's more or less baked into the bank stress tests announced in May. But it certainly won't help housing prices or consumer sentiment and it may not bode well for the staying power of a recovery.

We don't mean to suggest a return to the grim days of February when talk of a depression filled the air. However, if the economy perks up significantly in the next couple of quarters—and between the growing impact of the stimulus and eventual rebuilding inventories, there's a good chance it will--it might be unwise to extrapolate the good news. In a positive scenario, the economy could get back to 2 to 3% growth and stay there for several years as consumers work down debt. While that scenario is quite plausible, it's also possible that GDP growth gets up to something like 2 to 3% in the second half of the year but slips back into a mild recession late in 2010. The bottom line is that the recovery is likely to be weak and protracted and could be pretty bumpy to boot.

Our expectation of a slow and perhaps uneven recovery motivates our continued relentless focus on the financial strength of companies in client portfolios. In a typical recession, the biggest risk to debt-heavy companies comes during the recession itself. If a firm gets through the recession in reasonable shape, earnings come back pretty quickly, credit is available to roll over debt, and life goes on. This recovery may look quite different. Earnings will probably recover slowly[2]. Credit spreads, while down significantly from the historic levels reached six months ago, will remain elevated, and the Treasury's rapidly growing appetite for debt will push interest rates in general higher. Increasing interest costs in the face of subdued earnings could exert stress on companies with weak balance sheets for several years, with many surviving the recession only to succumb to a challenging recovery.

One way to illustrate the high bar we've set in evaluating balance sheets is to look at the debt ratings of companies in client portfolios.[3] While we prefer to do our own analysis and don't

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[2] Because we expect earnings to recover slowly, we've also put a premium on companies whose earnings have held up relatively well. If earnings declines are modest, then a slow recovery is much less of a concern.

[3] The comments that follow apply to client portfolios in aggregate; individual portfolios will be similar but not identical.

pay too much attention to credit ratings, there is inevitably a significant correlation in our assessments and those of S&P and Moody's[4,5], and their ratings provide a useful independent corroboration of our views. Of the stocks in client portfolios all but three are rated (and of the three companies not rated, two have no debt and loads of cash). Sorting the market value of the portfolios by credit rating[6], 100% is investment grade, with a breakdown as follows: 13% BBB, 50% A, 13% AA, and 24% AAA. This profile is far superior to the S&P 500, which contains dozens of below-investment grade credits and only 10% of market value in the AAA category.

Oddly and fortunately, we have not had to pay up for the high quality of the portfolios. The stock market runup from early March to early June focused on lower quality companies, resulting in more attractive valuations for the stronger companies we favor. This dynamic can be seen in the performance of the major indexes from the March lows to June 30th. Nasdaq, with the lowest relative quality, was up 45%. The Dow, with the highest relative quality, was up only 31%, with the S&P 500 splitting the difference at 38%.

With strong balance sheets, relatively steady earnings and low valuations, the stocks in client portfolios have the characteristics that typically result in excellent long-term forward returns. As difficult as the recovery may be, the general earnings trend will soon be positive. Earnings multiples on the portfolio are modest, so there's room for multiple expansion over time. And free cash flow yields in the portfolio are high, allowing for significant returns from dividends and/or stock repurchases. Of course, returns will also be subject to volatility in the overall stock market, which could be significant as the deleveraging of the global economy plays out. But the fundamental strength of portfolio holdings provides reason to believe long-term performance will compensate well for enduring that volatility.

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[4] Of course, when we scrutinize balance sheets, we are not measuring precisely the same thing as a rating agency. Still, the analysis is pretty similar. If this sounds odd, consider recent comments by legendary investor Jeremy Grantham. Grantham has for some time emphasized the virtues of "high quality" stocks. In a recent interview, he was asked to elaborate on what he meant by high quality. In responding, Grantham indicated he looks for the same things that Moody's or S&P would look for in assigning a high credit rating.

[5] In light of the events of the last couple of years, some would argue that rating agency opinions are of dubious value. However, the problems with ratings lay primarily in securitizations and a number of financial sector corporations exposed thereto. Outside of the financial sector corporate ratings have held up fine. And since our financial sector holdings are now less than three percent of holdings, they're not material to this discussion.

[6] The numbers that follow represent the total value of holdings in each tier divided by the total value of all rated holdings. For these purposes, we drop "+" and "-" and group all investment grade ratings into four tiers: AAA, AA, A and BBB. I.e., we consider AAA- to be AAA, we consider AA+ and AA- to be AA, etc.