



# WHEN PERFORMANCE DISAPPOINTS: WHAT'S GOING ON?

As a disciplined value manager, we must outperform our benchmark over time to earn our clients' trust. Our investment discipline of investing in undervalued businesses has served us well since our inception in 1989. And we at Optique are very proud of our long-term track record of adding value for our clients for more than 18 years.

Despite our strong long-term track record, short-term deviations from benchmark can and do occur from time to time. In 1999, for example, when value fell deeply out-of-favor, our Large Cap Value portfolio underperformed both the Russell 1000 Value Index and the S&P 500 Index by 900 basis points and 2400 basis points, respectively. That said, last year (2007) was the first year since 1999 that our Large Cap Value portfolio underperformed the S&P 500. Since our Large Cap Value portfolio's inception date, annual performance has only lagged its primary benchmark index, the Russell 1000 Value, six years out of our 18 year history. Since the inception of our Large Cap Value portfolio in 1989, our annualized performance remains ahead of the Russell 1000 Value Index, gaining 11.6% annualized compared to 10.8%. While temporary performance dispersion can be unnerving to our clients, we believe our internal focus should remain on investment process and discipline. Despite the 'noise' in the marketplace, we remain extremely disciplined in our approach: our investment process has not changed. We continue to analyze and seek to exploit fundamental investment opportunities in our opportunity sets relative to current valuations, as we always have.

We began 2008 fully aware of the economic challenges facing the US economy, but were optimistic in our view that a recession or extremely 'growth-lite' environment

would be averted. We were also hopeful that economic policy and company-specific actions being undertaken would render the sub-prime induced credit crunch to be relatively short-lived. Alas, this was not

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*"Times such as these test investor fortitude."*

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to be the case. The downward momentum of the US economy continued at an accelerated pace and the credit markets all but seized up. Fears of a severe recession grew and the near collapse of Bear Stearns profoundly impacted the manner in which market participants viewed risk causing some investors to flee equities altogether and leaving many 'survivors' shell-shocked and jittery.

In the end, the first quarter of 2008 was not kind to investors in general and not to us specifically. Our Large Cap Value portfolio declined 12.3% against a broad decline in US equities with the Russell 1000 Value Index down 8.8% and the S&P 500 Index down 9.4%. A performance setback of this magnitude is unusual for us, having, as indicated earlier, last occurred in 1999. So what is going on? Why has our performance been unusually challenged?

Unlike our performance shortfall in 2007, volatility in our financial holdings was not the issue relatively speaking. While our financials declined in the quarter, our performance in that segment of the portfolio was in-line with performance of financials in the Russell 1000 Value Index and exceeded the performance of that sector in the S&P 500 Index.

Instead, the first quarter performance at

Optique was spread across the portfolio. Legitimate concerns about a consumer-led US recession resulted in investors liquidating positions in names with any whisper of consumer vulnerability, whether or not evidence or company guidance of specific stress existed. This behavior of 'sell now, ask questions later' can be very painful in the short-term, as long-term investors live

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***"...Investor fear is creating long-term opportunities..."***

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through- in many cases- value destruction based solely on emotion. As we've highlighted on several occasions, our disciplined value methodology often results in us holding names in our portfolio which are out of favor yet well positioned to survive tougher economic times without much difficulty; such names tend to get hit the hardest in emotion- driven markets like the first quarter experienced.

To wit, names in our consumer staples holdings (traditionally a 'safe haven' sector in economically challenged markets) were the largest cause of our performance miss in the first quarter. Fears of trade down, whereby consumers switch to cheaper brands to save money and a stressed consumer segment sent shares of vintner Constellation Brands and grocer SuperValu swooning, each falling more than 20% during the quarter despite reassuring comments from management and financial results that came in largely as we, and the Street, expected. To put things in greater perspective, the 20% drop in share price came at a time when consensus annual (2008) earnings estimates for SuperValu dropped \$.02 or 0.7%, to \$2.75 in March from \$2.77 in December. For Constellation Brands, the earnings outlook remained unchanged! In fact, on April 3, the company announced its fourth quarter earnings that were significantly above estimates and set its 2009 outlook above Street view. Even shares of powerhouse Unilever were not immune from the market's wrath, declining over 10% despite its improving profitability and successful leverage of revenue and earnings growth in the emerging world.

For value investors, our Large Cap Value portfolio's approach to the technology sector has been quite successful over time. By and large, growth investors in the current environment have driven valuations in the sector to levels we find challenging, with earnings and revenue

growth projections elevated despite the fact that many names ultimately serve large consumer-facing end markets. Our portfolio's two tech-sector holdings turned in a mixed result for the quarter, with Check Point Software posting strong operating performance and a modest 2% price advance while Motorola which turned in a very dismal quarter was undermined by extreme weakness in its cell phone business. Investor activist Carl Icahn has recently increased his stake in the company and won two directorship placements on their board. Whether his moves will create shareholder value is questionable, and as many of our original catalysts for the name have been realized without a commensurate appreciation in market value, we are currently monitoring this holding carefully.

The energy sector, another sector where we have traditionally added value, was challenging as share prices of Marathon Oil declined 25% during the quarter on fears of peaking refining margins. The company offers compelling long-term growth and, when compared to its peer group, has one of the cheapest valuations in the energy sector, a lowly leveraged balance sheet and one of the best dividend yields. With oil prices at record levels, reports of slowing domestic demand and reductions in the 'miles driven' data, we believed it prudent to reduce our pure play exploration and production exposure—selling Apache— as we believe oil prices will halt their advance sometime in 2008 leaving the E&P subsector vulnerable to meaningful price decline. In retrospect, our actions in the sector have thus far appeared to be too early, costing us short-term relative performance but are still, in our opinion, appropriate given our longer-term outlook.

Having sold, on a valuation basis, the portfolio's shares in AT&T, we took a smaller position in SprintNextel, wanting to maintain exposure to the telecommunications sector, while again seeking to exploit relative valuation opportunities. SprintNextel was trading with very low expectations and at a heavy valuation discount to its wireless and wireline peer group. While we believe Sprint has the core ingredients to turn its business in the longer run, its CEO Dan Hesse outlined his turnaround plan which will take longer than we had expected. Such news was music to short sellers' ears, driving the shares down to a six year low.

Even with our recent performance setback, we have never been more enthusiastic about our portfolio's future opportunity. Highlights include:



**Constellation Brands:** The world's largest vintner, Constellation controls a portfolio of premium wines, including Robert Mondavi, Clos du Bois and Kim Crawford as well as Svedka vodka and Corona beer. The company generated a record \$370 million in free cash flow in its fiscal 2008 and sees producing \$310 to \$340 million in fiscal 2009, for a free cash flow yield of approximately 10%. With earnings set to rise 15% to 20% over the next year and its earnings multiple at 10 times, a 40% discount to Diageo and Brown Forman, the shares have meaningful upside opportunity.

**Barr Pharmaceuticals:** Generics maker Barr has more than just demographics and cost conscious consumers to support its shares. The company recently won an important patent battle with Bayer to begin marketing a generic version of oral contraceptive Yasmin. Combined with generic Fosamax, Barr should be able to increase revenues by at least \$120 million in 2009 or 5% on these new drug offerings alone. Furthermore, its recent acquisition of European based Pliva offers stronger developing market sales opportunities and greater efficiencies.

**SprintNextel:** Murphy's Law reigns at Sprint where nothing has gone right since Sprint and Nextel merged in 2006. With its market value collapsing from \$70 billion to under \$20 billion today, enormous value is embedded in this stock and can be realized with strong management action. Under new CEO Dan Hesse, management is working to reduce customer churn by improving customer service and positioning the company for growth. Only modest improvements are needed to alter investor sentiment on these shares.

**Computer Sciences:** Shares of this IT outsource provider have been out of favor since the company opted not to sell itself in the M&A craze of 2006. In spite of a solid federal government IT business and an improving outlook on its commercial IT business, the shares continue to languish. With revenue and earnings marching upwards, share repurchases and a recent acquisition to strengthen its healthcare IT business, these shares should command a much greater multiple than 11 times trailing earnings and 4 times cash flow.

**Eaton:** A little respect please. Eaton has proven quarter after quarter its earnings resiliency on strong global diversification despite exposure to heavy duty truck and auto parts. Although there are headwinds and the domestic market remains weak, international demand remains robust. Combined with moves to improve

operational efficiencies and expand international revenue, Eaton shares are underappreciated by investors that seem to be focused on the wrong issues.

**Check Point Software:** These shares have been stuck in a limited trading range for the past five years. This leading developer of security software and hardware has built a strong franchise for small to medium size businesses. Using its significant cash flow to fund strong R&D and make add-on acquisitions, the company is positioned to grow earnings at a double digit rate even in a tougher global economy.

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*“...there are many reasons to stay the course as better days lie ahead.”*

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Investor fear is creating great long-term opportunities for our Large Cap Value portfolio. During the first quarter of 2008, we added three new positions that we believe have strong risk reward characteristics: Kohl's, American International Group and Sony.

**Kohl's:** Shares of the discount department store have dropped nearly 50% from its peak in early 2007 as consumer spending has declined. While the outlook for consumer spending remains tepid at best, the earnings multiple on Kohl's shares has contracted from 30 times earnings in 2003 to twelve today while revenue and earnings growth have increased 76% and 98% respectively. Unlike larger retailers such as Target and Wal-Mart, Kohl's remains in its growth phase with management expectation of 500 new stores over the next five years. The long-term growth prospects remain very compelling.

**American International Group:** The financials have been the center of the maelstrom in recent quarters and few have been hurt as badly as AIG outside of the banking arena. The share price has nearly halved over the past year on losses from its super senior credit default swap portfolio due to the credit crisis. Most of these losses will likely reverse as the credit markets normalize over time and AIG's overall balance sheet remains quite strong. Add to that the company's size, financial strength, geographic and business diversity all for seven times 2008 estimated earnings. AIG shares represent an unusual bargain even in a troubled market.



**Sony:** Shares have fallen dramatically in recent months on concerns that a US slowdown and a rising yen will diminish growth opportunities. Still, the company's

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restructuring efforts are showing promising signs as revenue growth has resumed and operating margins have improved. Sony has been able to showcase some of its regained innovative prowess having won the HD-DVD format war with Toshiba. The company also is set to gain from the royalties of PlayStation 3 video games over the next several years.

Times such as these test investor fortitude. Despite the rampant pessimism, there are many reasons to stay the course as better days lie ahead. Valuations in the US markets haven't been more attractive in many years. Trading at 12.5 times earnings with a 3.5% dividend yield, our Large Cap Value portfolio has all of the core ingredients for stronger performance in the future. We continue to work daily to find opportunities to uncover long-term value for our clients and solicit your patience during these trying times.



555 MAIN STREET, SUITE 440 \* RACINE, WISCONSIN 53403  
PHONE: 262•619•2855 \* OPTIQUECAPITAL.COM  
FAX: 262•619•8345

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