



# DEJA VU: THE FAILURE OF INTRINSIC VALUE IN TODAY'S EQUITY MARKETS

*"The market reflects all available information, as the professors tell us. But, just as the funhouse mirrors don't always accurately reflect your weight, the markets don't always accurately reflect that information. Usually they are too pessimistic when it's bad, and too optimistic when it's good."*

- Ben Miller

For many investors, the rollercoaster stock market of 2008 has proven to be more than was bargained for. Like a three act play, the collapse of Bear Stearns was supposed to be the climax whereby the conflict was resolved (JPMorgan's rescue of Bear stabilizes the financial markets), the protagonist is victorious (the Fed slays the credit crisis) and the markets lived happily ever after. Indeed, in April and May stocks followed this course; the worst was behind us and it was safe to be back in the markets. Bourses around the globe began to recover and confidence gained until yet another financial panic set in during June, driving stocks to new lows and sending the value markets into a tailspin. With investors fleeing global equities and the dollar, commodity prices soared with oil setting new records on a daily basis. By June 30, the S&P 500 had set new yearly lows and the financial-heavy value indices such as the Russell 1000 Value Index and the S&P 500 Citi Value Index were down nearly 14% and 17% respectively.

The forces at work in the US and global economy today are worrying without doubt. A combination of relentless commodity inflation and severe housing and equity deflation is the worst of both worlds for American consumers as their costs rise, real incomes decline and American family net worth falls. It is no wonder that investors and non-investors alike are in a foul mood as future personal economic stability appears elusive.

Of course, as is typical in market panics, bad news amplifies into rumor and misinformation. In today's market, the rise of short selling feeds on this frenzy, resulting in a complete separation of corporate fundamentals and share prices. Wall Street analysts, now completely beholden to their large hedge fund clientele, were falling all over themselves in June downgrading each others' shares as well as those of every other bank and non-bank financial. Without regard to underlying fundamentals, all financial companies were suspect and by the time the banking sell-off ended in early July most large American banks saw their shares cut in half. To stem the panic, a number of banks issued public statements about their loss experience, capital levels and dividends in late June to little avail; the selling continued despite the reassurances. Yes, there are banks that are highly stressed given the downturn in housing and credit, but most banks remain profitable and well capitalized. Is it any wonder that many bank shares are now 50% or more above their lows set just a few weeks ago? The analyst community should be ashamed of their overhyped comments, not only because investors have lost millions of dollars without reason but also for creating a confidence crisis when none was warranted.

But we digress. The current stock market carnage is much worse than is captured in major market indices as shares of most consumer discretionary and financial companies have been cut in half.

Even the bluest of the blue chips have experienced severe market stress with many shares off 20% or more (See Table 1).

Instead, the investment picture has morphed into one of extreme momentum, both upward and downward. Through the

**TABLE 1**

AT&T	(21)	American Express	(26)
Microsoft	(23)	General Electric	(29)
Pfizer	(24)	AIG	(54)
Proctor & Gamble	(20)	Merck	(36)

end of the second quarter, just about the only stocks with year-to-date gains are those in the commodities sectors: energy, mining, and agriculture. Investors have latched onto these names hoping to keep their heads above water in increasingly turbulent waters. Unfortunately, the performance dispersion between them and the rest of the market grows more disparate daily. And like a rubber band, the resulting stress will result in a snap that will bring a new equilibrium to the markets.

Fortunately for long-term value investors like Optique, we have seen this movie before. While the circumstances may be different, the current conditions and outcome are not. Market bubbles play out in a fairly predictable manner. Bubble momentum takes hold. Investors, driven by greed, and managers by fear of underperforming, begin to chase a small number of stocks, selling everything else that might hurt performance in the short run. In 1999 and early 2000, the greed momentum investors were chasing technology shares. The paradigm had shifted; the world had changed. The only stocks worth owning were those of technology companies, along with selected media and telecoms. This strategy worked until it suddenly collapsed under its own weight in the spring of 2000.

---

***“And like a rubber band, the resulting stress will result in a snap that will bring a new equilibrium to the markets.”***

---

Today, the bubble is all about commodities. Be very wary of the “this time things are different mentality” as this is a siren’s song that will prove fleeting. The current commodity bubble will burst. Cracks are already forming. The ultimate timing is unclear, but burst it will. And as it does, the rest of the equity market will stage a remarkable recovery that will surprise most market prognosticators.

We believe passionately that balance is the order of the day. Commodity exposure is not “bad” just like technology exposure in 1999 wasn’t illogical. It is the expectations that

no longer appear to be grounded in reality. Commodity prices cannot continue to rise unchecked, as demand destruction and substitution effects will eventually take over, correcting the price overshoot. At Optique, we have always maintained exposure to commodity stocks, mostly in the energy sector. We see the sector as having long term value as well as being an important hedge against inflation. It is, however, not the only, nor the most important, sector of the market or our economy. Instead, it is the companies that provide long-term revenue and earnings growth due to strong innovation or utilization that will prove to be the ultimate winners.

This market of extremes, both domestically as well as internationally, is creating a number of exceptional buying opportunities for those investors willing to maintain an intermediate to long-term investment horizon. Some of our favorites include: Pfizer, General Electric, and Huntington Bancorp.

---

***“... it is the companies that provide long-term revenue and earnings growth due to strong innovation or utilization that will prove to be the ultimate winners.”***

---

**Pfizer (pharmaceutical):** Pfizer’s shares are down over 20% this year, and now trade at only 7.7 times earnings and 1.9 times book value – multiples last seen over twenty years ago. Pfizer has nearly \$29 billion in cash on its balance sheet and generates over \$15 billion dollars a year in cash flow from operations. With 20 drugs in late stage clinical trials, and 20-24 additional products to be in late stage trials by the end of 2009, the mid-term product pipeline is the deepest in the company’s history. The early-stage pipeline currently has over 35 products in development as well. Pfizer’s deep pockets also enable it to acquire additional product and establish alliances with smaller drug companies. For example, the recent acquisition of Coley Pharmaceuticals gives Pfizer the opportunity to share in profits from the



sale of new vaccines brought to market. In turn, Pfizer brings to the table their considerable resources and experience in research and development, clinical testing, and sales and marketing. The 6.8% dividend yield is an added bonus.

**General Electric (industrial):** GE shares have fallen over 25% this year, despite a generous dividend and stock repurchase plan, as investors have overlooked the solid results posted by the company's infrastructure division and feared the worst in the company's financial services arm. Admittedly, GE does have exposure to a limited amount of subprime through its GE Money and insurance arms and has exposure to the US consumer through its credit card operation, but acted prudently in the earlier stages of the mortgage crisis by selling off its domestic mortgage generation business while continuing to increase reserves as appropriate for delinquencies in the consumer finance portfolio. At the same time, the company has for years been diversifying its revenue stream on a worldwide basis, such that 50% of revenues are now generated outside the United States. Clearly, GE is well positioned in its global infrastructure division to capitalize on the booming alternative energy trends as well as the drive for fuel efficiency in aerospace and rail, allowing it to generate strong cash flow from its diversified business segments. At the same time, it continues to rationalize its portfolio of businesses to focus on- and invest in- those with the greatest opportunity for growth in revenue and earnings, while emphasizing return on investment. The company is now trading at just 12.3 times earnings and 6.2 times cash flow and its shares come with a 4.4% dividend yield.

**Huntington Bancshares (banking):** HBAN currently trades at 0.5x book value and 5.5x 2008 earnings. Current year earnings guidance was recently affirmed by company management during their second quarter earnings release. The stock price has been punished due to the bank's exposure to Franklin Credit, a subprime mortgage lender which Huntington inherited when they purchased Sky Financial in 2007. However, Huntington's exposure of \$1.5 billion has been reduced to \$1.1 billion following a \$400 million charge in the fourth quarter. Management has been pleased with the recent performance of Franklin Credit and took the loan off non-performing status in the second quarter. The bank operates in an economically challenged Ohio marketplace, but has seen signs of strength in Columbus and Cincinnati. Despite the difficult banking environment, Huntington was able to meaningfully grow their loan

portfolio in the second quarter and also generate sequential deposit growth. Most importantly, the bank is very well capitalized, with Tier 1 capital exceeding 9%, providing a nice cushion should the credit markets remain weak.

**Unilever (consumer staples):** Unilever is a global leader in both Food and Home and Personal Care, with global distribution and leading positions in many developing regions. Unilever has responded to the challenges of rising commodities prices and adverse foreign exchange rate

---

*“Current strains aside, the US equity markets have never been more attractive on many fronts.”*

---

movements with a restructuring program that has been successful in realizing significant cost savings, are on track to meet the full year goal of \$1.6 billion. Unilever's strong brands have enabled management to move decisively in taking pricing action to recover input cost inflation, as evidenced by the 50 basis points of underlying margin progression in the second quarter. Organic sales growth of 7% is well above the company's long term guided range of 3-5%. The company has made good progress with its program of disposing of lower-growth brands, such as the recently announced disposals of Bertolli and their North American laundry businesses, at good value for shareholders. At the same time, they have demonstrated with their recent purchase of Russian ice cream –maker Inmarko that they will add businesses which support strategic priorities. Russia had been identified as a priority market, and has continued to perform strongly, with underlying sales growth of over 17% in the most recent quarter. Despite Unilever's robust performance results, market uncertainty has driven the share price down over 20% this year. The shares trade at just 12.6 times this year's projected earnings, and offer a 3.7% dividend yield.

Market corrections are never pleasant, and this one has been particularly nasty. Current strains aside, the US equity markets have never been more attractive on many fronts. Within the value markets, security valuations and dividend yields have not been this attractive in many years. While the outlook on US and global economic growth remains murky, we are remain quite excited by the many opportunities we see today.



222 EAST ERIE STREET \* SUITE 500 \* MILWAUKEE, WISCONSIN 53202  
PHONE: 414-604-5200 \* FAX: 414-604-5201 \* OPTIQUECAPITAL.COM

The opinion and predictions expressed in this newsletter do not constitute any type of guarantee or warranty regarding market performance.

© Optique Capital Management, 2007