

# ACTIVE INVESTMENT MANAGEMENT: THE VALUE PROPOSITION

Widespread uncertainties continue to dominate the economic and market outlook. How high might taxes go? Will the current stimulus plan be enough? Have we stabilized the banking system? Can the Fed contain future inflationary pressures? While no one has the answers to these important questions, in our opinion, the current environment could not be better for active investment management. Investors no longer have the luxury of jumping aboard the rising P/E multiple train—that derailed years ago. Instead, we believe alpha will come the old fashioned way—through traditional stock picking. We believe our disciplined value philosophy positions us well for such an environment as we are confident that opportunities abound in numerous sectors and regions of the world.

As the chart below clearly illustrates, P/E multiples expanded beautifully in the 80's and 90's. Multiple expansion was certainly aided by technological advancements and general economic expansion. However, policymakers also effectively fought inflation, lowered taxes, and promoted less regulation. Too many people, from corporate directors to regulators to consumers, believed the volatile business cycle of the past had been tamed and accepted expanding risks with little fear.

The pendulum swing away from the laissez faire capitalism of the late twentieth century is in full motion. Higher taxes and greater regulation are the new market realities. Banks will be required to hold more

capital, and bank returns will, by definition, be depressed by the additional capital constraints. Healthcare reform continues to take shape, but at the very least HMO's will be hurt by sizable cuts to Medicare. Energy companies may not incur the windfall profits tax but most likely will be affected by some sort of climate legislation. Other sectors will most certainly face their own issues, but the punchline is this – why should stocks trade at a premium to their long term average of 16x trailing earnings given the aforementioned challenges? They won't. Also, the economic backdrop is equally weak in the context of enormous budget deficits and a consumer savings rate that should approach 10%.

Times have changed, and for the foreseeable future we simply won't need the 2nd homes and flat screen televisions that spurred economic growth over the last several years. This does not suggest that Armageddon is a foregone conclusion; in fact quite the opposite. Wise government spending on productivity-enhancing activities such as infrastructure and alternative energy will ultimately better our society and improve our wellbeing.

However, this takes time, and in the meantime investors will need proper security selection in order to generate meaningful returns.

We've positioned our portfolios to reflect the new environment of less leverage, more regulation, and depressed consumer spending. Several current holdings reflect the dominant themes that should drive superior



Source: Robert J. Shiller, Yale Department of Economics,  
Data based on average earnings from the previous 10 years

performance over the next few years. M&A activity will jump while the economy tries to find its footing. Companies will be challenged to generate meaningful organic growth while the economy is growing below its long term potential, thereby fostering growth through acquisition. Also, with financing for new deals mostly dead since last fall, the marketplace is likely to be flooded with pent-up demand for deals. We have positions in many companies that are likely to be the target of consolidation: niche businesses with strong market share, positive cash flow creation and minimal leverage.

A resurgent M&A market will clearly benefit well capitalized investment banks such as Goldman Sachs and JP Morgan. Not only is there less competition with Lehman and Bear Stearns gone and Merrill Lynch—now part of Bank of America—a shadow of its former self, Goldman and JP Morgan are in solid position to steal market share from struggling competitors such as Citigroup and Bank of America. This inevitable separation of market winners and losers will not benefit buyers of financial ETF's that must reflect the industry regardless of fundamentals. Similarly within banking, while the supermarket model has been severely tested in recent quarters, the financial conglomerate is far from dead. We believe that some of the rushed mergers provide compelling opportunities—as long as the acquisition stays within a company's core competencies. Wells Fargo, for example, is the premier banking franchise as no other institution cross-sells their products better than Wells. With the addition of Wachovia's branches, we expect Wells' to further enhance its position as the country's top bank.

Outside of financials, we expect the markets to reward companies with simple, well defined business plans. Time Warner, a current holding, is an excellent example. They've divested the cable business and are seeking strategic alternatives for AOL in order to focus on what it does best as a pure play content provider. Verizon Communications continues to simplify its business, as they recently sold their wireline businesses in 14 states in order to direct their efforts towards wireless and fiber-based wireline, two higher growth markets.

The commodity markets provide a final example of a great opportunity to add

alpha. Intelligent minds can disagree on the depth and duration of the current global recession, but we believe emerging markets provide a floor for energy demand. Our friends at International Strategy & Investment (ISI Group) have declared that "China's economic recovery is real, robust and V-shaped". In many respects, China is the price setter for commodities which favors an extended period of higher energy prices along with anemic increases in non-OPEC supply. Oil prices have diverged dramatically from the price of natural gas, to the point where oil now trades at 18 times the price of natural gas versus the long term average of 7 times. To leverage our expectation of a mean reverting pricing relationship, we own shares of natural gas focused exploration & production companies, including Apache, Anadarko Petroleum and Devon Energy.

A resurgent and confident China will not only impact commodities but drive demand for many imported components and finished goods to satisfy a thriving industrial complex and a growing middle class. While there are opportunities for direct Chinese equity investment, shares of companies with substantial export business to China offer long-term opportunities with a lesser degree of sovereign risk. For example, in South Korea, steel maker Posco and LCD maker LG Display have seen their respective sales to China nearly double over the past several years. Chinese growth and consumption is driving revenue and earnings growth for a wide range of companies from miner BHP Billiton in Australia to Canadian based fertilizer maker Potash and even to companies such as Fujifilm and Dai Nippon Printing in Japan.

The global economic and market downturn in 2008 has been painful indeed and a full recovery for many of the world's developed economies may be a few years away. Nonetheless, we see many investment opportunities to rebuild lost wealth. No doubt the current downturn is setting us up for another global bull market not unlike the 1980's and 1990's where valuation multiples exploded upward and passive management was difficult to beat. Until then, strategies focused on time-proven stock picking disciplines offer investors the best return options.

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