

WEDGEWATCH Q2

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The Bloody Crossroads

"Human beings have a seemingly fundamental tendency to compensate for lower risks in one area by taking greater risks in another."

–Malcolm Gladwell, author of *The Tipping Point*

As backdrop to the discussion that ensues, please consider the following lightly edited excerpt from Canadian professor Thomas Homer-Dixon's acclaimed, and still highly relevant, book *The Ingenuity Gap* (circa: 2000):

My first intuition that there could be something disturbing about the unfathomable complexity of our modern, human-made world came on a backpacking trip through Europe in 1977. I had stopped in Strasbourg, France, for several weeks, where I earned myself a small wage making kitchen cabinets and cooking meals for a local family. The father was a physicist. He worked at a nearby research laboratory that included a particle accelerator designed to pry open the deepest secrets of the atom. One sunny afternoon in August he took me on a tour of the facilities.

The Strasbourg machine seemed mammoth to me, stretching through room upon room filled with computers, wiring, tubing, and heavy magnets. I asked my physicist guide about one queer-looking component after another, and he tried to explain the machine's operation in simple terms. After an hour or so, however, a larger puzzle came to mind.

'Is there anybody,' I asked, 'who understands this thing in its entirety? Is there anyone who has expertise about all the components and who can put those individual bits of knowledge together into a truly complete understanding of the entire machine?'

'No,' the physicist answered, with a look that showed he thought the question a bit peculiar. 'No one understands this machine completely.' I felt some discomfort about this answer at the time, but didn't know exactly why.

More than twenty years later, as I gathered pieces of my ingenuity puzzle in North America, the reasons for my discomfort became clearer when a pair of [magazine] articles brought the issue into sharp focus. The Berkeley political scientist Steven Weber and the MIT economist Paul Krugman were discussing whether modern postindustrial economies had eliminated the business cycle.

In one of the articles, Weber argued that several developments in today's economies dampen the boom-bust swings of the business cycle. Our workforce is more flexible and less vulnerable to recession, he claimed. As well, new information technologies allow companies to better control their inventories, while globalization of finances, production, and economic demand makes the world economy less sensitive to economic conditions in any one country.

*At the time, the U.S. was in the midst of the longest peacetime economic expansion, so Weber's optimism seemed justified. Paul Krugman pointed out, however, that the business cycle had been declared dead before. In the late sixties, as America pumped up its economy with Vietnam War dollars, and shortly before the first major oil shock kicked off a decade of stagflation, a number of experts made claims similar to Weber's. 'Why does the business cycle persist?' Krugman asked. 'Because, as the bumper stickers don't quite say, stuff happens: the world refuses to stay put, and policy is always playing catch-up. **To look at the causes of booms and slumps since the business cycle was last declared dead is to be awed by the sheer variety of curve balls history throws at us.'***

Second Quarter 2010 Financial Statistics

DJIA: 9774.02

S&P 500: 1030.71

90-Day T-Bill: 0.17%

30-Yr. T-Bond: 3.89%

...Crossroads

*Paul Krugman's insightful comments, it seemed to me then, led to a more general conclusion. When things are going well, as they were for most people in the United States for most of the 1990s, it's easy to forget that we live in a world of **unknown unknowns**. Not only are we often ignorant of critical components, processes, and possibilities in the complex systems surrounding us, we're also often ignorant of our ignorance.*

The recent chain of events in the Gulf of Mexico is a very stark and painful reminder of society's increasing vulnerability to the (often unseen) weak links in advanced technology and/or human oversight. In a 1996 magazine essay that preceded his worldwide best seller *The Tipping Point*, Malcolm Gladwell struck a prescient chord when he cautioned that, "We have constructed a world in which potential for high-tech catastrophe is embedded in the fabric of day-to-day life." Echoing that same theme, though possibly a little late, several would-be Cassandra's, such as David Brooks of the *New York Times* (whose recent commentary from that publication follows), have surfaced to call attention to Gladwell's increasingly relevant and very important insight:

Over the past decades, we've come to depend on an ever-expanding array of intricate high-tech systems. These hardware and software systems are the guts of financial markets, energy exploration, space exploration, air travel, defense programs and modern production plants. These systems, which allow us to live as well as we do, are too complex for any single person to understand. Yet every day, individuals are asked to monitor the health of these networks, weigh the risks of system failure and take appropriate measures to reduce those risks. If there is anything we've learned, it is that humans are not great at measuring and responding to risk when placed in situations too complicated to understand.

Kiril Sokolof, author of the uniquely insightful *13D Research* newsletter, put it into even more graphic context, particularly for investors, when early last month he highlighted the risks associated with the modern world's burgeoning reliance on complex technologies: "Build a financial system governed by complex algorithms and opaque derivatives...drill for oil with multi-billion dollar robotic devices miles below the sea's surface...rely on continuous, secure data delivery on a system inherently vulnerable to hackers and malicious viruses...and you may as well put a bull's-eye on your back in the middle of a shooting range. **In a world that insists on placing blame, no investment is safe as complexity breakdowns form their own contagion and the consequent costs mount inexorably.**"

*"It's what you learn after you know it all that counts."
-John Wooden, legendary UCLA basketball coach (1910-2010)*

As professional investors reliant exclusively on publicly-traded securities, we at WEDGE are forced, like it or not, to deal with and to confront the complexities just highlighted. There is simply no way around it. Whether fully invested or fortuitously positioned with above-average cash balances, an unexpected exogenous shock to the markets can trigger a jarring absolute decline in the value of client portfolios on any given trading day (an uncomfortable consequence, no matter the circumstances, even if relative returns prove superior amidst such a sell-off).

So, given an increasingly complex and unstable world, **how can the institutional investor confidently adapt and survive amidst such a potentially treacherous backdrop?** Robert M. Maynard, Chief Investment Officer of the Public Employee Retirement System of Idaho, recently articulated a very lucid and highly applicable approach to such a challenge in a paper authored for the Brandes Institute, where he is a member of the Advisory Board, titled *Back to the Future: Conventional Investing in a Complex World*. With the Institute's permission, what follows, along with ample excerpts and quotations from Maynard's narrative, is our attempt to summarize several of his well-conceived work's key points:

In the early 1990s the life of the professional investor was relatively easy. "The guiding conventional investment philosophy was to have a portfolio that was simple" (relying primarily on the public markets), "transparent" (easy to understand and explain) "and focused" (concentrating extra efforts on a relatively small number of special strategies that would have material impacts on the portfolio). **"It favored implementing five to 10 basic portfolio initiatives that looked for extra return over five to 10 years, rather than 50 to 100 return strategies designed for the next five to 10 months or quarters."** In terms of risk control, it "relied primarily on the transparency of the portfolio as a whole and the clear nature of the relationship and behavior of its parts, and only secondarily on extensive quantitative risk models and systems. It avoided investment approaches that used significant leverage or non-transparent structures."

In the late 1990s and 2000s however, such a conventional approach, which, importantly, had served disciplined value investors well over multiple decades, came under attack. The resulting affronts to convention were, in large part, "based on the growing disparity between the long-term views of the capital markets and the shorter-term behavior of those markets." Typically, *five basic tenets underpinned the premise for a new approach to investing, "often described as the 'endowment model.'"*

As popularized by Yale and Harvard, "the endowment model is based on its own set of views. *First*, because the public market is extremely volatile, one should avoid that volatility by spreading out into other asset types that could be accessed effectively only through *intense active*

management, such as timber, private equity, commodities, and complicated (and often less transparent) fixed income (e.g., distressed debt and bank loans). *Second*, because the public market is inefficient, one can base a long-term investment approach primarily on intense active and opportunistic management, whether through hedge funds, the ‘search for alpha’ (e.g., portable alpha), extensions into shorting (market neutral, ‘130/30’ strategies, and the like), tactical asset allocation or global macro, use of leverage (either directly or through shorting), absolute return, or similar strategies. *Third*, because the market had become complex both in structure and in behavior, a complex investment organization and strategy was needed and one should let ‘a hundred flowers bloom’ (or a thousand) in the hopes that there would be more gains than losses, and the portfolio as a whole could thereby consistently beat the market. *Finally*, as an outgrowth, there was the notion that if some diversification was good, then a lot of diversification was better – that diversification into dozens of often illiquid investment opportunities and into dozens or hundreds of active management bets was the hallmark of sophisticated organization.”

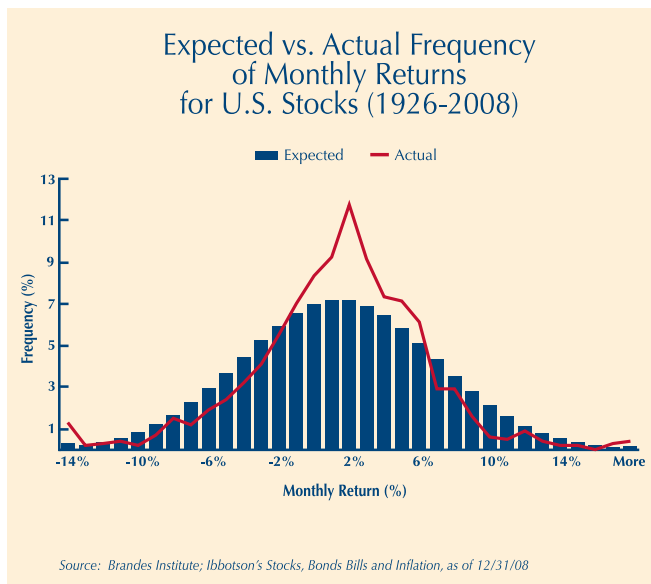
Although the premise for such an approach seemed to have merit, “the conclusions were wrong – often disastrously so. The events of 2008-2009 showed that both theoretically and practically the endowment model” had seriously “failed its first” major “stress test.” In fact, amidst the extreme market volatility of that time frame, with the general exception of cash, “there was no place to hide, and *many places where the new model took shelter turned out to be stunningly worse*. The shorter-term capital markets are inefficient – but it turns out that they are even more unpredictable than assumed by the standard model, and active management (as it’s practiced under the endowment model) faces even higher hurdles than previously imagined. Typically, **liquidity is overvalued – but as many endowments found out in 2008-2009, it becomes a pearl without price and invaluable when it generally disappears in a crisis.**”

“The capital markets are a complex, interactive, tightly coupled, and adaptive world, but the best response is not automatically a complex, tightly organized, and highly opportunistic investment structure. That type of organization is often brittle, prone to cascading failure, at best opaque to risk management, and has liquidity, headline, resource, and continuity risks.” To the contrary, “a simple and robust structure” can help increase the odds of survival over the long-term while also enhancing transparency and liquidity. “Even in a non-efficient, complex, non-linear, and turbulent market world, the best response still lies in a simple, transparent, and focused (but still diversified) portfolio – both for long-term returns and for purposes of real risk control. **The cockroach lives in a very, very complex environment with one of the best long-term success rates of any creature. Yet it has only one defense mechanism – running in the opposite direction of a puff of air.** *The equivalent for the investment world is, at the core, a very simple structure founded upon public market diversification with one basic defense mechanism: see a volatile movement, and react in*

the opposite direction (i.e., rebalance into it). A simple structure and strategy, if adhered to, has one of the best chances of surviving for many decades.”

For investors in publicly-traded securities, it is important to understand the inherent nature of U.S. stocks and thus the likely impact on long-term returns. “Much of the mathematics of the investment world is based on the idea of ‘normal randomness,’ where returns and actions are based on identical and independent activities (like coin tossing). The world on a month-to-month basis, however, is not ‘normal.’ Actual market returns have been both wilder and milder than standard theory predicts when looked at on a monthly (and shorter) basis. A histogram of the actual monthly returns compared to what would be expected for ‘normal,’ randomly distributed monthly returns is shown in” **Chart 1**.

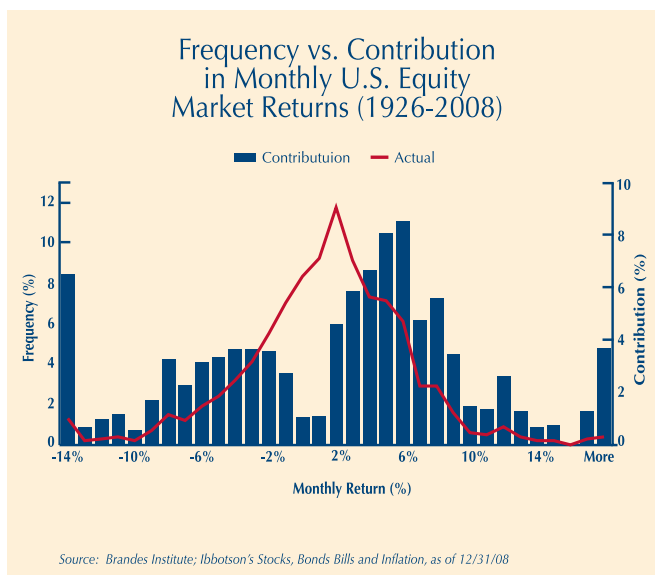
Chart 1



“First, there are ‘fat tails’ – meaning that there exist periods of very high volatility that are much worse (or much better) than would be expected. Note the upticks at each edge of” **Chart 1**. These ‘fat tail’ events are not very numerous, but produce “far more turbulent periods of extreme returns than are expected under normal random market theory. **The extreme movements, while relatively rare, are responsible for” (and contribute to) “much of the total market return.”** More specifically, per **Chart 2**, “over 10% of market movements came in only 1% of the months and over 40% of the market ‘action’ came in 13% of the market months (stock market movements of plus or minus 10%).” In addition, it’s important to note that “the daily behavior of the stock market volatility index (the VIX) over the past three decades exhibits periods of calm (e.g., 1991-1996, 2003-2006) punctuated by explosions of intense volatility.”

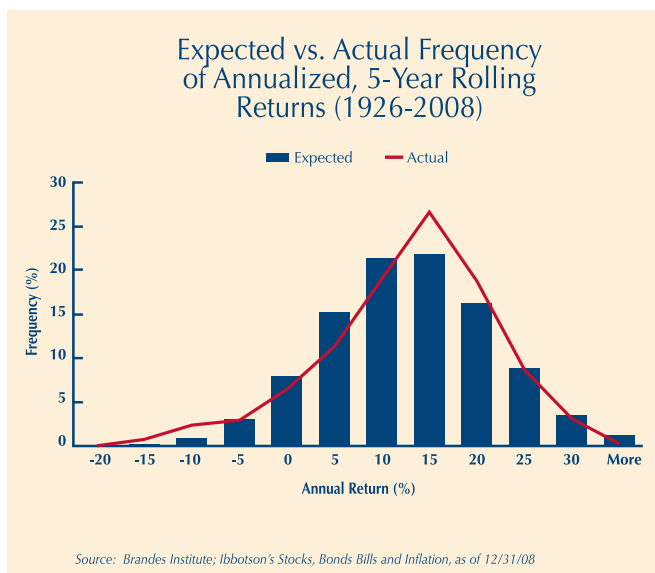
Despite the daily noise and machinations of the markets, **the long term is ultimately of greatest relevance to investors.** “**The impact of turbulent market behavior fades as the years pass and time horizons lengthen,** and” structuring “portfolios for returns over 5-10 year periods can” generally

Chart 2



utilize “tools based on the standard theory that have been created over the past 40 years. For example, *annualized 5-year rolling stock returns show a sharp reduction in the ‘fat tails’ and high peaks, and exhibit behavior much more consistent with the assumption of normal randomness.*” See Chart 3.

Chart 3



“One can” choose to “construct a portfolio with the basic goal of squeezing extra marginal returns out of calm, trending periods (‘picking up nickels’), or one can structure a portfolio with the basic goal of surviving shorter turbulent times in order to reach calmer 10+ year time frames.” However, “*it is difficult, if not impossible, to have both goals at once.*” The endowment model squeezes out extra marginal return at the risk of courting disaster in periods of high turbulence. A conventional approach prefers the goal of simply staying in the game during calm times in return for much higher chances of survival and avoiding disasters during the wild and turbulent times.” In addition, “*a conventional approach*

can hit ‘home runs’ that the endowment model will miss, particularly when large-capitalization equities have one of their periodic runs of substantial outperformance over other investment categories.”

“What happened is that all our elites failed us, especially academic elites. Faulty risk control mechanisms were taught in business schools and eventually law schools adopted the belief that everything is based on a Gaussian (normal) distribution. This turned out to be very wrong.”

–Charlie Munger, Vice-Chairman of Berkshire Hathaway speaking to investors in early May 2010

Continuity should not be underestimated as a performance-impacting factor as well. “*A key ingredient for investment success is maintaining a consistent investment focus through changing times.* On the other hand, investment disasters regularly occur because of an inability to maintain overall investment focus, the lack of a mechanism to monitor the ongoing long-term success or failure of particular investment postures, and, of special note, the inability to maintain those postures over time. In the short-term, **these deficiencies often show up as a failure to maintain a consistent investment approach through an entire investment cycle. Often, strategies are abandoned after a poor period – just at the point they are about to become successful.**” The converse is true as well.

“The problem is exacerbated in the public sector with rapidly changing boards and the short terms of the investment leadership of the typical organization. The average tenure of a public fund chief investment officer (CIO) is three to five years, which is also the average term of a public fund board member. **This type of turnover at the board and high staff level makes it very, very difficult to maintain a consistent approach and investment philosophy through even one investment cycle (5-7 years), much less the ‘long-term’ of 20 to 30 years** so often bandied about as the investment time horizon of public funds.” It is also important to note that “the more complex and complicated the investment program, the harder it becomes to maintain a consistent approach.”

Tactics matter as well. In order to gain the benefits of diversification, the ability to rebalance in the face of market turmoil is absolutely critical. “Rebalancing benefits increase as volatility rises, and decrease in less volatile times.” For example, “the benefit of rebalancing after a 10%” decline “is more than 10 times the benefit after a 1%” contraction, “and the benefit from rebalancing after a 50% move” down “is more than five times the benefit after a 10%” retreat. “The greatest benefit comes in times, like 2008-2009, when there are wild movements in portfolios.” That said, **the ability to rebalance must first exist before any benefits from it being put into action can accrue.** In the case of the endowment model, heavy exposure to private assets can markedly limit the ability to rebalance “as volatility rises.” At the stock market trough in March 2009, numerous institutions applying the endowment model found that they could not rebalance

sufficiently because they were frozen into existing position by the illiquidity of their assets." Needless to say, this proved a material constraint and setback at a time of great opportunity.

We'll close now with an insight that could prove significant (especially on a go-forward basis). "The 'heyday' of intense active management over the past 10 years" (through 12-31-09), arguably the golden age of the endowment model, "has corresponded to a period when the S&P 500 has been one of the relatively worst capital markets in the world." During that same time frame, however, small cap stocks, investment grade bonds and emerging market equities, among others, all materially outperformed that broad-based large cap index. In fact, **"any strategy that underweighted large**

capitalization U.S. stocks, whether sophisticated or not, would have done well in the past decade" (again through year-end 2009). "It is not clear," however, "that large capitalization underperformance can be counted upon in the future. The widespread adoption of alternative investment approaches has yet to face an S&P 500 dominated capital market" like that which transpired for much of the 1990s. Although investors are surely thankful for the sizeable market rebound since the March 2009 lows (and the relative respite from extreme turmoil), **it is only a matter of time before investors once again confront the bloody crossroads where complexity meets human psychology and misjudgment. The question, as always, is when?** Good luck.

Index	6/30/10 Price	2nd Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	9774.02	-10.0%	-6.3%
S&P 500	1030.71	-11.9	-7.6
Value Line Composite	295.82	-11.6	-4.3
American Exchange Comp.	1795.63	-5.8	-1.6
NASDAQ Composite	2109.24	-12.0	-7.0

*Does not include dividend income.

Altered States

As we have done in the past, we are borrowing our caption from the film industry. In the like-titled 1980 science fiction thriller, abnormal psychology professor Edward Jessup begins exploring altered states of consciousness by using sensory-deprivation in an isolation tank. He enhances his self-experiments by ingesting a derivative of a vine root he obtained on a visit to a Mexican Indian tribe. In one bizarre experiment, he emerges from the isolation tank biologically transformed, back to a supposedly smaller, less-evolved form.

Perhaps many elected officials in a number of U.S. states, like Dr. Jessup, have experienced their own political version of “sensory deprivation in an isolation tank.” For years, a favorable economic backdrop and sanguine credit markets shielded the true cost of their present and future spending plans from the focus of the electorate. **This is particularly true when we examine the huge unfunded liabilities (UL) of pensions and other post-employment benefits (OPEB), particularly retiree health care costs.** In the aftermath of the severe economic recession, reality is setting in as states and municipalities struggle to make ends meet.

Here at WEDGE, we have been crunching some numbers for each of the 50 states. Most of our data comes from the Pew Center for the States, the U.S. Census Bureau, and the Bureau of Economic Analysis. Unfortunately, the data is primarily from fiscal year 2008, so the numbers relating to unfunded liabilities are understated. *We simply wanted to know what the burden of existing debt plus unfunded pension and OPEB liabilities was in relation to Gross State Product.* After calculating this for each state, we ranked them from highest to lowest to get a sense for which states might be the most burdened, and **possibly** more subject to spending reductions, tax increases and/or reduction in credit ratings. We admit this measure may be somewhat crude and has its limitations, but it is a logical approach on which to compare various states.

So without further ado, here are the 10 most-burdened states:

Debt + UL + OPEB as a % of GSP	Rank (1 = Most Burdened)	State
34.44%	1	Hawaii
32.87%	2	New Jersey
32.12%	3	Connecticut
29.78%	4	Massachusetts
29.67%	5	Rhode Island
29.32%	6	Alaska
28.29%	7	West Virginia
25.00%	8	Maine
24.11%	9	Illinois
23.14%	10	Kentucky

Noticeably absent from the list are two states that tend to show up in the news quite often relating to budgetary pressures – New York and California. By our rankings, these fall out more or less in the middle of the pack. It will be interesting to watch New Jersey, second on our list, as newly-elected Governor Christie attempts to quickly improve the state’s fiscal position through draconian (and unpopular) cost cutting, etc.

We intend to keep a close eye on all of the states’ measures, and update our list as new data become available. **One thing seems certain however, from a fiscal and budgetary perspective there may be many “altered states” in the future, with numerous programs likely pared back to a smaller, less-evolved form.**

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