

WEDGE WATCH

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Blindsided

“When I played pro football, I never set out to hurt anyone deliberately – unless it was, you know, a league game or something.”

–Dick Butkus, Hall of Fame Linebacker for the Chicago Bears (1965-1973)

“From the snap of the ball to *the snap of the first bone* is closer to four seconds than five. One Mississippi: The quarterback turns and hands the ball to his running back. He watches him run two steps forward, turn, and flip the ball back to him. It’s what most people know as a “flea-flicker.” Two Mississippi: The quarterback searches for a receiver but instead sees the *middle* linebacker coming straight at him. It’s a running down – the start of the second quarter, first and 10 at midfield, with the score tied 7-7 – and the linebacker has been so completely suckered by the fake that he’s deep in the opposing team’s backfield. He thinks he’s come to tackle the running back but he is long gone, so the defender just keeps running toward the quarterback. Three Mississippi: The linebacker now sees that the quarterback has the ball. The quarterback, in turn, notices the linebacker coming straight at him, and so he has time to avoid him. He steps up and to the side and the defender flies right by and out of the play. The play is now 3.5 seconds old. Until this moment it has been defined by what the quarterback can see. *Now it – and he – is at the mercy of what he can’t see.*”

“Four Mississippi: The *outside* linebacker is coming. From the snap of the ball the quarterback has lost sight of him. He doesn’t see him carving a wide circle behind his back; he doesn’t see him outrun his blocker upfield and then turn back down; and he doesn’t see the blocker diving, frantically, at the opposing player’s ankles. He doesn’t see the linebacker leap, both arms over his head, and fill the sky behind him. The quarterback prides himself on his ability to stand in the pocket and disregard his fear. He thinks this quality is a prerequisite in a successful NFL quarterback. ‘When a quarterback looks at the rush,’ he says, ‘his career is over.’ He has played in 163 straight games, a record for the franchise. He’s led the team to two Super Bowls, and won one. He’s thirty-six years old. He’s certain he still has a few good years left in him. *He’s wrong. He has less than half a second.*”

Joe Theisman, subject of the preceding passage from the best-selling book *The Blindsided: Evolution of A Game*, was all too aware of the risk. *He just didn’t see it coming.* His career with the Washington Redskins was prematurely snuffed out the moment that near half-second passed when he was violently **blindsided** into a pile of arms and legs. Ironically, he and his coaches and his teammates had not only played against that day’s opponent in the past, they had studied untold hours of game film in preparation. The goal was to craft a plan to stymie the “force of nature” that was New York Giant All-Pro outside linebacker Lawrence Taylor. Unfortunately, those efforts proved cataclysmically futile (at least for Theisman, who suffered career-ending compound fractures of the tibia and fibula).

Investors, like NFL quarterbacks, ignore risk at their own peril. Sometimes, however, the promise of “easy money” is just too seductive. Raw greed has been known to trump fear, if not logic. *Human nature, after all, is a constant.* That said, like pro quarterbacks, investors would certainly benefit from, and eagerly

Third Quarter 2007 Financial Statistics

DJIA: 13895.63

S&P 500: 1526.75

90-Day T-Bill: 3.80%

30-Yr. T-Bond: 4.84%

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Blindsided

welcome, a reliable early warning system that could safely steer them away from danger. Though investors know all too well that prophetic capital markets signals are, by their nature, difficult to discern, *knowing where to look (or who to listen to) can create a real advantage in successfully navigating away from the proverbial “jagged edge” of Wall Street’s shoreline.*

Case in point: In recent years, a prominent Yale academician, who is arguably the preeminent authority on the two subjects about to be discussed, **presciently sounded the alarm on two different occasions (2000 and 2005) regarding bubbles he believed were of relatively enormous magnitude.** Robert Shiller, a highly-regarded economist and professor specializing in behavioral economics and finance, wrote the best-selling book *Irrational Exuberance*, which was fortuitously released just days before the NASDAQ (dot.com) bubble reached its deadly peak in March of 2000. In it, he warned of a psychologically manifested bubble in the U.S. equity markets (with a special focus on the internet- and technology-dominated NASDAQ). The rest of the story, of course, has been well-documented, though it’s worth a reminder that *the dizzying descent from the peak ultimately vaporized 78% of the NASDAQ’s value over the next 31 months.*

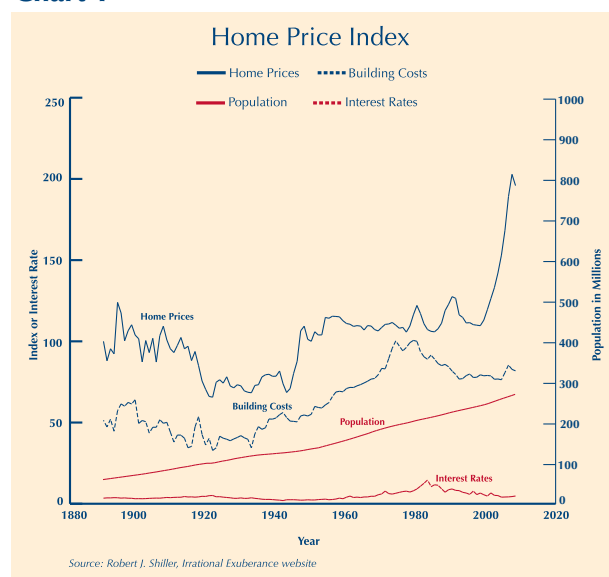
Shiller’s warning on equity valuations was remarkably spot-on. Like the stock market, however, which some believe is nothing more than a pure *random walk*, maybe Shiller’s near-perfect timing was simply that one-in-a-million event - nothing more than blind luck. That’s certainly a possibility, but consider this: *In 2005 he released an updated edition of the book which incorporated new research on what he deemed another emerging bubble, the U.S. housing market.*

Commonly held perceptions often don’t match up with reality. Investors, in both equities and residential real estate, tend to over-extrapolate recent trends (and often to their detriment). This, of course, is human nature; a predictable though inherently difficult-to-avoid error in judgment that has been repeated time and again through the ages. According to Shiller’s proprietary database, *“the real return on residential real estate in the United States from 1890 to 2004 was a modest 0.4% per annum.” Of particular note, “absent two brief periods over that time frame (after WWII and post 1997), real home prices overall have been mostly flat or declining.”* Contrary to common perception then,

residential real estate has not been a blow-the-doors-off investment over time. **It’s only in recent years that we’ve seen relatively dramatic real home price appreciation in many key markets around the country** (such as Los Angeles, New York City and Boston), **and around the globe** (e.g., London, Paris and Sydney).

Chart 1 from *Irrational Exuberance* graphically highlights the U.S. history. “Real home prices were generally declining from 1890 to 1940 although numerous *local* land bubbles surrounding the building of highways, canals and railroads transpired during that time frame.” Since then, *regional* real estate bubbles have evolved in numerous markets (on occasion), especially in what Shiller refers to as “the glamour cites” on both coasts.

Chart 1



However, he believes his data show the most recent boom to be more national than regional, to be unique in its pervasiveness, and to be of *unprecedented* proportion. Although home prices moved up meaningfully following World War II, there were real *structural* reasons underpinning that price appreciation. As highlighted in Shiller’s book, “government restrictions had severely limited the supply of new homes” during the war, setting the table perfectly for future price gains, especially in light of the Baby Boom following the *armistice*. Further stoking the scramble for housing then was “the GI Bill, which introduced subsidization of home purchases for seventeen million people.” Despite this demand backdrop, however, “there was no buying panic.” According to Shiller, via his extensive review of newspapers and magazines from the era, the general public was confident that a

surge in supply would catch up with demand and temper price gains. In respect to the former, they proved correct, as supply did eventually catch up, though prices (as previously noted) escalated well above the long-term average.

The U.S. real estate price boom that began gaining serious traction around 1998 looks much different than that which occurred following the Second World War. Although many supposedly plausible rationales have been floated in recent years, Shiller postulates that the same unbridled thirst for profit (and fear of being left behind) that drove NASDAQ stocks into the stratosphere in the late 1990's was, to a large degree, responsible for the residential price surge he believes peaked during the first half of 2006. To put it into more precise perspective, according to the *S&P/Case-Shiller National Home Price Index*, real home prices in the U.S. rose a remarkable 86% from the bottom in late 1996 to the peak 9.25 years later in the first quarter of 2006.

Unlike the structural supply shock that preceded the post-WWII housing surge cited earlier, *the post-2000 home price gusher was largely devoid of such structural imbalances* (e.g., construction costs were not the culprit, contrary to common opinion, as they have actually fallen, adjusted for inflation, since 1980). The monetary backdrop was, of course, uniquely conducive to home price speculation as Greenspan & Company pushed the fed funds rate down to 1% in 2003, an unprecedented level of easy money. However, there were other, potentially more important, factors at work. Rising home prices had begun to capture the imagination of homeowners and the news media alike. (This is a typical combustible mix that can ignite a bubble.) Unbeknownst to most of them, however, *the seeds of the cycle's next demise were already being sown far and wide.*

Students of economics know that excess profits attract competition and, in the case of real estate, that means new *supply*. According to a recent study by Professor Shiller (*Historic Turning Points in Real Estate* – June 2007), “residential investment as a share of U.S. GDP had risen to 6.2% by early 2006, the highest level since 1950,” which itself was an aberrantly high year triggered by the pent-up demand and post-war subsidies cited previously. By early 2006, however, real estate owners/investors were principally focused on the *uniqueness* of the particular market(s) where they

owned property (as opposed to the supply imbalance to come). At the same time, builders were aggressively stepping up to meet demand *in response to home prices that were historically elevated relative to construction costs* (the ever seductive lure of excess/abnormal profits).

This psychological phenomenon, which Shiller calls “uniqueness bias,” had apparently become quite pervasive by early 2006. A compelling anecdote illustrates the mindset at the time. In 2005, likely sensing the extreme nature of the bubble, *Berkshire Hathaway's* Warren Buffett shrewdly sold his long-time Laguna Beach vacation home (the same day he listed it) for a price that, according to him, valued the underlying land at the equivalent of an astronomical \$60 million per acre! How's that for a “bell ringer?” Shiller, not surprisingly, echoes this anecdotal *red flag* by stating that “**the boom of the 2000s appears to be much bigger than any that preceded it.**” He attributes it to *new-world-order thinking*; emerging recognition of the “growing world economy, which was producing greater affluence, and, with it, a rising tide of new capitalists who may forever outbid ordinary people hoping to own a home.” That (type of) story invites a boom that spreads everywhere—at least to any place where there is a sense of uniqueness (such as Laguna Beach perhaps?).

“If money is easy and cheap, there will be a lot of speculation. However, when the lenders are gone and the sellers sell, prices decline.”

–Warren Buffett (responding to a question on his outlook for residential real estate in May of 2005)

The concept of national bubbles, at least in terms of real estate prices, did not breach the collective consciousness of the masses until the “last decades of the twentieth century,” according to Shiller. His research shows that from 1890 to the late 1980s there was relatively little public discussion of home prices. More specifically, a microfilm newspaper search going all the way back to 1740, and a Lexis-Nexis search from the 1970s, shows that the terms *housing bubble* and *home bubble* were quite uncommon until just after the 1987 stock market crash (a time when bubbles were increasingly a topic of conversation worldwide). However, those terms died out soon after 1987 only to reappear in the late 1990's when their use subsequently took off dramatically.

Why should we be concerned with bubbles, real estate or otherwise? As dedicated students of capital markets history, we are ever mindful of the persistency of **mean-reversion** and the eventual carnage which can ensue when valuation adjustments are precipitated from irrational price levels. *Although there are increasing anecdotal signs, even beyond the subprime debacle, that the price fever in residential real estate has broken* (e.g., existing home sales down 17% from the 2005 peak, home prices down over 3% since 2Q06, the biggest decline since 1991), *investors and homeowners are likely still in denial* given the rapid (and in some cases dramatic) appreciation experienced in recent years. Dreams do die hard after all, especially when money is involved.

From our perspective, *it seems reasonable to conclude that we may have lived through two of the most significant bubbles in stock and real estate market history, and all within less than a decade of each other!* A truly remarkable phenomenon which, if true, should prompt investors to carefully consider its future implications in regard to domestic economic growth and, more importantly, future returns across the asset class spectrum. As Shiller pointed out in his late August speech at the annual Federal Reserve symposium in Jackson Hole, Wyoming, “Residential investment (which represents essentially all economic activity directly related to housing) is a volatile component of U.S. GDP and has had a highly significant relation to the business cycle.” More specifically, “it has gone through cycles that correspond closely to the nine recessions since 1950.” In fact, *“residential investment as a percent of GDP has had a prominent peak before almost every recession since 1950, with a lead varying from months to years.”* Given this historical backdrop and taking into consideration the unprecedented and anomalous nature of the still-evolving housing cycle, it seems plausible to assume, at a minimum, that a significant headwind for the economy may persist for some time.

In addressing the impact future housing price declines might have on the economy, Shiller took an even more pessimistic view in the same speech by stating that “there is a high probability of steady and substantial *real* home price declines extending over many years to come.” This is what he likes to call the “unavoidable truth” that ***“every housing boom of the last few centuries has been followed by several decades in which home values fell relative to inflation.”*** He has

quantified such statements in the past by citing his extensive study of prior housing cycles, which “indicate that major declines in real home prices—even 50% declines in some places—are entirely possible.” Although during the last cycle in the U.S., real home prices fell only 15% from the peak (3Q89 to 4Q96), some cities’ real prices, both here and abroad, fell substantially more. For example, “Los Angeles real home prices fell 42% from the December 1989 peak to the trough in March 1997. Real home prices in London fell 47% from the third quarter of 1988 to the fourth quarter of 1995.” Shiller states his bottom line cautionary perspective this way: *“Since the number of cities involved in the recent boom is so much higher than the last boom, we could see much more than the 15% real drop in national home price indices that we saw last time.”*

If Shiller’s analysis proves in the ballpark, then *construction spending* will pale in comparison to recent years, likely leading to a much slower growth economy. This is exactly what happened in Japan in the aftermath of their spectacular home price boom which peaked in 1990. There, according to Shiller, “urban *land* prices in large city areas declined for 15 years, until prices ultimately fell 65% by 2005.” Despite these alarming numbers, however, it’s important to remember that “even a 50% real decline in U.S. home prices over the next decade (though quite painful) may be less than catastrophic. Such a decline, on a nominal basis, would likely imply only a 20 to 25% cumulative decline (which would work out to about an average of 2% per annum over that time frame). Inflation, of course, would account for the remainder of the real decline.”

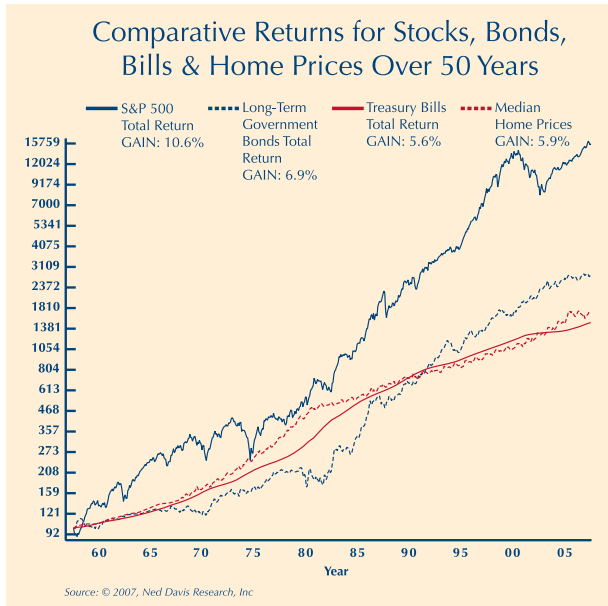
The alarming numbers just cited are, of course, far from certain outcomes here in the U.S. However, no matter the ultimate magnitude of the on-going housing downturn, there will likely be some severe collateral damage as a result (beyond what we’ve already seen). Given our very rough assessment of the probabilities, it seems reasonable to assume the Fed will, as a result, remain quite accommodative for some time. That leads to the next logical question: *what’s the silver lining* of such a backdrop? We believe a housing-constrained slow-growth economy, supported by a relatively easy money Fed, **should lead to solid total returns for blue chip stocks, driven, at the margin, by substantive expansion in price/earnings multiples** (Chart 2, on the next page, *shows, despite the post-2000 housing spike, the superior long-term returns for equities vs. housing*).

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Chart 2



From where we sit, it appears there is still substantial excess liquidity around the globe, and history shows that such liquidity tends to chase the inflating asset. If a meaningful and sustained rally in blue chips eventually begins to unfold (which seems a relatively high probability), the pundits will, in all likelihood, begin, once again, to extol the virtues of *earnings, cash flow, dividends and underleveraged balance sheets* - a rather quaint concept, at least to some, but one that is certainly long *overdue*, in our opinion. In the meantime, *it might be wise to sit up and take careful notice if Robert Shiller sounds a warning about another asset class bubble; unless, like the Washington Redskins' Joe Theisman, you're willing to risk getting blindsided.* Good luck.

Index	09/30/07 Price	3rd Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	13895.63	3.6%	11.5%
S&P 500	1526.75	1.6	7.6
Value Line Composite	472.87	-4.2	3.3
American Exchange Comp.	2410.19	2.3	17.2
NASDAQ Composite	2701.50	3.8	11.8

*Does not include dividend income.

Fixed Income

The Evolving Credit Cycle and Risk vs Reward

It is no secret that we have been concerned, for some time, about the credit excesses that have only recently become apparent in certain segments of the fixed income markets. We have repeatedly lamented the narrowness of credit spreads and low levels of volatility **relative to historical experience**. Now that the market has begun to re-price these risks, what sectors offer the best risk/reward trade-offs? Do spreads now adequately reflect risks, or is there more re-pricing to come? Has the recent Federal Reserve action raised the "all clear" sign to reload on risk taking?

At WEDGE, we endeavor to take a longer term view of credit and interest rate cycles, and allow history to guide us in forming portfolio strategies. Of course, history is never a perfect guide, but it can give important clues as to how relationships between (and among) certain variables have behaved in the past.

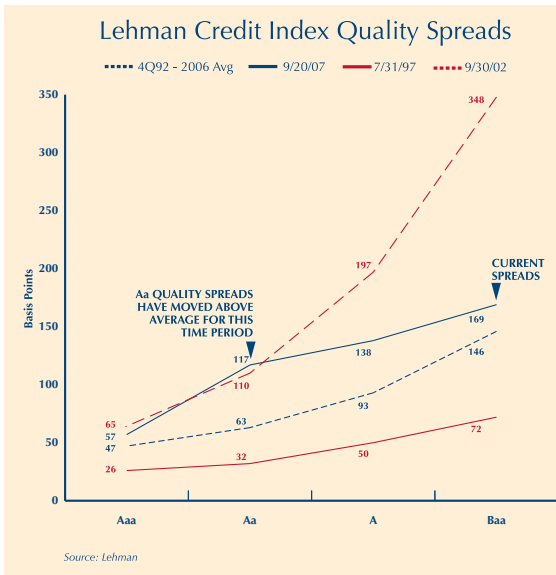
Chart 3 shows snapshots of quality spreads for the Lehman Credit Index at various points in time over the last 15 years. As boundaries, we have included the widest (9/30/2002) and the narrowest (7/31/1997) level

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Chart 3



of spreads. For another marker, we have included the **average** spread levels for the time period covered. Lastly, we included the current spread levels for each rating category. *What is fascinating to us is that the Aa rating category has widened dramatically in recent months, and is now wider than the prior widens for the time period!*

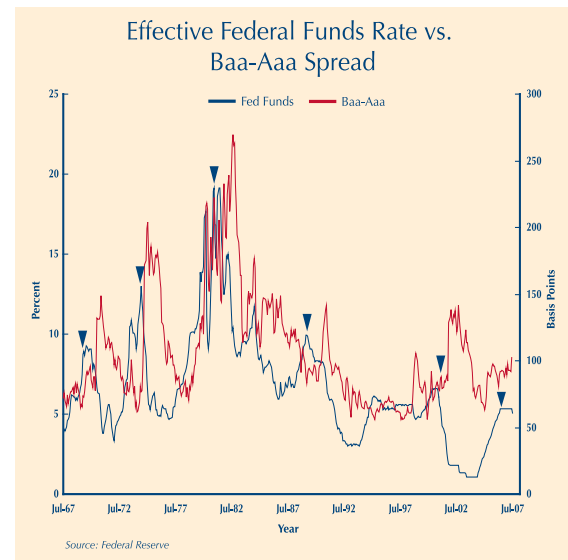
Of course, a great deal of this spread widening has been driven by the spillover effects of the subprime lending crisis to the banking, brokerage and financial institutions sector. Many companies in this space carry Aa ratings. What is important is that in the recent spread widening episode, *many Aa-rated industrial companies were indiscriminately painted with the same brush* (a normal occurrence during a flight to quality period). This allowed us to add to certain corporate and taxable municipal positions at what we deemed very attractive prices.

What about moving down the credit spectrum, given that spread widening has occurred there as well? We are cautious of taking on more credit risk at this time for several reasons. Referring again to **Chart 3**, the current spread relationship between

the Baa category and higher-rated sectors does not appear to justify the incremental risk. For example, the current spread between the Baa and Aa categories is only 52 basis points, while the historical average is approximately 83 basis points.

Another important reason that it may be imprudent to move down in credit quality at this time is revealed in **Chart 4**. We have plotted the effective *federal funds rate* against the spread between Moody's Baa and Aaa corporate bond yields. Notice that, generally speaking, the *federal funds rate* tends to peak a number of months before the Baa-Aaa spread. Therefore, if we have just witnessed the near-term peak in the *federal funds rate*, **history would suggest that Baa corporate yields are currently insufficient relative to Aaa corporates.**

Chart 4



To summarize, it appears that some higher quality (Aa-rated) corporate and taxable municipal bonds represent good value relative to comparable-maturity Treasuries in the current market environment. However, it is probably too early to move down the credit spectrum, given current and historic relative valuations.

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