

WEDGE WATCH

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Signal Fires – Letting Nature Take Its Course

“In the early days we were close to nature. We judged time, weather conditions, and many things by the elements – the good earth, the blue sky, the flying of geese, and the changing winds. We looked to these for guidance and answers. Today we are again evaluating the changing winds. May we be strong in spirit and equal to our Fathers of another day in reading the signs accurately and interpreting them wisely.”

– Native American (various attributions)

As a wetter than average spring gave way to summer, a severe drought had begun to set in across the region. With it came early summer thunderstorms that produced lightning without rain. Beyond that, however, nothing seemed abnormal. Eleven of 20 early-season forest fires burned themselves out while the rest raised no unusual concerns. However, by the third week of July, the increasingly dry conditions helped set in motion forces that would ultimately trigger a conflagration unlike any known in the region before or since. Over the next several weeks of that unforgettable summer, massive fires in and around the treasure that is Yellowstone National Park would dominate the television news. As the nation watched in horror, over a million acres surrounding Old Faithful, and its sister geysers, were engulfed in flames in what was thought to be a tragedy of epic proportion. Despite the courageous and often heroic efforts of over 25,000 firefighters, at a total cost estimated in excess of \$125 million, the fires ultimately blackened a staggering 1.2 million acres. Thankfully though, they did manage to save the iconic Old Faithful Inn along with some other important structures. Within the confines of Yellowstone itself, nearly 800,000 acres (about 36% of the park’s total) were burned. In the end, the largest fire-fighting effort in our nation’s history was no match for Mother Nature. It was not until the first snows of autumn, around mid-September, that the flames began to dampen; though they would not be fully extinguished for another two months when winter snow finally blanketed the region.

Although wildfires are quite common across forested regions of the western U.S., it took a rather unique confluence of events to trigger *The Great Yellowstone Fire of 1988*. The forests in the high country of that region are dominated by the lodgepole pine, which grow in uninterrupted dense stands of “various vintages.” At the time of the 1988 fires, a large majority of the lodgepole pine forests in Yellowstone were between 200 and 250 years old and, therefore, nearing the end of their life cycle. In addition, the mountain pine beetle scourge had killed many trees there over the prior 20-plus years, creating a dense laddered structure of fuels to feed the fires. Providing an additional spark, excessive rainfall over the preceding five years had severely tempered the normal course of summer wildfires necessary to prevent excessive accumulation of undergrowth and old timber. *Underpinning these unique factors, however, was something even more significant.*

Over a period of nearly four decades following the Great Depression, the National Park Service’s stated policy in Yellowstone was to **proactively intervene** in an effort to quickly snuff out fires (hence the advent of Smokey the Bear), *believing the health of the ecosystem would be preserved as a result*. Preceding that initiative, the U.S. Army had implemented a similar policy in the region back in 1886, which remained operative for the next 100 years. Unfortunately, *over time, those policies made the forests there more flammable, more dangerous and much more difficult to protect, not easier*. As with the implementation of many well-meaning policies over the course of civilized history, this *misguided approach* helped sow the seeds of future disaster (via the [law of unintended consequences](#)). As a result, with the passage of time, a monumental *day of reckoning* would prove inevitable.

Fourth Quarter 2008 Financial Statistics

DJIA: 8776.39

S&P 500: 903.25

90-Day T-Bill: 0.08%

30-Yr. T-Bond: 2.68%

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...Course

Like the century-old wildfire fighting policy that was a precursor to the Yellowstone fire, the recent period of *financial meltdown* across virtually every asset class was, in part, the inevitable result of self-inflicted policy wounds. Case in point: since peaking in the early 1980s, the personal savings rate in the U.S. proceeded to decline materially over the subsequent two and a half decades (all the way to zero), stoked by an increasingly reckless propensity to spend and consume. This fiscal breakdown was, in its final and most dramatic stage, 2003 to 2007, driven by the unprecedented appreciation of residential real estate, and the associated gross liberalization of lending standards. In time, these trends would help trigger a near cataclysmic fissure in the global financial system. However, it was actually a more “top-down” decision which may better explain the financial conflagration we have recently witnessed.

Over the eighteen years following the commencement of the longest bull market on record (inception date August 1982), equity investors grew to worship at the altar of the Federal Reserve. The middle of that same year saw the beginning of Fed Chairman Paul Volcker’s now legendary 1979 to 1982 “blunt force” tightening of the money supply. This policy was aimed at forcefully breaking the back of a savage inflationary spiral. From then on, interest rates began a remarkable and sustained decline that would last well over two decades. *During that time, equities, which in the early 1980s had reached historically low valuation levels, would become a universally popular asset class.* As years and decades passed, investors increasingly adopted a near “blind faith” in the power of the Fed. A faith that was rewarded time and again by holding fast and/or accumulating stocks whenever the equity market violently reversed to the downside.

During his long tenure as head of the Federal Reserve, which encompassed much of the bull market phase just referenced, Alan Greenspan and the FOMC helped enable and perpetuate that so-called *virtuous cycle*. They did this by routinely intervening at the first tangible signs of equity market dislocations and/or economic slowings (the now-famous Greenspan “Put”). Their actions seemed to imply that the Fed had the unique ability, through proactive use of monetary authority, to calibrate and manage the business cycle in a way that tempered, and often prevented, economic contractions. Much like the National Park Service in Yellowstone, Greenspan & Company felt it was best to put out fires before they spread too far. Unfortunately, just as with the ill-conceived firefighting policy in Yellowstone, **such habitual, and often aggressive, monetary interventions interfered with the natural “ebb and flow” of the business cycle. These actions prevented the deadwood in the economy from being sufficiently cleared out** so that *healthy and sustainable* economic renewal could evolve naturally. With the benefit of hindsight, the June 2003 Greenspan-led FOMC decision to push short-term interest rates to the lowest level in a generation, and to

keep them there for an entire year, unintentionally sparked the banked fires of the housing and mortgage markets that would eventually help lead to economic disaster of **unthinkable** proportions.

The moral of this story is that *interfering with the natural flow of the universe can often lead to unpleasant outcomes and/or unintended consequences.* Take the infamous case of Long-Term Capital Management (LTCM). The eleventh-hour September 1998 Federal Reserve-led bailout of that gigantic, and monstrously overleveraged, hedge fund had much the same effect as that of the National Park Service policy of putting out fires before they spread. Over time, both would fuel and enable excess buildup of highly flammable underbrush and deadwood as far as the eye could see (and beyond).

What the Fed and the various banks, who collectively stepped in to douse the flames at LTCM, didn’t understand, or weren’t willing to confront, was that **the meltdown of LTCM was a signal fire that the financial system was being pushed well beyond safe limits.** This flashpoint was a relatively overt “tip-off” that the system needed to begin *naturally* purging the excess leverage (no matter how painful) in order for its immune system not to be tragically compromised down the road. Unfortunately, that jarring wake-up call was ignored, as human nature’s deeply-inherent need for *perceived* control (in this case via a bailout) trumped the better judgment of “letting the chips fall where they may.” It would not be until nearly *nine and a half years* later, at which point the entire financial system had leveraged itself grossly beyond prudence, that an even more ominous “Mayday” call would go out (in the form of the near-fatal cardiac arrest of *Bear Stearns*). By then, as we now know, it was already too late. In short order, even bigger dominoes would fall and **the capital markets and banking system, as we’ve known them, would likely never be the same.**

“Finance is often poetically just; it punishes the reckless with special fervor.”

– Roger Lowenstein, author of *When Genius Failed: The Rise and Fall of LTCM*

In just fifteen months the global financial system has been brought to its knees, and bruised, battered, and bloodied investors are struggling mightily to understand what it all means. With that as backdrop, let’s address a principal \$64,000 question on investor’s minds; **where do equities go from here?** No matter how bad the macroeconomic backdrop appears (and it certainly looks dire at the moment), our basic principles at *WEDGE* lead us to a decidedly “bottom-up,” value-oriented approach in the never-ending quest to answer that important question. Here’s our take, for better or worse, on the current and future backdrop for stocks.

The equity market, being a natural discounting mechanism, typically bottoms six months or so ahead of the economic trough. Using that as a proxy, the late November 2008 low for the S&P 500 suggests the economy will bottom in the late May, early June time frame. However, if Ben Graham’s oft-schizophrenic “Mr.

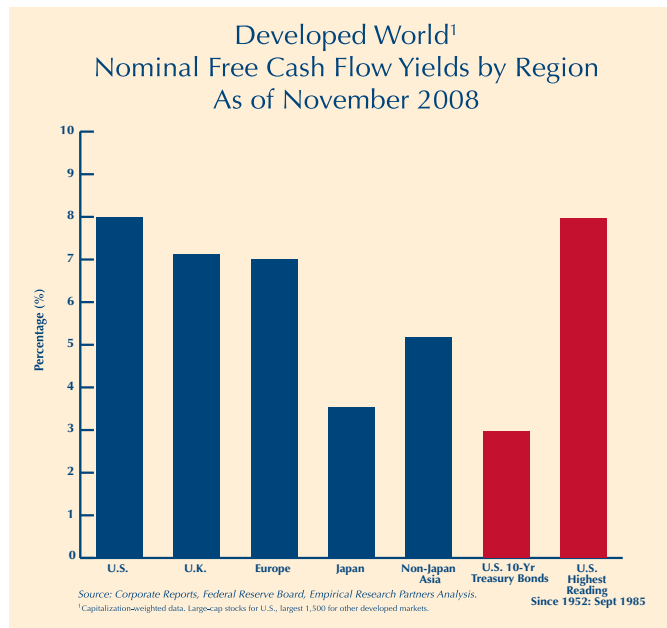
Market” turns even more pessimistic on the economy going forward, stocks could certainly reverse to the downside. In fact, it would not be a total shock if the market threatened to retest or breach the November '08 low at some point this year. Were that to happen, however, we would likely approach such a reversal as a long-term buying opportunity from a risk/reward perspective.

Famed Prussian military strategist Carl von Clausewitz penned the following in 1832: “the great uncertainty of all data in war is a peculiar difficulty, because all action must, to a certain extent, be planned in mere twilight, which in addition not unfrequently [sic] – like the effect of a fog or moonshine – gives to things exaggerated dimensions and unnatural appearance.” It’s a well-known maxim on Wall Street that investors abhor fog (uncertainty), so they instinctively cast about for a beacon to help them traverse it. Such a guiding light is essential to successfully navigating a dense fog, like that which enveloped the equity market after the stunning collapse of Lehman Brothers on September 15, 2008. From our perspective, amidst the still-lingering mist of the global economic contraction, we believe valuation, that all-important metric, should be the beacon of choice for long-term investors. In fact, given the magnitude of the bear market from early October 2007 to late November 2008, a mind-numbing 51.9% decline peak-to-trough, *we believe valuation, as it has historically, will likely prove the single most important determinant of future long-term returns going forward.* In that context, it’s very important to remember that this generation’s worst bear market is actually the 2nd most severe on record, topped only by the 1929 to 1932 debacle which vaporized 86% of the market’s value. (See the April 2008 issue of *WEDGE Watch* for a statistical history of bear markets and bear market recoveries since the Great Depression – wedgcapital.com.) As a result, the crushing equity market downturn that evolved over the past year **left in its wake one of the most depressed valuation backdrops in at least two decades** (note the excerpt below from Warren Buffett’s bullish op-ed to the *New York Times* on October 17, 2008).

“...the market will move higher, perhaps substantially so, well before either economic sentiment or the economy turns up. So if you wait for the robins, spring will be over.”
 – Warren Buffett (on why he was selling Treasuries and buying stocks in his personal account this past fall)

Chart 1 depicts *free cash flow yield* (operating cash flow minus capital expenditures) for key equity market indices of each of the major developed regions of the world (as of late November). As can be seen, the U.S. market, with its eight percent *free cash flow yield*, appeared the most undervalued and, relative to history, had only been that high *on one other occasion over the past 56 years*. In addition, relative to Baa-rated corporate bond yields, which have recently hovered near record spreads, the average *free cash flow yield* for domestic stocks had not been that high since the late 1950’s (see **Chart 2**). *Of particular interest, the equity market debacle does not appear to have discriminated on the basis of balance sheet quality as the free cash flow yield for stocks with the highest bond ratings actually exceeded that of the other, less robust, rating categories* (see **Chart 3**). From our perspective, this seemingly impermanent anomaly signals opportunity, at least on a relative basis, for long-term

Chart 1



investors. In other words, against a uniquely uncertain economic backdrop, companies with the greatest amount of perceived staying power (via, in part, their cash-rich and/or underleveraged balance sheets) appear to offer an attractive “two-fer” of upside potential and downside protection (margin-of-safety). Needless to say, **this combination is quite rare.**

A return to a more normal economic recovery trajectory by 2010, which, of course, is by no means a given, would likely bode relatively well for domestic stocks across all capitalizations. However, it is important to note that **history has been particularly kind to value investors following major market bottoms.** As can be seen in **Chart 4**, *the least expensive stocks on a valuation basis have materially outperformed the broad market* (as measured all the way back to 1926) *in the year following a market bottom.* This very positive historical backdrop would seem to bode well for value-oriented investors going forward.

Despite the seemingly constructive valuation backdrop for stocks, the outlook for the economy over the next 12-24 months remains highly ambiguous. Of particular note, using historic economic data from developed economies around the globe as a guide, *housing-led banking crises* have coincided with the longest and most severe economic downturns worldwide since 1960. That said, *even the cataclysmic economic contraction of the Great Depression lasted only 43 months* before GDP began to grow again (though unemployment stayed extraordinarily high for an extended period beyond). As it stands today, it would appear that we are at least one year into the current recession (according to the *National Bureau of Economic Research*), marking the longest domestic contraction since 1982. Given the massive liquidity that is now being pumped into major economies worldwide (unlike the policy response that followed the 1929 crash), it would seem only a matter of time before the credit markets thaw sufficiently for commerce to begin stabilizing. From that point, economic growth should begin to move, slowly but surely, back toward some

Chart 2

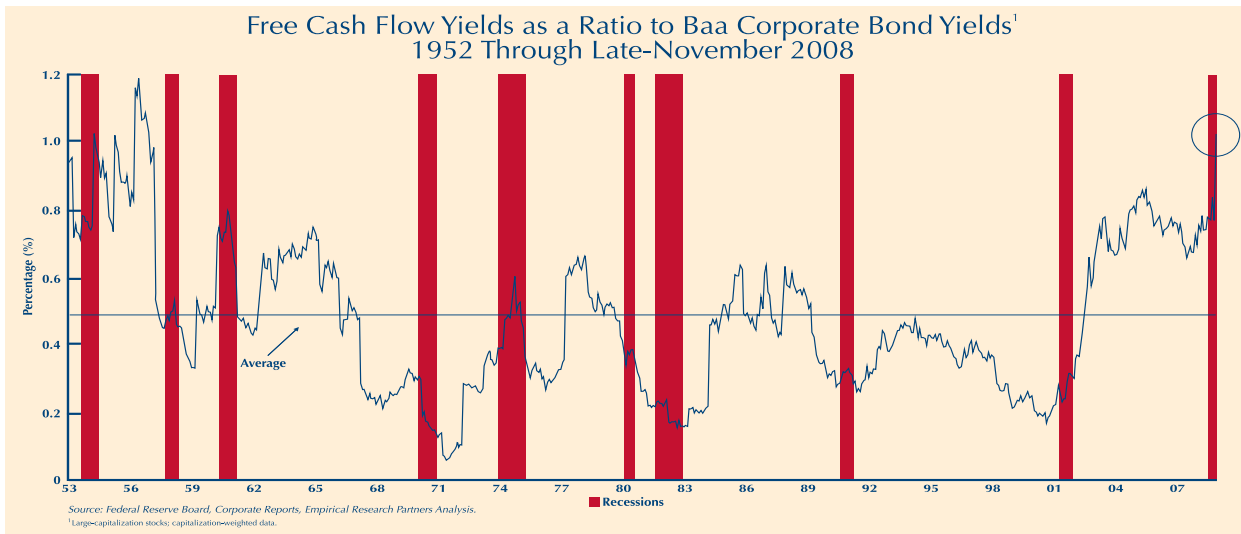


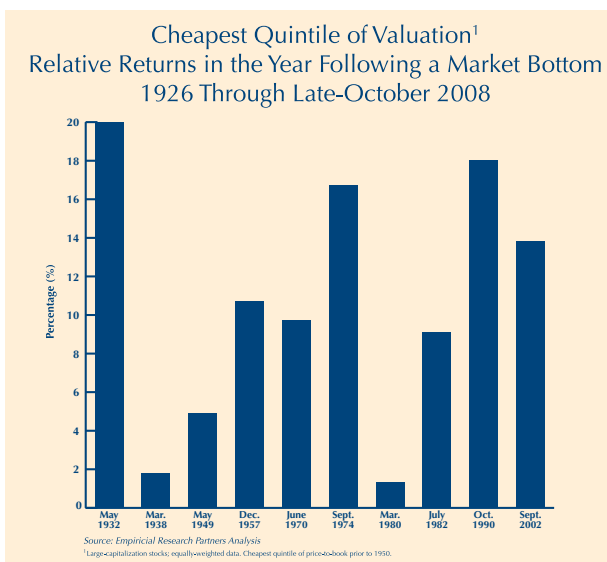
Chart 3



semblance of normalcy (though setbacks along the way should not be ruled out). **China, in particular, could be a very big economic wild-card in 2009.**

Beyond the very overt and aberrational fiscal and monetary stimulus being implemented by the Fed and the Treasury today, there are other important structural underpinnings to our economy that are imperative to note. **Unlike during the Great Depression, the U.S. economy has extensive "safety-nets" built in that did not exist at that time** (i.e., unemployment insurance, Social Security, Medicaid/Medicare, welfare assistance, etc.). *One of the most important of these "shock absorbers" is the FDIC insurance fund* which, had it been in place in 1929, would likely have prevented the staggering number of catastrophic bank runs and failures which helped trigger such epic economic carnage across the U.S. Just a few months ago, amidst growing fears of Depression-like bank runs, which had been unthinkable for so many decades prior, the FDIC averted a potential repeat of 1929 by dramatically raising bank deposit insurance limits. Thankfully, they also had the foresight to concurrently implement an FDIC insurance program for money market funds, which are very widely-held today, to stem the emerging panic that was quickly snowballing there. *We believe these developments are quite significant and provide a critical underpinning and downside buffer for the U.S. economy* (especially if the downturn is deeper and more protracted than that of the typical post WWII recession). Nevertheless, it is fair to say that we've never seen the economy hit the wall as hard as it did during October and November of last year.

Chart 4



"This whole thing (the recent economically-driven collapse in domestic oil and gas drilling) is happening more at videogame speed than real life."
– Bob Simpson, Chairman and CEO of XTO Energy, Inc.

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Given the still highly tenuous economic backdrop, a coldly sober view seems prudent since history is very clear that a *massively overleveraged financial system will not* heal overnight. Sufficient time must first pass, and it would not be entirely a shock if the course of healing extended well beyond the norm for the typical economic recovery. However, *the dramatic deleveraging the markets are in the midst of will ultimately run its course, with or without help from the financial authorities, just as the Yellowstone fires did when winter arrived in November of 1988.* The bad debts must eventually be liquidated and/or offloaded to investors possessing stronger, more patient hands. When the market begins to sense the economic “light at the end of the tunnel” (i.e., when confidence increases that the economy can sustain a normal recovery), the **massive cash hoards** now hiding out on the sidelines (the highest level since 1990) will likely begin to move, in a *series of waves*, back into equities. In the meantime, our equity research team at WEDGE will continue to troll for stocks of companies whose long-term fundamentals appear to be *unimpaired* by what may prove to be one of the most challenging economic dislocations since the Great Depression.

In the summer of 1994 a spark lit a fire in the dry woods of Payette County, Idaho in the northwest corner of the state

near the Montana border. Soon, it was whipped into a massive and uncontrollable firestorm by powerful, shifting winds. Several hundred miles away, as that new fire blazed, Rocky Barker, author of *Scorched Earth: How the Fires of Yellowstone Changed America*, and a resident fire ecology expert were touring parts of Yellowstone that had been badly burned during The Great Fire of 1988. What they saw there that day made a deep and lasting impression on them. “In the shadow of dead, blackened 300-year-old Douglas firs, a new generation of trees was rising above the fireweed and aster. Green, deep carpets of lodgepole pine were growing from the ashes of firestorms past. Mixed stands of spruce, lodgepole and white bark pine – similar to those in Payette County – **had been reborn.**” Both men recognized, at nearly the same moment, that a similar fate would await the Payette. **“When the weather changes the fires will stop”** they thought; just as the smoldering flames had that fateful November day several years earlier in Yellowstone. Each of the men understood, deep in their gut, that “when the smoke, ash and firefighters are just a memory the forest will still persist.” In time, though only at Mother Nature’s chosen pace, wildlife, trees and flora will return to the woods in rich and full abundance. As down through the ages, the natural rhythm of the forest shall endure. **A similar fate, in due course, awaits the economy and the markets.** *Happy New Year and thank you for your business and continued support.*

Index	12/31/08 Price	4th Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	8776.39	-19.1%	-33.8%
S&P 500	903.25	-22.6	-38.5
Value Line Composite	225.90	-33.5	-48.7
American Exchange Comp.	1397.53	-21.8	-42.0
NASDAQ Composite	1577.03	-24.6	-40.5

*Does not include dividend income.

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Fixed Income

World's Largest Hedge Fund?

As if the current economic recession and financial crisis weren't enough to worry about, there is a small but growing chorus questioning the ultimate cost of various governmental efforts to mitigate the impact of both. From the Federal Reserve's various programs to ease credit market conditions, to the Treasury's "TARP," there is increasing concern that these initiatives will lead to higher inflation and/or \$1 trillion deficits in the not-too-distant future. As our title suggests, though, we wonder if the U.S. government is merely constructing a hedge fund of enormous proportions, with the potential for enormous rewards – and risks!

Hedge funds, of course, seek to exploit pricing discrepancies between or among different securities or market segments, by using long/short positions or by using leverage (borrowed funds) to enhance returns. This sounds a lot like what the Federal Reserve (swapping Treasury securities for riskier assets) and the Treasury (injecting capital into banks for preferred stock yielding 5% and financing it by issuing much lower yielding Treasury bills/notes/bonds) have been doing.

Whatever the outcome of these programs, there is no doubt that the near-term cost is quite low. Why? Well, the Federal Reserve is literally in charge of the printing press and the Treasury is able to borrow at near-record low rates (and there has been talk of the Fed issuing its own debt). **Chart 5** shows the U.S. Treasury 10-year constant maturity yield on a monthly basis since 1953. Note that in recent months, as the financial crisis intensified and the economy weakened, Treasury yields have plunged to near all-time lows. **Clearly, any concerns about inflation or large and growing fiscal deficits are well in the background. So, the good news is that "Hedge Fund USA" currently has no problem whatsoever financing its purchase of risky assets.**

The policy implications of the Fed and Treasury actions are clear – do whatever it takes to lower interest rates, improve credit conditions, bolster capital positions of financial institutions – all in an effort to jump start lending and economic growth. If all goes well, higher market prices for the riskier assets purchased by the Fed and the Treasury, along with an economic recovery, could create a huge gain for taxpayers.

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Chart 5



As always, however, we must also consider the longer term implications of such policies. In other words, what are the risks to these policy measures? As mentioned earlier, **inflation could be a problem down the road** as the Fed rapidly expands its balance sheet. Hints of this threat could show up in a declining dollar, higher commodity prices, and through increased inflationary expectations, as measured by the yield spread between comparable maturity coupon Treasuries and TIPS (Treasury Inflation Protected Securities).

The exploding federal deficit presents *another risk*. **The Treasury's massive borrowing needs could ultimately put upward pressure on interest rates** if investors (particularly foreign) begin to require higher yields given the increased supply of bonds. This could negate part of the stimulus effect of the increased federal spending (whether it's spent on risky mortgage assets or roads and bridges).

Clearly, monetary and fiscal policy are both well into uncharted territory. Given the extraordinarily weak economic backdrop, there is probably little choice but to pursue the current path. However, we're watching closely to see if "Hedge Fund USA" can deliver. If not, the "unwind" may be very unpleasant. **Stay tuned.**

