

# The Perspective

Rational, independent thinking™

## Preserving Your Sanity

July 2008

Silver Heights Capital Management Inc. is a discretionary investment counsellor.

We manage money for affluent families, foundations, and select institutions. We are focused on preserving our clients' capital and growing it over time.

We utilize a rational and rigorous process to find, analyze, and select investments for our clients.



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CAPITAL MANAGEMENT

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## Preserving Your Sanity

To say that the markets have been volatile recently would be as much of an understatement as saying that Tiger Woods is an “okay” golfer. The rumblings of economic concerns in the U.S. grow louder by the day. Once unthinkable possibilities such as the collapse of Fannie Mae and Freddie Mac, two financial giants that underpin the mortgage industry in the U.S., are now front and centre in investors’ minds.

Record oil prices. Check. A housing collapse in the U.S. Check. Capital crises at many of the world’s largest financial institutions. Check. Rumours about GM – once the largest and most profitable company in the U.S. – going bankrupt. Check. How can investors maintain their composure and sanity in such uncertain times?



# The Perspective

*from Silver Heights*

*It is **precisely** in times like this that investors must do a gut check and revisit investing fundamentals.*

Just like in one's personal life, times of turbulence are the times when it is most important for people to act in accordance with the set of values that are most dear to them. These are values that were developed during less trying times, when emotions didn't rule, when there was time to properly think and assess, and to plan. These core beliefs are what give you the strength to weather the storm.

Today's market gyrations can cause investors to question their investing approach. It's easy to be scared into making changes to your approach based on the extreme short-term price movements that many stocks have experienced. This is *exactly* the wrong time to be making such a change. A change driven by fear and emotion is the antithesis of the action a rational investor should take. While no one admits to being irrational, we see it all the time in people's fear-driven investment decisions.

At Silver Heights, we take comfort from our investing framework: we buy assets when they are offered for sale in the marketplace for less than their true economic worth. This framework is our touchstone and the saviour of our sanity in times of market insanity.

*Ironically, today's emotionally-driven volatility highlights one of the core principles underlying our investment framework: stock prices do **not** always properly reflect the value of the underlying business.*

It's not a model that we invented, and it's not one that's complicated. Unfortunately, "simple to understand" does not necessarily equate to "simple to implement". This approach takes patience and a temperament that allows you to have opinions that differ from the crowd, when a thorough and rational analysis leads you to that conclusion. The market's wild swings may make some question their sanity, but a disciplined and fundamentally-based approach to selecting your investments will help you preserve it.

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*from Silver Heights*

When we first provide an overview of our philosophy of “buying a dollar for less than a dollar” to potential clients, the question, “Does the market really get it wrong like you say it does?” is commonly asked. We’ve often pointed to each day’s stock price listings in the newspapers as an example of stock prices being more volatile than business values. If you scan the 52-week highs and lows for the stocks, it’s not uncommon to see a two or three-to-one ratio between the high and the low. Most businesses’ values do not change to that degree in any given year.

In today’s markets, examples like Fannie Mae are even more poignant case studies highlighting that markets *do* get it wrong – and equally important – to a significant degree. Fannie Mae used to be thought of as one of the market’s “go-to” stocks for many retail and institutional investors. Last fall, this stock was nearly \$70. Recently, it’s been as low as \$7. Could the fundamentals of the business have changed *that* much in so short a time? Given that the bulk of Fannie Mae’s book of mortgages that are on the balance sheet today were likely on the balance sheet last fall, we wouldn’t think that the stock price decline was due solely to a deterioration in the business (although overall economic deterioration has undoubtedly had a negative effect on their operations). We would suggest that the market *substantially* underestimated the riskiness of – and therefore, overvalued – the assets on Fannie Mae’s balance sheet, and that the recent recognition of these risks is the primary driver behind the incredible decline in the company’s stock.

Whereas some stocks have suffered severe price declines because they were overvalued, many other stocks have been caught in the general market downdraft and have suffered declines that have made them significantly undervalued. Take Lithia Motors as an example. Lithia is one of America’s largest auto retailers, with over 100 retail locations and over \$3 billion in sales in 2007. During the past ten years, the company has generated earnings per share ranging from \$1.14 to as high as \$2.46. In early 2007, the stock was over \$30 per share. Record oil prices, continued market share losses from the U.S. automakers (to which Lithia has a material exposure), and financial troubles at the domestic automakers themselves – coupled with bearish market sentiment – have driven the stock to \$4 per share.



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We don't think that bricks & mortar car retailing will disappear. Contrary to what a casual observer may think, new car retailers make most of their money not from the sale of the cars, but rather from parts & service, finance & insurance, and the body shop. In the same ten-year period referenced earlier, Lithia's annual net income has ranged from \$11 million to over \$50 million. Today, the market value attributed to Lithia is about \$80 million. We think Lithia will be able to make the adjustments necessary to survive the current tough auto retail environment (*e.g.*, high oil prices, rapidly-declining sales of trucks & SUVs) and today's price will be recognized as one of the most attractive buying opportunities we've seen in many years.

## What's the value in going back to basics?

We're all human and anyone who says they are completely immune to the emotional impact of seeing such dramatic stock price swings is likely lying. The real challenge is the ability to put aside the emotions, and to act in a logical manner.

*The value in having a well thought out investing framework – if it's a rational one – is that it gives you the conviction to make decisions that may be difficult emotionally.*

The significant stock price declines in recent months have often been driven by a recognition of the riskiness of certain assets. For other companies however, their stock prices have been caught in the vortex of fear and many previously reasonably-valued companies are now **significantly** undervalued. How can you differentiate between those that are rightfully "marked down" and those that are tremendous investment opportunities? It is impossible to consistently make profitable investment decisions if they're all emotionally-driven. You need to have a rational framework that provides a fundamental footing on which to guide your actions.

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*from Silver Heights*

Without one, it's merely guessing.

Sincerely,



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