Eidelman Capital Management

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OPTIMISM AMIDST PESSIMISM

BY TOM EIDELMAN

The volatile market has made me a popular guy. Everyone from my basketball teammates to my mother-in-law wants to know what the heck is going on with the stock market and more importantly what they should do. The S&P 500 index is down 14.7% from its highs and the newspapers have been posting dire headlines focusing on "recession," "credit crises", and "housing collapse." It has not been uncommon to see the Dow Jones up 300 points one day, only to be followed by a 300 drop the next. With negative headlines and falling stock prices, it is no wonder that many people are concerned. If you too feel this way, hopefully this letter will be both enlightening and reassuring.

What is Going On?

It all started when low interest rates made home ownership more affordable. Real estate prices rose at an unprecedented rate. After 50 years of rising at an average annual rate of about 1% plus inflation, housing prices took off at an annual rate of 6% plus inflation from 2002 to 2006. Since the houses themselves served as collateral for mortgages, the lender's risk was dramatically decreased. If homeowners couldn't pay their loan, the bank could foreclose and sell the appreciated house at a profit. Lenders consequently began to relax their lending standards. Lenders began to make loans to people with low credit scores, no income verification, or no money down. As long as the underlying collateral kept appreciating, the lender had little to worry about.

This cycle of rising prices → leading to more credit → leading to higher prices reached extraordinarily high levels. This cycle also trickled over into consumer spending. Consumers felt richer as their homes increased in value and many withdrew some of this money using home equity lines of credit, essentially using their homes as ATM machines and spending that money on everything from apparel to vacations. Unfortunately, this cycle was unsustainable and has since reversed.

Now, housing prices are decreasing, lending standards are tightening, inventories of unsold homes are high, home equity withdrawals have diminished, and consumer spending has slowed. This negative cycle is putting stress on many parts of the economy, primarily homebuilders and banks, but also consumer spending as a whole.

What's Next?

It will take some time for the credit cycle to unwind. The U.S. still has a record 10-month supply of unsold home inventory to sell and a seemingly endless supply of risky loans which need to play out. Investment banks are writing down the value of many subprime and other exotic mortgage securities and there could be more write downs to come. While we don't know how long this cycle will last, we are pretty sure of one thing: The market will begin to move up well before the economy recovers. The stock market is a forward looking indicator and is notorious for "climbing the wall of worry" long before the actual fundamentals turn around. By the time the credit worries cease, housing prices recover, and optimism creeps back into the market, the stock market will have already dramatically appreciated.

Over the past 50 years, the average recession has lasted about 10 months. As I mentioned before, the market actually begins moving up before the economy recovers. The market has typically bottomed 5 months after recessions began and 5 months before they ended. In other words, the market has historically hit bottom in the middle of recessions.

Lets assume that we are in a recession, which I believe we are. The recession probably began around the time when the market peaked in November of 2007. If we take this month to be the beginning, that means that we are already 4 months into the recession and if history repeats itself, stock prices may already be near the bottom.

Reasons for Optimism: Prices & Pessimism

The first reason for optimism is that the bad news is already priced in. Financial stocks are down 33% from their highs and even companies that seem relatively immune to the overall economy and credit issues have come down significantly from their highs. The Value Line PE ratio, which measures the median PE valuation ratio of all 3000 stocks in its universe, has decreased 21% from 19.7x last year to 15.6x earnings today. This market valuation is right in line with the 50-year historical average of the S&P 500 of 16x earnings. The current 15.6x earnings valuation equates to a 6.4% earnings yield (1/15.6). With 10-year government interest rates at 3.5%, we believe stocks look very attractive with a 6.4% earnings yield plus growth.

The second reason for optimism is that the majority of investors are pessimistic. This sounds like an oxymoron, but it is not. History has shown that when investors are scared, the market subsequently does very well. You can read more about this phenomenon in our research piece entitled “Bearish is Bullish.” How can this be? When investors are concerned about the economy they won’t pay as much for stocks and other risky assets. Their expectations of individual companies decrease and they scrutinize each investment. However, extreme moods don’t last very long. As pessimism fades and optimism grows, investors start to pay more for stocks. They look at individual stocks from a rosier perspective and give management outlooks the benefit of the doubt. This happiness doesn’t last forever and stocks fall as their euphoria fades. History teaches us to buy pessimism and sell euphoria. Today, market sentiment is decidedly bearish. In the latest investor intelligence polls, only 36% of investors said they were bullish, consumer confidence just hit a new five year low, and the latest cover story of BusinessWeek was entitled “Waking up to the Recession.” The market is bearish, so we are bullish.

What to Do

In full and fair disclosure, the success of our company has not been due to forecasting the economy or macroeconomic predictions. Our bread and butter business is picking stocks which we feel are undervalued and are priced to earn an exceptional return and outperform the popular indices. Some of our most successful years have come out of times of market turmoil because that is when we found many enticing investment opportunities. We believe the market is again offering to sell us some great companies at discounted prices. We are taking advantage of this opportunity by buying stocks and constructing diversified portfolios which we believe have the best odds of beating the market and providing excellent investment returns.

We are excited about three of our most recent purchases which I will outline and we also remain optimistic on many of the high quality companies that we already own, many of which continue to earn high free cash flow, beat earnings estimates, trade at reasonable valuations and are performing relatively well. Our three latest picks include:

PNM Resources – PNM - $12.47

PNM owns a regulated electric utility in New Mexico. Regulated utilities are entitled to a fair return from the government for any prudent expenditures. This guarantee makes utilities great investment candidates when they face difficulty and their stocks trade way down on earnings concerns. PNM has been undergoing operational and regulatory difficulty due to higher than anticipated coal, steel, concrete, gas, and oil prices. The regulatory commission recently denied PNM's request for a higher return and more importantly a fuel adjustment clause which would allow PNM to be reimbursed for those soaring energy costs. It is our belief that PNM is entitled to a fair ROE on all prudent investments and fuel is certainly a critical and prudent investment. While it may take some time to work out via another rate request, emergency rate relief, or appeal to the State Supreme Court, we believe PNM should recover to an industry average ROE and trade at a premium to tangible book. PNM current trades below tangible book of $14.60/share, while other comparable utilities trade at 1.4x book. We believe fair value for PNM shares are in excess of $20/share.

ICT Group – ICTG – $10.09

ICT Group is an outsourcing company which primarily manages call centers for U.S. financial institutions out of the Philippines. ICT has come under cost pressure recently due to a large customer relocation of a U.S. call center to the Philippines and key customers (mostly financial companies) coming under pressure from the credit crises. Despite the headwinds facing their customers, ICT landed two large $40m business wins from financial customers. They make more from offshore outsourcing and save their customers money because they only pay $13/hr for employees in the Philippines versus $25/hr in the U.S. ICT management has said they expect every quarter this year to better than the previous one starting right now and will end the year earning at a rate of $.80/sh. With a tangible book value of $9.60/sh, including $2 in cash, ICTG trades right at book value compared to its peers which trade at 2x book value. Given their assets and earning power, we believe ICTG shares are worth upward of $15 a share.

Castlepoint Holdings – CPHL – $9.73

Castlepoint was founded by Michael Lee, the founder of another successful insurer called Tower Group (TWGP). Castlepoint was started to meet an immediate need for quota share reinsurance for Tower Group. CPHL was contracted to receive a large portion of Tower business on a quota share basis for 3 years. We believe this company presents an attractive way to buy Tower's knowhow and profitable small policy/low severity insurance at a discount. CPHL trades under book while Tower trades at over 2x book. It is our view that at the end of 2008, Castlepoint should trade at a premium to its 2008 estimated book value of $12.50 per share.

Conclusion

I believe our investment portfolio, including the three investments discussed above, are ideally positioned to benefit from the eventual stock market rebound. While we do not know when the credit crisis will unwind or when the economic downturn will subside, we are confident that if we continue to invest in a diversified portfolio of undervalued securities which meet our strict criteria, particularly at times when the prevailing opinion is pessimistic, we will achieve superior returns for our clients.

If you have any question or comments about this letter, feel free to contact me at tom@eidelmancapital.com.

Tom Eidelman
Vice President