Eidelman Capital Management

Quarterly Letter December 2009

Dear Clients & Friends,

2009 was a stellar year for the stock market, albeit nerve-wracking. After starting the first quarter down 12%, the S&P 500 index roared back, handsomely rewarding strong-stomached investors with a full year gain of 26.5%. Our value composite did even better, significantly outperforming the S&P 500 after fees.

This time last year, many investors were fearful of a second "Great Depression" and stock prices were sinking fast. In last year's December 2008 letter we wrote: "History suggests that the best time to invest is when stocks are cheap, investors are scared, and corporate insiders are loading up." We went on to explain that the prevailing valuations, sentiment, and insider buying metrics indicated that it was time to buy. More importantly, we were finding individual values in stocks and high-yield bonds such as GMAC and Sallie Mae.

Now that the market has advanced over 70% from its lows, is it too late to invest? What do we see for next year? 2010 could prove more challenging. While the economy has shown evidence of recovery (slowing job losses, housing stabilizing, credit markets back to pre-Lehman levels, and leading economic indicators up), average stock valuations are above historical averages and bond yields have dropped to less enticing levels. Our favorite stock market valuation measure (Shiller cyclically adjusted PE ratios) shows the S&P 500 trading at 20.5x earnings vs. a historical average around 17.5x. This indicates to us that earning good returns will require uncovering pockets of value and finding special situations.

As I wrote last quarter, one area where we are finding value is in blue-chip companies. Our top 10 blue-chip holdings have an average 2010 estimated PE ratio of just 13.3x earnings compared to 21.5x for the S&P 500. In other words, despite their superior quality, our blue-chip holdings are trading at a 38% discount to the market average. While hard to find, our other strategy to attain good returns in 2010 is continuing to find special situations. Special situations are stocks or bonds expected to rise as a result of a future event such as a redeployment of assets, new management, merger, or sale of a division. One example is a preferred stock held by many of our clients, Fremont General. We expect it to rise further when a new management team redeploys cash it raised from selling it's portfolio of subprime loans.

With growing government deficits and record levels of money printing, many of our clients are concerned with the prospects of inflation. We too are concerned and have spent countless hours trying to determine the potential impact and timing of inflation or even if deflation is the bigger risk. I outline our findings in the next section entitled "Inflation vs. Deflation," but I'll give you the bottom line right now: We think both inflation and deflation present a significant risk, but do not have conviction either way. In other words, we don't know. But like a hurricane or earthquake that could strike, we are preparing either way.

We believe our portfolios have the right balance of undervalued quality stocks and special situations that should perform well under any economic scenario. We will continue to increase client communication, educate, and look to find value wherever it may hide. We look forward to another great year.

Sincerely,

Tom Eidelman, CFA
Vice President

INFLATION VS DEFLATION

BY TOM EIDELMAN

Inflation - a continuing rise in the general price level usually attributed to an increase in the volume of money and credit relative to available goods and services. – *Merriam-Webster Dictionary*

Why Inflation Matters

High levels of inflation lead to problems in the economy. Higher inflation leads to higher interest rates and lower stock market PE ratios. Inflation also causes savers to lose purchasing power. As the old saying goes: "A dollar doesn't buy what it used to."

Take for example, a Big Mac sandwich at McDonalds. It cost $2.44 in 1999, but just ten years later that same burger costs $3.57. That means that $100 would have bought 42 Big Macs in 1999, but only 28 in 2009, for a loss of purchasing power of 33% over 10 years. Of course, inflation doesn't just hit hamburgers. The cost of medical care, housing, education, transportation, and other key living expenses have increased by similar amounts due to inflation.

The modest inflation used in the previous example averaged just 3.8% per year, but today many are concerned inflation could reach double digits like it did in the early 80s.

It is our job to protect and grow the purchasing power of our client's assets. For this reason, we must have a handle on the potential risk of higher inflation. Our conclusion is that a large increase in inflation is a real possibility, but not a foregone conclusion. I will now explain why the risk is real, the opposite is also possible, and how we are positioning our clients' portfolios to prosper under either scenario.

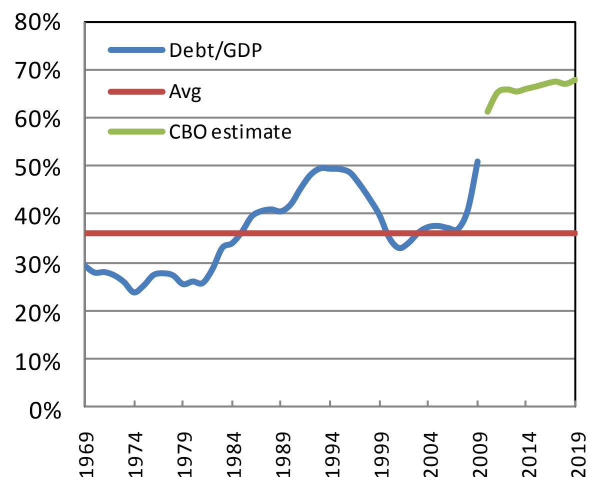
The Case for Inflation

The prevailing case for inflation often made by such pundits as Peter Schiff, Glenn Beck, and Jim Rogers is: 1) The US government has accumulated too much debt. 2) The US government will not be able to pay it off without resorting to printing more money. 3) Printing more money will result in much higher rates of inflation. Lets evaluate this hypothesis and see how it is playing out.

U.S. Government Debt is High

The U.S. debt is at its highest level since WWII and is projected to grow into the foreseeable future.

Chart A: U.S. Net Public Debt/GDP

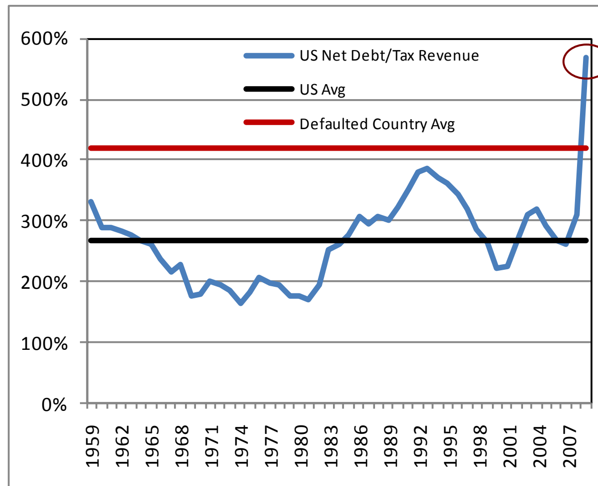


This high debt level *understates* the true liability as the government has additional exposure to state & local governments, guarantees for financial institutions including Fannie Mae and Freddie Mac, and will need to refuel such cash-starved entities as the FDIC, Pension Benefited Guarantee Corp, and IMF. Most significantly, this debt excludes growing obligations for social security and Medicare. In sum, the U.S. debt level is very high, but how high is *too high*?

U.S. at the Breaking Point

In the book *This Time is Different*, Harvard economists Reinhart and Rogoff analyzed every country that has experienced episodes of sovereign default or inflation greater than 20%. Looking at 89 such episodes from 1827 to 2003 for which they had full data, the average breaking point level was a public debt/tax revenue ratio of 4.21x. If we consider this level the potential breaking point, the U.S. has just surpassed this threshold (Chart B, next page).

Chart B: U.S. Debt vs Historical Default Level



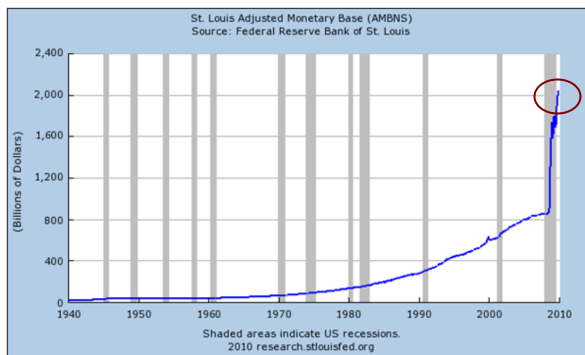
Note: Chart shows the current U.S. debt level compared to defaulted countries level prior to default. Total Public Debt/Tax Revenue ratio was used because GDP data wasn't available for all countries.

The federal government clearly has a concerning level of debt, but have they resorted to printing money?

Record Money Printing

The Federal Reserve has engaged in "quantitative easing," which is technical jargon for printing money. Since the beginning of the credit crisis, the Fed has printed more than $1 trillion new dollars, increasing the monetary base by a whopping 143% .

Chart C: U.S. Monetary Base (1940-2009)



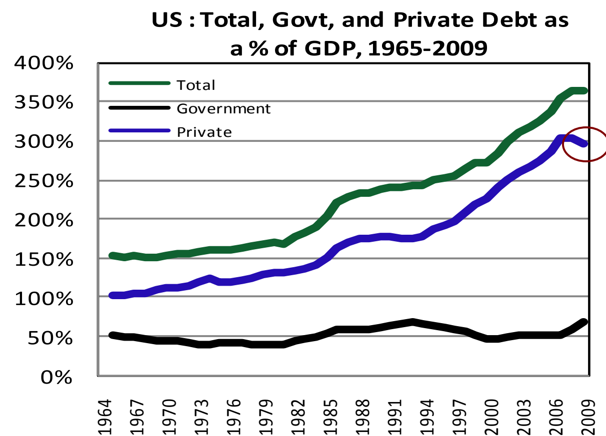
Note: Monetary Base is defined as coins, paper money, and commercial bank reserves with the central bank.

However, the Fed's reasoning for such an increase was not because they couldn't afford paying back or refinancing their debts (as proven by record-low interest rates). The fed increased the monetary base to jumpstart bank lending in an attempt to combat deflation. So far, the U.S. has actually experienced deflation.

Deflation

If you read the definition of inflation again at the beginning of this letter, you'll see that inflation is defined as the increase in the supply money AND *credit*. What is happening is that while the Federal Reserve is increasing the monetary base at a record rate, banks and other lending institutions, which make up the vast majority of credit outstanding, are not lending. After increasing 8% per year, private credit outstanding declined in 2009 for the first time in over 40 years.

Chart D: U.S. Total Credit Outstanding

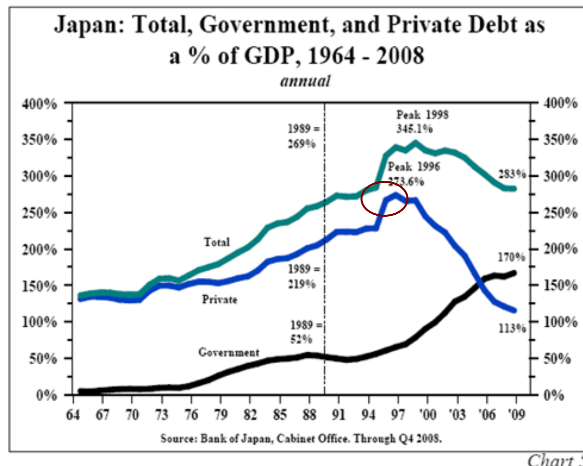


Total credit outstanding in the U.S. of $52.6 trillion is much larger than the monetary base. While the fed increased the monetary base $1 trillion, private credit decreased by an equally offsetting $1 trillion. The net result was a negligible increase in total credit and consequently, no inflation. Some believe that the U.S. will continue this trend which is similar to what has happened in Japan.

Japan's Lost Decade

Japan has experienced a government debt ratio even higher than the US and has suffered a decade of deflation. After a stock market and real estate bubble of their own, Japan's private credit outstanding peaked in 1996 and has steadily declined.

Chart E: Japan Total Credit Outstanding



Some believe that American borrowing has now peaked and will experience similar declines in credit over time resulting in a period of chronic deflation. So what do we think? Will the U.S. experience soaring inflation or a period of modest deflation like Japan?

Our Take: Prepare for Either

We are very concerned with the mounting debt levels of U.S. government debt and the historical precedent of such debt levels causing inflation. However, we also believe that growth in credit in the form of home equity loans, credit cards, etc will slow considerably as American's reevaluate their financial positions with regards to lower housing and stock prices. In summary, we don't know, therefore, we are preparing our portfolios for either scenario.

The Best Investments for Inflation: Real Assets

Since we perceive inflation to be a real threat, we want to own investments that have proven most successful during such periods. Since 1960, in years when inflation exceeded 5%, both gold & silver returned an average of 21% annually, handily outperforming returns for the stock and bond markets.

Pan American Silver (PAAS) is a silver mining company that could perform well if the price of silver climbs due to inflation. We particularly like PAAS because shares are undervalued relative to its historical price/silver ratio and thus could perform well even if high inflation doesn't come to fruition.

The Buffett Method of Inflation Protection

High-quality stocks are another investment area that can perform well in inflationary periods. In 1977 Warren Buffett was quoted as saying: "stocks are probably still the best of all the poor alternatives in an era of inflation—at least they are if you buy in at appropriate prices." In a recent Barron's interview, Money Manager of the Decade nominee Donald Yacktman said: "I would rather have Coca-Cola than gold any day of the week. The ability to raise prices is like a machine that prints money."

Under high inflation, rising costs and interest rates act as a double whammy on stocks by causing a decline in profit margins and PE ratios. For this reason, the best stocks to own during such times are companies that can pass on inflation in the form of higher prices and stocks that already trade at low valuations, thus mitigating those potential threats.

In last quarter's letter entitled "The Case for Quality," I outlined a few examples including Walmart (WMT), McDonalds (MCD), and Pfizer (PFE) whose dominant market positions and low valuations should provide ample protection against rising inflation. If these ideas are good during inflationary times, how does one prepare for deflation?

Cash May be King

In times of deflation, the best investments are safe fixed income investments. Unfortunately, 10-year Treasury bonds appear overvalued with yields of just 3.8% while the going rates for money market funds are an even lower 1%. Despite the minimal interest rate, we believe a comfortable cash position is prudent. Cash is best utilized as "dry powder" that can be used to buy assets when they become oversold again.

High-quality stocks may be another avenue by which to protect and grow wealth during moderate deflation. With strong financial and competitive positions, these firms can grow even in a slow economy and won't be overburdened with unbearable debt loads as deflation makes debts more expensive to pay back. Most importantly, high quality stocks are undervalued and thus provide a "margin of safety" against general declines in the stock market indices.

The Optimal Portfolio: High Quality Stocks, Special Situations, Cash, and a touch of Silver

We believe our portfolios are positioned to do well under any economic scenario. Our strategy has always been to find value in the market wherever it hides. We are fortunate to find value in high quality stocks and special situations, which have traditionally done well during tough inflationary or deflationary times. In addition to these areas, we will maintain a reasonable cash cushion to take advantage of a potential market correction and hold exposure to silver to capitalize if inflation heats up. Overall, we feel our portfolios are well positioned for another successful year.