

ROLLING BUBBLES

April 3, 2007

Financial manias, more commonly called bubbles, are nothing more than a period of excess involving a particular asset class. Most often, bubbles occur as unintended consequences of political decisions, which in turn trigger behavioral responses on the part of investors. It is difficult to know when one is in a bubble because rationalization and rhetoric from advocates serve to distort the truth and perpetuate the bubble. As sound reasoning prevails, markets begin to react and a correction ensues. The magnitude and depth of the correction depends on the size of the bubble. As one Wall Street maven quipped in the middle of a market decline several years ago, “If they ain’t scared yet, they’re either stupid or just don’t know what’s going on!” That sums up the mood as we begin the second quarter of 2007.

Rather than launch into a written diatribe describing the sub-prime loan issue, I’d rather climb to the “40,000 foot level” and describe a more strategic view of where we may be heading. While this discussion will prove to be lengthy, it is the best way to explain your current portfolio make-up as well as any future shifts that we may initiate on your behalf, so, please bear with me.

Our last real bubble, the hi-tech crash of 2000, was a classic. The turn of the 20th century (Y2K) was preceded with much talk and analysis focused on potential computer glitches which promised to shut off our economy. We were fearful of traffic light breakdowns, airport closures, factory and plant failures, and yes, a banking system failure. Orders for new computers and software skyrocketed in preparation to insulate against these disasters while Alan Greenspan, then at the helm of the Fed., cooperated by injecting massive amounts of money to finance the effort. Earnings of technology companies took off and Wall Street gurus suddenly were expounding on the “new economy”, where the earnings of these technology companies would continue growing at 50% rates as far as the eye could see. Caught up in this mentality, the Federal Reserve spiked the money supply on the eve of 2000 in order to get cash into the hands of Americans in the event of bank machine failure.

I remember visiting a client, a self-made country boy with a very automated logging and saw mill operation in the southeastern part of the country. His saw and planing mills processed raw logs to finished retail products with only two employees who were located in computer control centers. I asked him during a plant visit what Y2K preparation had cost him. He smiled and said, “Nothing, that’s all hogwash...” Well, Y2K came and went and his operation didn’t miss a beat, but millions of investors did. Computer sales stalled and Alan Greenspan had to withdraw all the excess liquidity he previously put into the system prior to the date change...we all know the rest of the story.

True to form, politicians and regulators got into the fray, finding scapegoats and legislating new regulations which made the aftermath of the bubble even more painful for corporations and their investors.

In recent years, as politicians created new tax codes, they were careful to protect the sanctity of the American home. By making the home mortgage interest the only remaining interest deduction available to Americans, they in effect subsidized mortgage payments and the interest rates for these mortgages. Investors flocked to these higher rates providing large sums of money for home borrowers. To make homes even more attractive, the tax code allowed for \$500,000 of tax free profits to married couples. Obviously, these tax breaks attracted all kinds of investors, and once again, the makings of a bubble were in place. Investor response came in the form of inventive mortgage packages, featuring “no money down”, “interest only for three years”, and “variable rate” mortgages. Lending requirements were loosening and people who ordinarily could not qualify for credit were given mortgages. With all this available credit, the prices of homes skyrocketed.

Now mortgage defaults are making the headlines and sub-prime borrowers are the first to fall, along with most of the sub-prime lending institutions and many of the home builders.

The current debate on Wall Street centers on whether this sub-prime problem will spread or be contained. Frankly, at Cadinha & Co., we feel this debate is inherently moot. The sub-prime borrower is simply the weakest link in the mortgage chain...and it has broken. The facts show that most mortgages have been securitized and these securities (with a value well into the trillions of dollars) can be found in most bank, insurance company and finance company portfolios. It is simply impossible to know where these securities lie and furthermore to differentiate between the good and the bad. Major Wall Street firms are responsible for much of the securitization along with the trillions of dollars of derivatives that are divined to augment institutional portfolios. Obviously, the risk in the finance sector of the market has increased tremendously. Accordingly, we have exited this sector with sales of bank, insurance and Wall Street brokerage investments. (For a more detailed analysis of this housing dilemma, see Neil Rose’s enclosed Quarterly Commentary.)

Already circling are the post-bubble vultures: the politicians, posturing for the next election, scanning the horizon for scapegoats and suggesting more regulation. Some things never change.

What might be next? Hedge fund investors, having amassed trillions of dollars, escaping the many investment regulations in order to realize a higher return, may well be the next trouble spot! High leverage tactics featuring international borrowing and investments could well create havoc in the currency exchange market if hedge fund managers attempt to “unwind” their positions.

Selected low interest rate markets such as Japan could benefit quickly through any resulting currency adjustment. Gold investors could also benefit; hence the presence of these investments in client portfolios. Our dollar, which sits on three years of interest rate increases, is vulnerable to any hedge fund unwinding. Dollar weakness will benefit multinational companies with earnings coming primarily from overseas. Currency weakness means earnings increases for these companies and we like this visibility. Some names with these characteristics are: Procter & Gamble, Coca-Cola, Exxon Mobil, Intel, Hewlett Packard, IBM, Johnson & Johnson, 3M, and Schlumberger, to name a few.

In the distance we see another area for concern. In an effort to avoid public company regulation, investors are flocking to “Private Equity” pools, hoping to buy stock in public companies and take these companies private. Once private, various tactics can be employed to enhance investor returns. Recognizing this increasingly popular trend, we have made a few “deep value” investment on your behalf, anticipating that private equity investors will eventually be willing to purchase your shares at a much higher price. Temple-Inland, Altria, and the railroads fall into this category. Railroads, in addition to being cheap, represent the primary means for getting ethanol to market. This should give them pricing power with higher earnings to follow.

The political push into ethanol has caused the price of food to increase as the substitution affects surrounding corn take hold. Inflation will likely follow creating a problem for long-term bonds. Accordingly, we are sticking with shorter-term maturities for our bond components. Record corn plantings this year should eventually correct these inflation distortions, but the interim ride in bonds could be bumpy.

I will spare you any commentary about the war, international politics, nuclear threats and our own political morass. Suffice it to say that we are watching these issues unfold with much interest.

Hopefully, you now have a better understanding of your portfolio structure. We find ourselves in a world of “rolling bubbles” and great change resulting in a rather eclectic collection of securities. Without explanation, your portfolio may not make much sense, so thank you for enduring this piece.

Yes, the world is dicey, and yes, our domestic capital structure is risky, and yes, the current politics are frightening. Yet interestingly, I have every confidence about how we at Cadinha & Co. are approaching this new world and our ability to offer you continued safe steerage along with greater profitability in the future. We can see a lot of opportunity in this confusing environment, but must exercise patience and discipline in order to capitalize on that vision. I hope this letter finds you well...

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Chairman and CEO