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## **Investment Outlook & Commentary Second Quarter, 2008**

Defensive posturing has helped take the sting out of a bear market, and defense will still be the name of our game as the financial and fiscal storms batter equity markets.

The financial crisis continues with investors learning just how large and unruly Wall Street's web of debt has become. It seems trillions of dollars of prime and subprime mortgages were just the beginning; the web included tens of trillions of dollars worth of Collateralized Debt Obligations (CDOs), Structured Investment Vehicles (SIVs), Auction Rate Notes (ARNs), Credit Default Swaps (CDSs), and the other forms of packaged debt given acronyms to help people forget how risky and complex they are.

Trillions of dollars...it's beyond conceptualization. Yet nearly a hundred trillion of this was traded between Wall Street banks, insurers, hedge funds, and even many pension funds and retirement accounts. With banks and other financial firms teetering on insolvency and official recession near, governmental intervention has grown more substantive, albeit at a daunting cost. A \$168 billion stimulus package will send tax rebate checks to most taxpayers starting in May; numerous loans of ever-increasing amounts and durations have been given by the Federal Reserve to banks; and the Fed has executed its first bailout of this crisis in the \$30 billion bailout of Bear Stearns.

### *Bailout of Bear Stearns*

Bear Stearns, a highly regarded Wall Street house that after an 85-year history—including surviving a great depression, a dozen more recessions, and two world wars—found itself belly-up, finished as an independent firm. Bear *was* as independent as a “me-too” Wall Street can get; a firm that didn't peddle retail brokerage, credit cards, and the other products aspiring financial one-stop shops do.

However the massive fortunes made on Wall Street through creative securitizations and speculative trading was just too tempting not to mimic, and Bear found itself packaging, selling, and even buying for clients and itself subprime mortgages and other dubious financial assets. When the markets realized that a 7 percent bond backed by over-extended and subprime borrowers was no deal at all, Bear not only lost a lot of money, it lost something even more valuable: its reputation. Bear's bread-and-butter business, brokerage and custody services for investment firms and hedge funds, dried up as clients, fearing Bear's insolvency, pulled billions of dollars; and Bear's lenders walked away. The firm was finished.

Bear shows us just how little we know about the depth and breadth of what's plaguing our financial system. As Bear's stock price slipped from about \$76 to \$61.50 over a mere five trading days ending on Wednesday, March 12, Bear's CEO reassured viewers on CNBC that Bear was healthy—something a CEO in a post-Enron world doesn't do fraudulently unless he has a litigious death wish.

Two days later on Friday, March 14, the market determined Bear was worth \$30 a share. Then on Sunday, Bear's management, after seeing a large client base and lenders alike walk away on Friday, decided to sell out to J.P. Morgan for \$2 dollar a share. J.P. Morgan made its offer only after the urging and financial assurance by the Fed that it would assume any losses from unwinding Bear's \$30 billion of toxic financial assets. A Fed-bailout indeed, even though fronted by J.P. Morgan.

Last winter, a billionaire investor—the kind of investor with the clout to get as much information on a company's prospects as one can get—wagered a lot of money on Bear Stearns at \$107 a share. A bargain, I'm sure he thought, since the stock's price was sharply off its recent \$170 high. That billionaire investor, a smart Brit known to be one of the world's premier currency traders, has lost over a billion dollars in less than six months.

### *An opaque industry*

With insiders and rich outsiders alike unable to wrap their arms around what Bear Stearns is worth (true even now, as J.P. Morgan recently agreed to raise their offer to \$10 a share), an obvious question arises: How can anyone accurately evaluate any of our nation's large financial firms?

We don't think one can, and this was probably true even before the mortgage collapse. The operations of banks, investments banks, and even most insurers have grown increasingly opaque over the past several years. These companies' earnings are no longer driven by serving as financial intermediaries (such as brokering trades) or as advisers (such as advising mergers); rather, they are driven by legions of MBAs who come up with ever-more complex financial products to sell, and by investing and speculating with their clients' and the firm's own money.

Until this business model changes—and we hope the current debacle has a sobering effect on managements—buying shares in most large financial companies is closer to speculation—a potentially profitable endeavor, but something we won't do with our clients' money.

### *What we're shopping*

A good thing about bear markets, if there is such a thing, is that along with the stocks that deserve to be punished, the market tends to cut the prices of strong companies as well. And in this environment where portfolios are relatively hunkered down and cash holdings are high, we feel its time to start searching for Great Businesses to own, or, if we own them already, to up the ante.

Because greatness, like beauty, is in the eye of the beholder, let me define what we feel is a truly Great Business. (In the past you may have heard us refer to these types of companies as “core” holdings, the stocks we'll hold even as we drop overall stock allocation to get to a more defensive asset allocation.)

First, a Great Business offers a product or service with favorable *long-term* competitive advantages. These advantages generally come through a number of forms, including:

- *Brand name recognition:* Say we were given a billion dollars to build RC Cola into the global soda leader. After we spent the money on improving the product and launching the smartest of marketing campaigns, we would likely fail. A hundred years and countless dollars into building the Coca Cola brand name have not only given Coke dominant market share, but share of mind as well. Everyone *knows* Coke and billions love it. That shouldn't change for decades to come.
- *Economies of scale:* Being able to always under price competitors is like playing craps with loaded dice—just ask Costco or Wal-Mart.
- *Regulatory barriers to entry:* Examples are many and include large defense contractors. The U.S. government isn't interested in thousands of defense companies; you don't see entrepreneurs building bomb startups in Silicon Valley garages. Those people go to jail. Defense is an oligopoly and the demand for its products increase over time. If it doesn't, you'll just have to settle for world peace.
- *Patents and exclusive access:* Although these advantages can be fleeting, many drug and natural resource companies have made fortunes taking advantage of intellectual and physical property rights.

Secondly, a Great Business has great financials. Much of this is due to the nature of their products and services that usually see growth in sales year after year, regardless of the economic environment. These companies generally don't need huge investments in property, plant, and equipment to operate or grow; don't have to borrow money; and generate strong and predictable free cash flow. These qualities typically result in pristine balance sheets with little or no debt and income statements that usually look better every year.

Lastly, Great Businesses have strong and honest management. Over the past ten years, from the dot-com bust to the current financial crisis, investors are learning just how important are the people charged with running our companies. Too many companies, including those that would otherwise be Great, are tarnished by poor corporate governance and perverse financial incentives for managements that reward regardless of the effect on shareholder value.

While the criteria for a Great Business are simple enough, finding companies that fit is harder than you'd think. A great product or technology usually is not enough. Think autos, airlines, or most high-tech and internet services—great and even necessary products, but most providers never amount to great investments over time.

After identifying Great Businesses (likely a short list), we look for a price we're willing to pay for each. Unfortunately, Great Businesses usually sell at premiums to other companies: you pay more for a dollar of their earnings than you do for a dollar of earnings from a more typical company. This is reasonable given that a dollar of earnings from a Great Business has a higher likelihood of both growing over time and being more stable in bad economic times.

#### *Growth and Large Cap tail winds*

The present market environment is lowering the premium investors must pay for Great Businesses. We have been noticing this anecdotally; but, also see this phenomenon through looking at relative valuations for "Growth" versus "Value" stocks as well as "Large Cap" vs. "Small Cap" stocks.

By our criteria, Great Businesses tend to share more in common with "Growth" companies than "Value" companies. Besides having more predictable and higher growth attributes than Value, Growth companies have higher P/E and P/Book ratios and lower dividend yield, reflecting both the premium paid for Growth as well as Growth's emphasis on internal growth as opposed to getting back cash to shareholders from dividends.

Since the dot-com bust, Value stocks have outperformed Growth, due in part not only to the massive premium the markets placed on Growth in the late 1990s (especially tech stocks); but, also to the large tax cut on dividend income. The Bush tax cuts lowered the capital gains tax rate from 20 percent to 15 percent and decreased the dividend tax rate from a rate equal to a shareholder's income tax rate (the highest of which was 39.6 percent at the time) to 15 percent. At the margin, this was a greater boost to companies paying higher dividends, thus favoring Value.

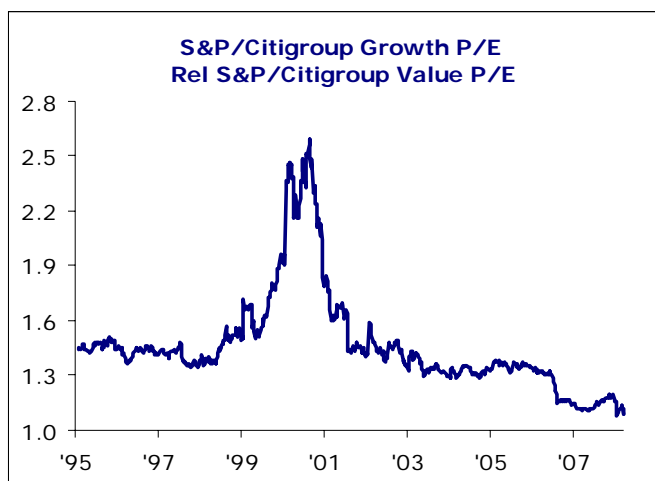


Figure 1

Source: Strategas, LP

Today, the premium of Growth stocks' earnings to Value is the lowest it has been in quite some time (Figure 1). This valuation spread, combined with the fact Value stocks tend to be more cyclical in nature, and the tax rates on dividends are set to move back to their pre-Bush tax cut levels, suggest Growth should out perform.

Besides being more Growth-oriented, Great Businesses tend to be larger companies. As with Growth, "Large" companies usually sell at premiums due largely to their relative financial stability, ubiquity, and scale. Also like with Growth, Large companies' premium have eroded this decade, in fact so much so that investors today pay more for a dollar of earnings from a Small company than they do a Large one (Figure 2).

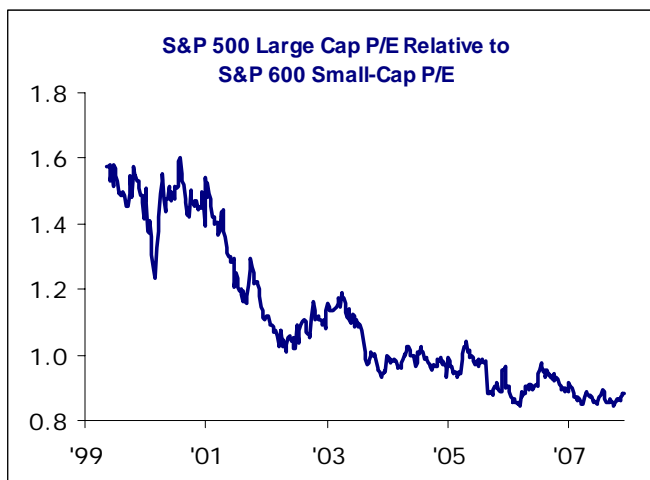


Figure 2

Source: Strategas, LP

Going forward, the Growth and Large company tail winds may be further supported by higher exposure of sales and earnings to faster growing overseas' markets; and a greater ability to raise prices and control costs. In all, we believe the environment is set for a rare opportunity to put some money to work, and so we're pouring through dozens of companies' annual reports weekly, shopping for Great Businesses, currently the world's best investment deals.

### *TIPS*

In Balanced and Fixed Income portfolios we have recently added Treasury Inflation Protected Securities (TIPS). The Fed's interventions have pumped hundreds of billions of dollars into the financial system and lowered interest rates substantially. We feel we need to hedge the risks these actions pose to inflation and the Dollar. Generally speaking, TIPS are Treasury bonds indexed to inflation (as measured by the Consumer Price Index). While the market anticipates inflation in the low 2 percent range, current inflation is roughly 3.5 to 4 percent. Should inflation data continue to come in higher than expectations, TIPS should out perform Treasury bonds, as should gold and any foreign currency holdings.

TIPS, gold, and foreign currencies are hedges, added to counteract bond positions that should do poorly in such an environment. We'll keep you posted when we get a little more conviction on interest rates, inflation, and the Dollar. Meanwhile, we're hunkered down as further unwinding and abrupt policy moves further market volatility in bond markets.

Preservation of capital will continue to be a driving motivator for us on the equity side as well, where we remain underweight. With the bear market alive and well, we're hesitant to call any bottom. However, we are alert and watching, knowing that bearish times allow longer-term investors to buy the truly Great Businesses at sale-like prices.

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