



## Simplicity Still Pays

For the past few months, America's subprime mortgage drama has dominated the news, but its threat to the overall economy puzzles some people. If mortgage providers unwisely extended credit to unqualified borrowers, they must refinance or repossess the properties, as they have in the past. Why on earth would this situation threaten the world economy? According to a headline in the December 27, 2007, *Wall Street Journal*, "Wall Street Wizardry Amplified Credit Crisis." Apparently, financial gamesmanship has ensured that what could have been a localized problem will instead hurt a lot of people.

### HOT POTATO

The *Journal* explained how Collateralized Debt Obligations (CDOs), which are designed to spread and mitigate debt risk, instead magnified and concentrated risk. CDOs and similar products are, in effect, packages of securities based on mortgages and other debt. Of course, when referring to subprime loans, "security" seems like an awful misnomer. Banks package their loans into financial products, selling as investments the cash flow and interest profits from the mortgages.

Theoretically, this dilutes default risk through diversification; many different types of loans are mixed together. How does such an instrument end up achieving the exact opposite of its intended outcome? Our knee-jerk response is to quote Berkshire Hathaway Vice-Chairman Charlie Munger: "When you mix raisins with turds, you've still got turds." But bad loans are just bad loans, even if banks make more bad loans than usual. The greater risk to the economy can be found in the *Journal's* explanation of a CDO called Norma:

"For Norma, N.I.R. assembled \$1.5 billion in investments. Most were not actual securities, but derivatives linked to triple-B-rated mortgage securities. Called credit default swaps, these derivatives worked like insurance policies on subprime residential mortgage-backed securities or on the CDOs that held them. Norma, acting as the insurer, would receive a regular premium payment, which it would pass on to its investors. The buyer of protection, which was initially Merrill Lynch, would receive payouts from Norma if the insured securities were hurt by losses.... In principle, credit-default swaps help banks and other investors pass along risks they don't want to keep. But in the case of subprime mortgages, the derivatives have magnified the effect of losses, because they allowed bankers to create an unlimited number of CDOs linked to the same mortgage-backed bonds."

If you did not understand that explanation, you are in good company; large banks writing down tens of billions of dollars in losses may not have understood it either. The *Journal* summarized the gist of the argument nicely: "Norma contributed to a speculative market that dwarfed the value of the subprime mortgages on which it was based. It was also part of a chain of mortgage-linked investments that took stakes in one another." That's right:

knowing that subprime mortgages were pigs, bankers applied enough lipstick and rouge to make the loans attractive to investors. But the banks made these packages so attractive that they bought them from each other!

Once again, Wall Street's prevailing ethos, that "if it's worth doing, it's worth overdoing," benefits a few and endangers many (although we concede it also creates opportunities for entrepreneur-



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ial investors). The misuse of CDOs reminds us of Mel Brooks' 1968 film and recent Broadway musical, *The Producers*. You may recall the premise: two conmen oversell shares of a musical, intending to produce a flop, which will allow them to keep the money their investors will write off as losses. Unfortunately, the play is an inadvertent smash hit, ruining the conmen's plans. CDOs were invented so banks could transfer risk and earn fees in the process, but when banks started issuing multiple CDOs based on the same securities and buying them from each other, things got out of hand.

### ARE BANK WRITE-OFFS ON THE LEVEL?

Those watching the subprime debacle and waiting for "the other shoe to drop" are in for an unpleasant surprise: it will soon be raining shoes. Many financial institutions, large and small, invested heavily in mortgage-backed securities, but many have not yet written down the value of these securities. Because the market for CDOs has all but disappeared, banks can sweep these investments under the rug of "level 3" assets, a Financial Accounting Standards Board (FASB) category for illiquid investments.

As John Mauldin explains in his weekly newsletter, "Level 1 means assets that can be marked-to-market, where an asset's worth is based on a real price, like a stock quote. Level 2 is mark-to-model, an estimate based on observable inputs which is used when no quoted prices are available. You can go get several bids and average them, or base your assumption on what similar assets sold for. Level 3 values are based on 'unobservable' inputs reflecting companies' 'own assumptions' about the way assets should be priced." So the value of level 3 assets is based on the owner's internal valuation formulae. This buys time before they have to admit and write down their true losses. Frankly, no one can estimate how great these losses may be.

But moving the "assets" into level 3 creates a new problem, and one that directly threatens our consumer-driven economy. There's nothing inherently wrong with illiquid assets, but banks need to

meet minimum capitalization requirements, so moving large stakes into the level 3 category requires that lenders rebuild capital. What is the easiest, quickest way to rebuild capital? Stop making loans. This is how imprudent loans to unqualified borrowers, traded as financial instruments by fee-hungry financiers, can lead to a credit crunch for everybody, possibly stopping the economy in its tracks.

The complexity of CDOs probably made them seem more attractive to many, but breaking the concept down to its simplest expression could have helped a lot of people see the danger sooner. Subprime mortgages and the instruments built on them only work in economies and financial markets that only go up, continuously and forever. We do not know of any markets that only go up, so we think these instruments look more like a Ponzi scheme than a rational investment. For some reason, people fall for this over and over and over again.

### SIMPLICITY FOR THE LONG TERM

We don't fear complexity, but we prefer simplicity in our investments. Over time, the stock market rewards simplicity.

When we call Wal-Mart, Whole Foods, Hershey or Wrigley simple businesses, we do not mean to trivialize the competitive challenges these companies face everyday. We consider them simple because it is immediately clear how they make money, and how they make money for investors. Wal-Mart sells everyday goods at low prices, Whole Foods sells healthy foods, Hershey makes chocolate, and Wrigley makes chewing gum. That part is simple, but each company worked hard to achieve competitive advantage that allows it to execute its simple business in very profitable ways.

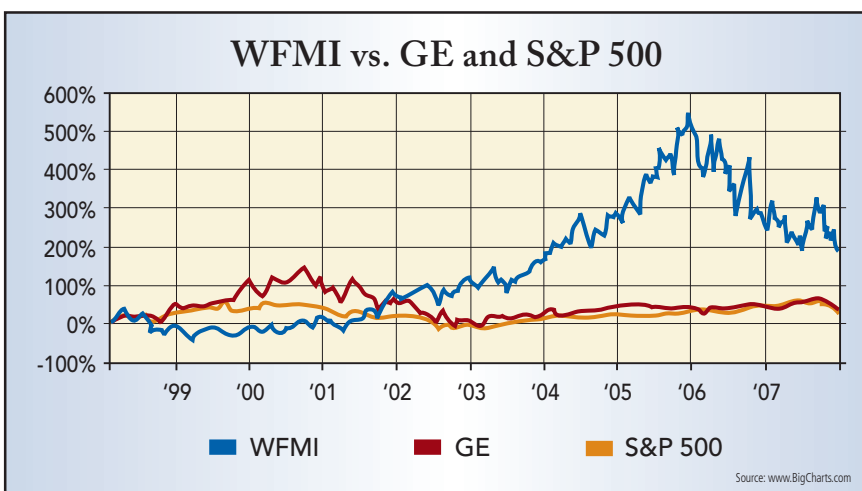
Even a company doing complicated things can qualify as a simple company. Noven Pharmaceuticals creates and markets superior drug delivery methods, such as patches for treatment of ADHD and estrogen therapy for menopause. The advantages of Noven patches are easy to see: they are much smaller than competing patches, stick better with less skin irritation, and investors get some additional margin of safety through long patents. Drug companies partner with Noven because the patches extend and differentiate proven drug compounds with low development costs and short regulatory approval time frames.

A "simple" company easily passes the elevator test favored by venture capitalists when hearing a proposal: if you can explain the business in the time it takes to get from the lobby to the office, it may have merit. To meet this test, a collateralized debt obligation based on credit default swap derivatives would require a very tall building indeed.

One reason we long-term investors prefer simplicity is that during times of trouble, Wall Street often experiences a "flight to quality," meaning that after their overcomplicated speculative gambles have gone sour, investors salve their wounds by turning to reliable performers. Thus, simple companies often have an edge when the market falters.

### DÉJÀ VU ALL OVER AGAIN

From junk bonds to tech bubbles to energy trading to subprime mortgages, Wall Street hotshots are forever inventing new and more complicated ways to make money, but for whom? On the face of it,



### A SIMPLE ADVANTAGE

It has become difficult to explain in a sentence or two exactly what General Electric does. GE builds many wonderful things that enhance the lives of people all over the world, but as you can see from this ten-year chart, the huge conglomerate's internal diversification has led it's performance to mimic the S&P 500 market index. Whole Foods, on the other hand, can be explained by simply expanding on their name: Whole Foods markets healthy groceries.

subprime lending made little sense: why did lending money to unqualified individuals seem like a good idea? Regardless, when the Wall Street money wranglers stepped in, we saw that there's no bad idea that cannot be made worse through the intervention of a greedy MBA. Any engineer will tell you that every increase in complexity includes an increase in possible points of failure. This is just as true for investments as it is for electronic circuits, skyscrapers and automobile engines.

In the Forbes.com review of our book, *The Entrepreneurial*

Investor, the writer noted that we cite Warren Buffett in nearly every chapter. Well, here we go again. In the 1990s, high tech investors and "new economy" analysts ruthlessly savaged Buffett for his old-fashioned adherence to obsolete concepts like "profit" and "cash flow." Long-term, he was right and they were wrong. And long-term is what matters: the objective of investing is not to boast about how rich you were for a few months in the 1990s, but to continuously build your resources over time. To do so, appreciate the value of simplicity. ▲

## Perspectives on Spending

We've written for years that the government's declaration of inflation as non-existent or under control merely reflects flawed measurements, which do not include energy, healthcare or groceries, three areas that affect all Americans and have been rising steadily. Regardless of official pronouncements, Americans living paycheck to paycheck (and that's almost everyone in a country with a negative savings rate) know that their money buys less every month.

For perspective, we occasionally compare spending categories to the Gross Domestic Product, which is defined as the total market value of all final goods and services produced within a country in a given period of time (usually a calendar year). Unfortunately, it takes a while to compile all the necessary numbers, so the information sometimes seems stale.

Even so, such a comparison generates interesting questions. Take a look at the nation's approximate spending on healthcare, energy, petroleum (subset of energy costs), and defense in 1970 and 2004:

### Healthcare

1970: 7.1% of GDP  
2004: 15.5% of GDP

### Energy

1970: 8% of GDP  
2004: 7.4% of GDP

### Petroleum

1970: 5% of GDP  
2004: 4% of GDP

### Govt. Spending: Defense

1970: 9.2% of GDP  
2004: 4% of GDP

The healthcare increase comes as no surprise, but many people find it hard to believe that energy costs were fairly stable and defense spending actually halved as a percentage of GDP during this period. Naturally, we spend a lot of money on defense, but apparently the economy has grown much faster than our military spending. Are we under-spending? Have we dramatically improved efficiencies in procurement? Has the end of the Cold War delivered a peace dividend? Are we under-prepared for possible threats?

Or do the last three years of war and soaring oil prices render meaningless this data from 2004?

The stock market, the economy, and monetary policy, here and abroad, are all connected. As investors we need to generate questions about these forces and their interactions to better understand the full range of possibilities in the coming years. Can the Federal Reserve lower oil prices by tightening monetary policy? That's what happened in the 1980s. Would lower oil prices slow exploration, leading to tighter supplies and higher prices later? How would higher or lower transportation and energy costs reverberate through the rest of the economy?

We'd love to hear what you think about the comparative cost of healthcare, energy and defense. Send us your thoughts by email at [info@wcam.com](mailto:info@wcam.com) and we'll respond in a future issue of *Exclusive Outlook*. ▲

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