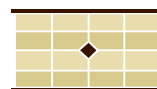


EXCLUSIVE OUTLOOK



WEST COAST
ASSET MANAGEMENT

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NEW YEAR'S RESOLUTION: LEARN FROM OUR MISTAKES

THOSE WHO RESOLVE TO LEARN from past financial mistakes will be entering 2009 with a great deal of caution. 2008 was an epic year for the discovery of errors among regulators and financial institutions of all sorts, including money managers, investment banks, traditional banks, and insurance companies. When gigantic, well-established companies like Washington Mutual, AIG, Citigroup, Lehman Brothers, Bear Stearns, Fannie Mae, and Freddie Mac collapse within a matter of months, we know that mistakes have been made.

Considering the frequency and consistency of economic catastrophes over the last three or four hundred years, one might surmise that the human race is incapable of learning from its financial mistakes. In aggregate, this may be true. From tulip-mania to the panic of 1897 to the Great Depression to today, markets reenact the same absurd behavior over and over and over again. But for individuals, there are plenty of lessons to be learned from recent mistakes.

LIQUIDITY

On December 10, 2008, the Wall Street Journal profiled Bill Miller, formerly "the era's greatest mutual-fund manager." As manager of Legg Mason's Value Trust, Miller outperformed the market every year for fifteen years, only to lose 58% of the fund's value in 2008. Like many value investors, Miller boldly bought distressed stocks he believed were undervalued. When financial industry stocks sank, Miller went on a buying spree. According to the Journal, "What he saw as an opportunity turned into the biggest market crash since the Great Depression."

Miller offered a frank assessment of his error:

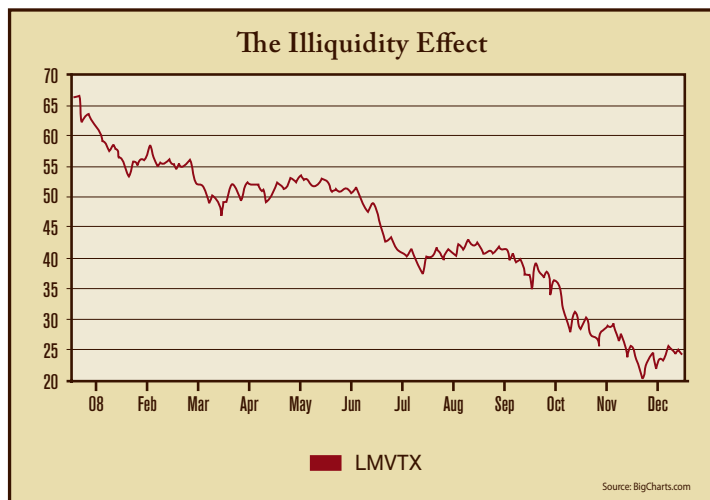
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“The thing I didn’t do, from Day One, was properly assess the severity of this liquidity crisis.” According to the Journal, he failed to consider “that a whole group of once-stalwart companies would collapse.”

He was not alone. You may know the old aphorism that “all signs of rain fail in dry weather.” The concept applies to finance as well as precipitation. For investors, liquidity refers to the ease with which you can access cash from your investments. How fast can you get out of a stock if you need to sell it? Usually there is a fairly rational market and when heavy selling pressures a stock price, ready buyers pick up the shares on the cheap and maintain market equilibrium. But liquidity is not guaranteed, and prices drop quickly when people cannot find buyers – regardless of the company’s underlying value.

When prices are dropping rapidly, buyers retreat to wait for the bottom, or become reluctant to buy something they may be unable to sell. When nobody is buying, liquidity disappears. This proves extra harmful to small cap companies, which feel a disproportionate impact compared to companies with massive market caps.

The one-year chart for Legg Mason’s Value Trust fund illustrates not only the effect of underestimating the liquidity crisis, but how quickly the market’s loss of liquidity drove prices down.



For most long-term investors, a temporary loss of liquidity isn’t too much of a problem. By temporary, we do not necessarily mean “short-term.” Even a long-term illiquid investment presents little trouble for someone with liquidity elsewhere. The market historically shows tremendous resilience and those who can ride out the storm for a few years need not turn temporary losses into permanent ones by selling during a liquidity panic.

Money managers, on the other hand, face a more serious challenge during times of constrained liquidity. When everyone is selling regardless of price or underlying value, managers may be compelled by clients or leverage or other pressures to sell securities they would prefer to keep. Some managers contract with their clients for discretion to manage funds as they see fit, but all managers must ultimately obey the wishes of clients unless they have lock-ups, as do most hedge funds. Groups that manage a lot of money may be MORE susceptible to panic selling than individuals, turning the perception of a price crash into reality. Satisfying client demands for redemption can cause

prices to drop further, creating a vicious cycle of panic selling.

For individuals, Wall Street panics affect investors differently depending on their goals and timeframes. A sixty-year-old with a thirty-year-old 401(k) and a twenty-year-old with a brand new IRA find themselves in completely different situations right now. The elder may have lost 50% or more of his nest egg in the last year, whereas the new investor has lost little and been presented with rare bargains and an opportunity for significant future appreciation. Liquidity means little to the twenty-year-old, and can mean everything to the investor approaching retirement.

For both individuals and managers, illiquidity reduces our agility when better opportunities present themselves and we cannot capitalize on them. But illiquid investments are typically cheaper because they reflect a liquidity discount, and are often attractive to value investors as part of a broader portfolio. So liquidity can be a double-edged sword, but the financial meltdown of 2007-2008 reminds us to better respect both sides of the blade.

For us, two significant lessons emerge from Mr. Miller’s experience. One, naturally, is to prioritize liquidity in investment decisions – both the liquidity of the companies and the ability to buy/sell them. But another lesson concerns a common psychological blind spot afflicting many investors. Most sensible people ask, “What’s the worst that could happen” when reviewing a prospective investment. Even when we correctly identify the worst-case scenario, the blind spot is this: we secretly believe that the worst cannot happen, so we do not take it seriously. Moreover, the worst could be something we have never conceived of, like a company losing half of its war chest of “cash” by investing it in failed auction rate securities.

SELF SUFFICIENCY

Here in California, many of us maintain earthquake kits to provide us with food, water, medical supplies and other necessities (like coffee!) to ensure our survival after a major quake. A strong balance sheet can be a company’s survival kit after a credit earthquake. In good times (or even bad times that do not include a complete credit freeze), good companies can find capital at reasonable terms. In horrific times such as the present, even great companies struggle to secure capital. Even 2010 bonds for Wrigley (now part of Mars, Inc.), which is not struggling for capital, yield nearly 10% today!

Companies with overcapitalized balance sheets not only avoid credit squeezes – which can permanently damage equity value as a result of dilutive financing – but they are able to prey on the weak and acquire other companies at incredible fire sale prices, especially in difficult times like these. This is again a double edged sword, as leveraged companies often appear cheaper, and in normal credit environments investors expect that financing will not present a big obstacle.

One important balance sheet caveat: Cash is important, but it is less important than the hands that wield it. Cash should be deployed to increase value. In the wrong hands it can lead to stupid acquisitions or other bad investments. Know management’s history vis a vis disposition of assets. Also, as many learned in 2008, cash is not always cash. Many companies invest in Auction Rate Securities (ARS), many of which turned out to be worthless even though they were “cash equivalents” on the balance sheet.

Many California households only boast fully stocked earthquake kits for a few weeks after a small temblor. Over time, family members raid the kit for canned goods or flashlight batteries. Then, in a real emergency, they find themselves unprepared. Keep an eye on the

balance sheet to ensure that the companies you own will have options available when trouble comes.

Debt isn't necessarily bad, depending on how much debt and in relation to what business, but too much debt is another matter. General Electric has nearly \$1 trillion in liabilities, but is AAA rated, although Standard & Poor's recently announced that GE could lose this status within two years. We've been saying for years that GE is really a finance company and subject to the growing pressures in that industry. The company has nearly \$200 billion in short-term debt that may require refinancing, but who will lend that amount, and at what terms? Maybe they will make it, but does a \$170 billion market cap justify the risk of owning the stock behind all of this debt? Warren Buffett has invested in GE, but he likely gets paid back even if the company goes bankrupt because he bought preferred stock.

DON'T BELIEVE EVERYTHING YOU THINK

Well-known value investor Seth Klarman recently wrote the following:

"In capital markets, price is set by the most panicked seller at the end of a trading day. Value, which is determined by cash flows and assets, is not. In this environment, the chaos is so extreme, the panic selling so urgent, that there is almost no possibility that sellers are acting on superior information. Indeed, in situation after situation, it seems clear that fundamentals do not factor into their decision making at all."

Investors should welcome skeptics and devil's advocates into every decision

Groupthink inflates bubbles and groupthink pops them. The mob giveth and the mob taketh away. This is why investors should welcome skeptics and devil's advocates into every decision. We need to surround ourselves with people whose opinions contradict our own. Even those of us who regularly visit companies and try to kick the tires sometimes see what we want to see and hear what we want to hear. Even if we think we are good at questioning everything, it pays to invite debate and to solicit ideas and comments from as many people as possible. We need to talk to the competition more and talk to the analysts who are panning prospective investments.

On the one hand, we all want to avoid "headline risk," the kind of losses that come from bad or misunderstood press. But on the other hand, an entrepreneurial investor who understands a company's

fundamentals can capitalize on headline risk, buying when a company becomes undervalued through sentiment rather than sense. One caveat is that sometimes perception leads to reality when companies depend on constant access to capital, but bad press discourages lenders.

A motorcycling enthusiast tells us that even though he is a very experienced rider, when things go wrong – a patch of loose gravel or the sudden appearance of a wild animal – a focus on fundamentals saves him. "My knees grip the tank, my head lifts, and my eyes lock onto where I need to go." We like the analogy because in the stock market, one should always pay attention to the fundamentals, especially when things go wrong.

TAKING OUR MEDICINE

George Santayana famously said that those who do not learn from the past are condemned to repeat it. Today, as we face an awfully familiar looking financial crisis, Santayana's comment sounds less like an admonition and more like a description of human nature.

Everyone has 20-20 hindsight. As then Los Angeles Dodgers manager Tommy Lasorda said after St. Louis Cardinal Jack Clark hit a championship-winning home run against his team, "After we pitch to Jack Clark, even my wife knows we should have walked him."

Of course, learning from our mistakes is not as simple as it sounds. In *The Black Swan* (Random House, 2007), author Nassim Nicholas Taleb explains a common human weakness. After we experience a random, completely unexpected event, we tend to construct a logical explanation that makes the unexpected event seem perfectly predictable. The Black Swan effect may be best described by the title of Taleb's prior book, *Foiled by Randomness* (Random House, 2004). By building ever more elaborate models and convincing ourselves we can plan for the unexpected, we fail to plan for the unexpected, which is, by definition, unexpected. Today, everyone knows that Merrill Lynch was headed for disaster a year ago. Who knew it a year ago?

But Jack Clark hitting a home run was not a "Black Swan" event. Lasorda simply thought his pitcher could best Clark. He made a mistake.

Benjamin Graham created the tenets of value investing from the lessons of his (and the nation's) financial mistakes leading up to the Great Depression. Perhaps the greatest lesson of the current crisis is that we already know the answers: understand a company's liquidity, balance sheet, sensitivity to the economy and commodity prices, and realistic worst-case scenarios. 2009 will show whether we have the discipline to execute our strategy according to the lessons we have already learned. ♦

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OUR PHILOSOPHY – WEST COAST ASSET MANAGEMENT's investments are focused in a small number of companies that we thoroughly understand. In our experience, this lowers the risk of losing capital and enables each investment selection to have a meaningful impact on results. We believe the stock market is driven by fear, greed and conflicted interests, which create exceptional buying opportunities for vigilant and nimble investors with a long-term horizon. Our experience has taught us to believe what we see, not what we hear, which is why every investment decision is based on our own hands-on research. We do not limit our investments to companies of a specific sector, size or valuation category – we simply seek the best opportunities to increase wealth and minimize risk. We believe investing is part art, part science, and all craft.