marshfield associates

Letter to Clients
August, 2011

High Anxiety

"Hope for the best, expect the worst
Some drink champagne, some die of thirst
No way of knowing
Which way it's going
Hope for the best, expect the worst!"

Mel Brooks

While really nothing to joke about, current affairs (take your pick: the debt ceiling debacle and the take-no-prisoners political environment, the S & P downgrade of the US, the fissures showing in the EU's foundation) have lately had something of the ridiculous about them. While each of these events may have been unexpected in its particulars, none has been beyond historical norms in terms of the kinds of things that routinely occur in a complex world. These occurrences are not so much "unprecedented" (as the unimaginative financial media would have you believe) as they are without precise and facile analogy to prior historical events. As such, they fail to fit into a comfortable template to which investors can turn in order to ascertain what this might mean for stocks going forward. Volatility, anxiety, and panic have been the not so surprising results. For us, however, these events are simply reminders of the perennial benefits of taking a skeptical approach to both analysis and valuation from the outset. If you take a jaundiced view of things from the beginning, random negative developments (or positive surprises) along the way might add to the fact set you must analyze but probably won't rock your convictions unless they undermine your investment thesis entirely.

Embracing skepticism does not, however, mean that one should indulge in mindless naysaying. Rather, skepticism is a habit of thought that allows for critical examination of conventional wisdom. Skeptics are equal opportunity doubters, raising an arched eyebrow at popular opinion, whether it's running positive or negative. Today, popular belief subsumes both poles: social networking companies like LinkedIn have received giddily high valuations on their IPOs, while well-run and capital-rich financial services companies have struggled to trade anywhere near book value. Being skeptical allows us to sidestep both the overly optimistic and the excessively pessimistic; in effect, it allows us to disengage from both the enthusiasms and the panics that undermine long-term returns.

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The braying headlines and frantic hand-wringing engendered by recent events notwithstanding, we see nothing that fundamentally undermines the long-term business cases made by our companies. Yes, the American political process is polarized and any kind of compromise is hard-won. But however unappetizing it was to see the debt-ceiling sausage being made, the cooks in the kitchen came up with something everyone could eat, if not happily stomach. Default was averted and a path toward some kind of deficit reduction plan has been set forth. Yes, the economy may be somewhat more anemic than anticipated and unemployment more stubborn, but the economic assumptions we have had to make in order to buy our stocks continue to look reasonably conservative to us. While a case can be made that confidence is so fragile that a double dip recession will be a self-fulfilling prophesy, we view that argument with…skepticism. Yes, the EU has yet to fully address the fundamental flaw in a system in which monetary policy is centralized but fiscal policy is dispersed. But it will be Europe that bears the brunt of its lack of foresight and the unsustainable levels of debt among its member countries. While that can spell trouble for some U.S. companies, the net competitive consequence for strong American financial institutions in particular is likely to outweigh that. Yes, S & P downgraded the U.S. (not England or France?), but as we see it, that fundamentally changes nothing; except as a barometer of anti-Washington pique, it is likely of little practical consequence long-run, as demonstrated by investors' flight out of the stock market August 8 and into…Treasuries. We would note, as an aside, that there is something especially comical about the selloff in **Moody's** in the wake of the downgrade. While S & P did the industry no favors by making such a silly move, the fact remains that the ratings agencies have shown themselves to be of continued relevance, largely immune from liability as opinion-providers, and in proud possession of a raft of new disclosure requirements that tax prospective new entrants far more than they do existing players.

We are also skeptical of the increasingly popular notion that a reprise of the recession would look similar to (or worse than) the crisis of 2008. As alluded to above, financial services firms today have significantly improved balance sheets and higher capital levels, tighter underwriting standards, and reserve releases as credit problems roll off their books. In fact, **Wells Fargo**, **US Bancorp**, and **Goldman Sachs** are as well or better capitalized than they have ever been and have substantial liquidity (though each was criticized just last month by analysts for the amount of liquidity it was carrying). US Bancorp was so conservative during the last decade that it does not have legacy portfolios to speak of, while those that Wells has, which were mostly inherited from Wachovia, are manageable and declining at a decent pace. Both have substantial loan loss reserves. Both are benefitting from (1) the more conservative loan environment of the last few years, (2) the considerable economies of scale that exist in the banking business, and (3) the flight to quality that happens in environments like the current one. As we have written about before, good economic times relatively benefit poorly run banks, while bad economic times relatively benefit well-run banks. With respect to Goldman, we note with some surprise that, as of

this writing, it is trading below tangible book value. There could be some validity in that -- even the securities they own can decline in value. However, we would note that it historically has been quite good at making money in tough markets. Also, if the worry is about legal exposures, we believe that it is easier to sue Goldman than to sue it successfully, a point that was recently reinforced by it – yet again – reducing the "reasonably possible" legal costs it anticipates having to pay. Of course, only time will tell.

Buying financial companies at or below book value (assuming that book value is real – in other words, that it reflects accurately or conservatively what the company's assets and liabilities are worth) means that not much has to go well for us to make money. Put a different way, it means that numerous things can go wrong and still allow us an attractive return on our investment. Here's the math: when we buy a stock, we want to earn at least an 11 percent return over time. This means that if a company can earn a return on equity of 11 percent or better, it will be a good investment for us. Even in the last few years, returns have been better than that, with the exception of **Berkshire Hathaway**, which was held back by the softening insurance environment, its aversion to returning capital to shareholders, and its large public equity portfolio of value-oriented stocks. Even Berkshire, however, has grown book at over 7 percent per year since 2007. Our other large financials grew book at annual rates varying from 13 percent to 23 percent over that timeframe. While in the last twelve months, **Fairfax Financial Holdings** actually lost book value (due to a combination of insured disasters and its negative view of the equity markets), it stands to benefit from market turmoil. Fairfax has a portfolio built for this environment, with 86 percent of its stock portfolio hedged and in addition a very large bet that will pay off if a downturn is accompanied by deflation. It also has a substantial cash position, with over a billion dollars in cash on the balance sheet – not bad for a company worth just over $8 billion. Finally, while Goldman's book grew by only 7 percent over the last year, its long-term record is substantially in excess of that; while it has reduced its leverage significantly and will be limited in the extent and nature of its proprietary trading, we believe that it still knows how to deploy capital and make money for its shareholders.

As may be clear from the discussion of Fairfax, the risk to our property and casualty companies is not that claims will rise. After all, the weather doesn't know what the stock market is doing. The risk is that their investment portfolios will suffer in this kind of environment. Berkshire's and **Arch Capital's** portfolios aren't as exquisitely designed for the current environment as Fairfax's, but they are invested by people who are well aware that bad things can happen in the capital markets and that they have to safeguard their ability to pay claims. Berkshire – as we saw in 2008 and as we can see today by its fixed price offer to buy Transatlantic, a reinsurer, for 77 percent of book – is quite willing to put money to work in difficult market environments.

As we write this letter, the stock market has gyrated through a series of large gains and substantial losses in very short order. If in our business we're essentially making book on the future, we'd far rather make book on the business prospects of individual companies than on which way the market will turn and when. When we talk about our conservative approach, we are not talking politics or policy but, rather, the way in which we make such predictions. While we are long-run optimists when it comes to the soundness of the American economic system, we are short-run pessimists; we assume when we buy something that whatever made it cheap may well make it cheaper – perhaps much cheaper, and perhaps for much longer. We also know that bad things do in fact happen to good companies – we can't always know what form those things will take, but we can try to price them in by adding a buffer to our buy price. But so long as the underlying business is resilient and the price we are paying reflects a none-too-rosy set of expectations, we believe we can both protect ourselves from truly "unprecedented" developments and also benefit down the road from a return to normalcy. We do so at the conscious expense of sometimes looking foolhardy in the interim.

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