Ruminations of
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Oh Give Me a Home

Recent data on housing starts in the U.S. have given a ray of hope to those looking for a rebound in this very important segment of our economy. Indeed, most Americans have more of their wealth in real estate than any other asset class (or more precisely, this is what most folks think; given the current state of the economy, this notion might need to be revisited). A March housing report indicated increases in sales for existing homes in six of the past eight months. Could this be the start of a new, very welcome trend leading our economy out of the weeds?

Readers know the Contrary Investor spends a great deal of time and energy studying demographics — "demographics is destiny" is a foundation of our philosophy. A letter to *The Economist* magazine recently, submitted by Ian Ellis, the President of hedge fund MicroCapital, addressed the housing situation from a demographic point of view in a very cogent, contrarian fashion. His comments are as follows:

"Sir — Your special report on property (March 5th) made scant reference to two important determinants of the American residential property market: the underlying demographic impacts on demand and supply, and the serious shortcomings of a fixed-rate mortgage market. While the demand function for first-time buyers is frequently analyzed, the fact that Americans make their largest home purchase at the average age of 45 is rarely considered. Once one appreciates this fact, and that the apex of the baby boom was 1961, it should be no surprise that the peak year of inflation-adjusted home prices was 2006, after 15 years of increasing demand.

The average age at which Americans make their largest home sale is 60. Since the number of Americans born in 1976 is almost 25 percent lower than the number born in 1961, and the bulk of aggregate property value is in the largest homes, it is therefore reasonable to assume there will be no equilibrium in the American market until approximately 2021.

Moreover, in addition to the 25 percent of home-owners with negative equity, a similar proportion have insufficient positive equity to refinance their high fixed-rate mortgages. Until home equity improves and/or a vibrant variable-rate market develops, there will be many reluctant sellers.

The outlook for homeowners is unavoidably grim."

Ellis cites 25 percent of homeowners underwater on their equity. The worst city in the U.S. for this dubious distinction is Las Vegas, with recent numbers showing over *80 percent* upside-down!

Home equity lines of credit were not too long ago considered essentially an owner's ATM, with spending from tapping this resource fueling our economy. Now, not so much. But "housing" is a very big, very broad industry, and a large part of successful investing is in knowing what to avoid, as well as where to put money.

Big homebuilders like Toll Brothers (TOL), DR Horton (DHI) and Pulte (PHM) have struggled for quite some time, and should probably be avoided. But United Technologies (UTX) is a significantly more diversified play on housing, with divisions ranging from aircraft engines (Pratt & Whitney) to housing-centric Carrier heating and air conditioning units and fire and security offerings. For the just-ended quarter, revenue at the Carrier division was up 12.1 percent year-over-year, and fire and security gained 15.1 percent.

Then there are the home improvement stores like Home Depot (HD) and Lowes (LOW). Even underwater homeowners will likely spend money to maintain their largest asset, and the recent storms across much of the country should spur additional spending. Neither of these companies could be considered contrarian plays at current levels, having risen about 20 percent each over the past 12 months. But to completely discount spending on housing is not a good course of action.

At the same time, it is clear that there will be a long term battle between government spending on construction and infrastructure versus health care and human services in light of our debt crisis. And another often overlooked force in our housing market is the increased interest from foreign buyers in distressed, but attractive markets like Miami. The weak dollar and depressed prices have wealthy Hispanics and Europeans flocking to our markets. Further, there will clearly be lots of money spent on so-called "green" construction projects, including LEED certified buildings and LED lighting. Lots to think about!

Given that most of us don't relish the thought of living on the streets, home ownership will be an important and inevitable part of our finances. But the demographics, so eloquently set out by Mr. Ellis, are hard to fight. Perhaps it would be to simply stay out of this fray and look for better opportunities.

❑ Alex Seagle

It's Been a Very Good Year

Although we are a fly-speck in the pantheon of investment managers, Fraser Management does invest money for a select group of faithful individuals and institutions, and we are truly grateful for the trust they place in us. Our investment philosophy follows the ideas set out in this rambling missive, albeit with a much more disciplined, tighter approach thanks to the efforts of our Portfolio Manager, Len Davenport, CFA. Each quarter, we send a report to our clients with our thoughts and their results. The Contrary Investor would like to share our latest letter.

Fraser Themes – A Good Place to Be

We were rewarded during the first quarter of 2011, with our model portfolio significantly outperforming the broader market indices. This was the result of our owning companies participating in several themes most investment managers have overlooked or misunderstood. Contrarian investing is often lonely, and as we pointed out in last quarter's report, it involves patience and commitment. Patience and commitment equals high conviction and a long term time horizon for investing in our themes. We regularly perform analysis to determine the contributors and detractors on performance in our portfolio. The result of this analysis, while very often interesting, is more importantly critical in identifying risks and opportunities as shorter term market sentiment swings out of sync with what is really going on. We have target allocations for each of our holdings, and rebalance your portfolio when these "bogeys" are off. Stocks that have done particularly well are trimmed, and those companies lagging are closely studied for opportunities to add to positions.

The World is a Scary Place

As I write this letter, crude oil is at $108 per barrel (with gasoline at $4 a gallon in several states); the U.S. has entered the battle in Libya, with unrest in that region spreading and our potential ongoing involvement uncertain; our Congress seems more interested in scoring political points than in addressing crucial debt issues; and the weather is truly weird. In addition, housing prices – generally regarded as the largest part of people's net worth – remain under pressure. This is the Chinese symbol for "crisis": 危机

The symbol is actually two characters – one for "danger" and one for "opportunity." This notion very accurately describes the investment process! Our job is to identify the dangers and opportunities in the equity markets, and position your assets accordingly. We work hard every day to do just that.

Looking Forward

We pay very little attention to the groupthink of conventional Wall Street pundits. Each year at our Contrary Opinion Forum, we produce two lapel buttons offering the wisdom of outside-the-box thinking. One of my favorites from many years ago advises "Be Brave to Expect the Crowd to Be Wrong." It is clear to us that several factors will shape the investment landscape for a number of years, and it is equally clear that these influences are not fully appreciated: the population in developed countries is aging, while developing nations, with younger populations, are enjoying higher economic growth rates as well as the associated problems of inflation and social unrest; alternative energy is becoming more important, especially in light of the disaster in Japan; our climate is unsettled, leading to the need for investment in infrastructure repair and replacement; recent census data firmly reinforces our contention that the economic and electoral impact of the Hispanic component of our population continues to grow; and consolidation within the financial services industry is robust. In short, we like our themes, and we are firmly committed to them as the best ways to invest money in the stock market.

❑ Alex Seagle

Mistake Number 1: Ignore Rule 22

"Rule 22: Look beyond obvious similarities between a current investment situation and one that appears equivalent in the past. Consider other important factors that may result in a markedly different outcome."

David Dreman

Common sense (which ain't so common!) would lead one to believe we human investors would do our best to duplicate our prior successes, and avoid our previous failures. Most investors took a beating in the tech bubble in the early 2000s. If you didn't get burned in 2008 and bail out of equities, and your trepidation caused you to be late getting back into the market — if you got back in at all — you should be running a hedge fund and have so much money no one can afford to talk to you. It seems to be a pretty simple lesson to learn: avoid extremes in Crowd sentiment, both optimistic and pessimistic, and don't worry about squeezing out the last drop of profit.

The fact is that lots of folks don't heed the lessons of their past investment decisions, no matter how painful, and are extremely good at replicating behavior that does not work consistently. And it turns out professional money managers aren't much better.

It is important to understand that there are not always extremes in sentiment. Extremes in optimism most often end in bubbles that inevitably burst. Extremes in pessimism lead to missed opportunities to at least be correct in the first part of "buy low, sell high."

There is art, and there is science, and there are those rare investors who respect both. With no intent of derision, consider purely technical analysts. They study charts of past price movements, convinced that these patterns will be repeated in the future, and they are often correct. But the Contrary Investor would argue they are not correct much more often, if at all, than investors who study investor sentiment and behavior and ignore technical indicators. The really good investors respect both factors: scientific and artistic. An outstanding example of one such investor is our friend David Fuller.

David is an American who has lived and worked in London for many years, and offers a unique service studying both the art and the science at www.fullermoney.com. There is a free daily post sent via email that, at the very least, we would urge readers to request. For more detailed reports and charts, he offers a subscription service that has devotees around the globe. It is wide-ranging, humble, original, and valuable. In his words, the “wisdom of the collective” empowers investors through knowledge.

But back to the theme of Crowd sentiment, and how to profit from it. One way of gauging where money is flowing in and out of the equity markets is the measure of sector strength. Sectors go in and out of favor regularly, though not necessarily logically. As I write this, the strongest sectors, in terms of stock performance versus the broad S&P 500 Index over the last quarter are Basic and Raw Materials, Energy, and Healthcare. The weakest are Financial Services and Utilities. These are the leaders and the laggards. In the middle are sectors like Technology, Industrials, and Consumer Staples.

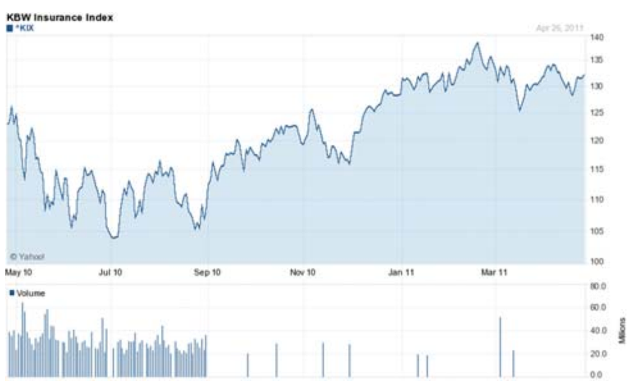
But taking a closer look reveals a microcosm of the pitfalls of following a course that exclusively believes the past is future. Between mid-March and early April, the S&P rose about 6.25 percent, while the best performing sectors for the previous quarter took a pretty substantial hit as investors rotated out for positions formerly at the bottom, particularly in healthcare. Granted, this is a very short term view of the issue, but you get the idea. This is not an example of an extreme in Crowd thinking, but nicely illustrates how sentiment drives money (and therefore, returns) in and out of certain stocks.

The Contrary Investor would argue that what is lacking for most investors is not a strategy, but discipline in applying the strategy. More often than not, investors think they are doing what worked in the past, but really are not. At Fraser Management, our discipline does not focus on sector rotation, but rather on broad themes we believe most investors do not fully understand or do not fully appreciate. However, virtually every individual stock has been placed in a sector. Often, companies we believe will benefit from the themes we follow span a number of sectors. For example, our contention that the impact of Hispanic migration to the U.S. is a powerful, underappreciated trend, has led us to buy stocks in Consumer Staples, as well as Services sector. But in the case of our theme that there will be ongoing consolidation within the Financial Services sector, there is very little crossover. That is a situation we like very much. We like it when a theme we follow is underappreciated *and* the sector is out of favor.

While this is arguable, Financial Services is basically banking, insurance, and brokerage.

Is Crowd sentiment against this sector at an extreme? We don't know. Certainly the recently reported compensation packages for key executives at several financial institutions just bailed out by the U.S. taxpayer did more than just raise eyebrows, so in that sense there is considerable sentiment!

1 Year Bank Index



1 Year Insurance Company Index

For the past year, the S&P 500 has returned a little over 15 percent, as of March 31st, so clearly the Financial Services sector has under-performed the broader market. But things might be looking up for the group, especially with regard to consolidation. A recent study conducted by Deutsche Bank indicated that most financial institutions thought their growth over the next 10 years would come primarily from global consolidation and mergers and acquisitions. In addition, insurers like Hartford have enjoyed upgrades in their ratings from respected companies like A.M. Best (they didn't fall for the same nonsense that S&P and Moody's stumbled into).

In 2010 157 banks failed in the U.S. There are now a few players looking to capitalize on failing banks, and they are not the giants in the industry. Banking regulators are actively attempting to broker deals to transition failing banks to stronger hands.

Here's an idea (not a recommendation) worth study: Hilltop Holdings (NYSE: HTH). Hilltop is the brainchild of billionaire investor Gerald J. Ford (no, not the former President since he is dead). Mr. Ford's career has centered on investing in and turning around troubled banks. At the end of 2010, the company had net cash of about $500 million, with a market capitalization of about $550 million. This is a truly rare position, and perhaps one of the best examples of out-of-sync market sentiment in the Contrary Investor's memory. The stock is down about 17.5 percent over the last year, but A.M. Best affirmed their investment-grade credit rating in April. They haven't made a lot of deals yet, but these are smart, experienced folks squarely in the sights of what we believe to be a long-term trend.

In addition, HTH will be investing alongside Mr. Ford's personal money in the form of Ford Group Holdings, which was granted the first national shelf charter allowing it to buy failed bank assets directly from the FDIC. This would seem to be a classic misunder-stood, underappreciated situation. While management is not infallible, they have a better than solid track record. And there are no guarantees the company can find great acquisition candidates, plus they have no big "mother ship" company backing them up.

But consider this: last year the number of "troubled banks" (as deemed so by the FDIC) increased to 416, or about 5 percent of FDIC insured institutions. That number has been growing, and most are small or regional banks with no exposure to toxic mortgage assets. They are more likely "troubled" because they lent to real estate developers and the like that can't pay their bills. They have a lot of solid assets also, and these could pay off handsomely.

- Alex Seagle

Words to Consider

The sole purpose of a child's middle name is so he can tell when he's really in trouble.

~ Justine Vogt

When in doubt, mumble; when in trouble, delegate; when in charge, ponder.

~ James Boren

I intend to live forever. So far, so good.

~ Stephen Wright

If you think nobody cares if you're alive, try missing a couple of payments.

~ Earl Wilson

Dogs are the leaders of the planet. If you saw two life forms, one of them making a poop, and the other carrying it for him, who would you assume is in charge?

~ Jerry Seinfeld

Diligence is the mother of good luck.

~ Benjamin Franklin

The Value of a Conference

At last year's Contrary Opinion Forum, held in early October of 2010, I asked our panel of esteemed speakers for their best investable idea at the time. There were a range of ideas offered, and I have kept track of results to date (roughly 6 months). Jeff deGraaf, who recently founded Renaissance Macro Research (www.renmac.com) is currently in the lead. His call was buy silver, and golly has he been right! In early October, an ounce of silver was below $25 per ounce; at the end of April 2011 it closed at about $45 per ounce, which equals an annualized return of about 160 percent. David Fuller choose uranium, which would have enjoyed about the same results if not for a recent pullback. We will continue to monitor results over a longer term, but these are excellent examples of the value of our conference. What is worth to get one — not to mention two — great ideas in the context of a collegial, relaxed meeting with wonderful food, fun people, and beautiful scenery? Join us this coming October!

A Blatant Plug

In case you didn't know, Fraser Management Associates manages money for individuals and institutions on a fee-based platform, utilizing the thematic philosophy espoused in this newsletter and by our founder, Jim Fraser. Despite the ramblings presented in this humble missive, we think we're pretty good at it. It would be our pleasure and honor to provide information on our holdings, history and performance for anyone interested in an alternative to more traditional and mundane offerings. Give us a call at 802.658.0322, or shoot us an email at alex@fraser.com.

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