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Be Ready to Act When Market Opens a Door to Opportunity

Whitney Tilson
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After a long period of almost unprecedented calm, volatility has returned to the stock market in grand fashion. The reaction on the part of most investors is, at best, unease, and, at worst, downright panic. It's human nature: for most investors, the pain of stocks going down is more tangible than the joy of when they go up. The common impulse is to do something – anything – to minimize the pain.

While I take no pleasure in others' misfortunes, we've historically made most of our profits from other investors behaving in a panicked and irrational fashion and selling us certain stocks at prices far below their intrinsic value. More volatility equals cheaper stocks, which equals higher returns.

Successful value investors work hard to position themselves and their portfolios to capitalize on just such turbulent times. They buy only with what they consider a wide margin of safety in each position. They buy what is out of favor, not what is hitting new highs. They hold cash when they can't find sufficiently great ideas to employ capital. In essence, they do their worrying well in advance of market turmoil, not after it starts to happen.

This leaves them ready to be offensive rather than defensive when markets break. They have purchasing power and focus on evaluating their current portfolio and adding to positions that have been unduly marked down and pursuing long-followed ideas that have only recently become cheap enough to consider. Legg Mason investment strategist Michael Mauboussin describes the mindset well: "One truly remarkable thing about our firm is how calm it is. People don't get too worked up whether outcomes are particularly good or particularly challenging. We try to keep plugging away on the process and how expected returns on the portfolios are improving as market prices correct."

One of the best places to look for value is what I call "babies thrown out with the bathwater" – in other words, scour the most out-of-favor sectors for good companies whose stocks have been crushed due to overblown concerns about the industry that do not, in fact, have an impact on the company. To begin our search, we asked ourselves: what's the most despised sector in the stock market today? The clear answer: financial companies in general, especially those with exposure to structured finance and/or subprime.

Many companies fit the bill, but we focused on one we have owned for years, Resource America, a rapidly growing company that manages assets across a broad range of categories and earns attractive spreads on structured finance pools. Not surprisingly, the stock has been cut in half in recent months. While it was no fun seeing one of our holdings decline so quickly, we smelled opportunity, redid our analysis, spoke with management and became convinced that the market is wrong on Resource America, incorrectly assessing its potential liabilities. We have been adding aggressively to the position such that it is now among our largest.

Resource America consists of four business groups. The area that most concerns investors, Resource Financial Fund Management, manages pools of collateralized obligations in the trust preferred, asset-backed securities and leveraged loan markets. Assets under management are nearly $17bn, up from $10.5bn one year ago. RFFM earns management fees of 25-50 basis points on these pools, and structuring fees.

The key to getting comfortable with this business is understanding that Resource America, unlike many of its peers (which are now encountering distress), maintained a discipline when setting up these pools by moving them off Resource America's balance sheet and financing them with non-recourse debt. As a result, it is the debt-holders, not Resource America, who bear nearly all of the default risk. Although this model resulted in less net interest spread for the company during the boom times, it also meant that the recent jump in defaults and drying up of liquidity had not affected Resource America's business materially. This is contrary to what the stock price indicates – hence the opportunity.

A final reason we have so much confidence in this investment is our long-term relationship with Jonathan Cohen, Resource America chief executive, whom we believe is a strong operating manager, very risk-averse, trustworthy and shareholder oriented. Resource America's management and board share our belief that the stock is significantly undervalued – we think its intrinsic value approaches $30 a share – and just announced a $50m share buyback, which at current prices represents more than 15 per cent of the company.

The market in recent weeks has been a wild ride, and I'd bet my last dollar it's not over. Keep a close eye on stocks you like and be ready to act with conviction when Mr. Market opens the door to opportunity – it may not stay open long.

Whitney Tilson is a money manager who co-edits Value Investor Insight and co-founded the Value Investing Congress. E-mail: feedback@tilsonfunds.com