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Nothing to fear on the wild ride

Whitney Tilson
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In a perfectly efficient market, stock prices and company intrinsic values would move in lockstep. Thankfully, the real market is not so efficient, and smart investors are able to take advantage when a stock price diverges markedly from its underlying value. Panic and fear create buying opportunities; euphoria and complacency deliver great opportunities to sell.

Prudently acting on these opportunities, however, is much easier said than done. One key problem is no less than the hard-wiring of our brains: "The 100bn neurons that are packed into that three-pound clump of tissue between your ears can generate an emotional tornado when you think about money," writes Jason Zweig in his excellent new book, *Your Money and Your Brain*. As you can imagine, emotional tornadoes are not conducive to rational decision-making.

When confronted with a potential risk, two small knobs of tissue deep in our brains, the amygdalae, generate immediate hot emotions such as fear and anger that help us address those risks. Our pulse quickens, our muscles tense and our brains centre nearly full attention on the threat. All of this makes perfect evolutionary sense, helping our ancestors respond to natural threats to life and limb.

The problem for investors is that this same natural "reflexive" response mechanism is triggered by losing money, or believing that you might. However, says Zweig, "When a potential threat is financial instead of physical, reflexive fear will put you in danger more often than it will get you out of it. A moment of panic can wreak havoc on your investing strategy." This helps explain why investors frequently sell when they should be buying or sit on the sidelines out of fear for much longer than is advisable.

Taking a proverbial deep breath before responding to short-term market moves goes a long way to avoiding panic-induced mistakes. This gives our "reflective" brain time to kick in and enable a more objective decision, says Zweig. Also important are regular disciplines or checklists to follow in making any buy or sell decision. Many investors institute formal reviews of any holding whose value falls a given percentage, asking what – other than the share price – has fundamentally changed in the investment thesis. This doesn't ensure the right decision is made, but increases the likelihood that any decision is made for the right reasons.

We've made a lot of money over the years buying cheap stocks from panicked sellers, particularly in good companies in out-of-favour sectors. We're now actively sifting through the carnage in the financial sector. Unfortunately, most of the stocks we're looking at end up in our “Too Hard” box. They appear cheap based on multiples of earnings or book value, but we have no way of judging their exposure to the subprime mess, so we have no confidence in our ability – or anyone else’s! – to forecast what earnings will be and how much book value might be impaired.

Take Citigroup, for example. Trading at under 10x trailing earnings, yielding 5.6 per cent, and with analyst pessimism at all-time highs, now might appear to be a great time to buy. Perhaps, but while Citi certainly isn’t going away, we think there’s more bad news to come. Merrill Lynch recently wrote down its super-senior CDO securities (what an oxymoron!) by 30 per cent or more. Apply 30 per cent to Citi’s $43bn of exposure to these assets and you get $12.9bn of losses, rather than the $8bn-$11bn Citi has already owned up to. Citi has another $11.7bn of securities tied to subprime loans that were being held, or warehoused, until they could be added to debt pools for investors, on which there will surely be significant losses. They also have unknown exposure to the $80bn of structured investment vehicles (SIVs) that it manages, no permanent CEO and, I believe, a failed strategy of trying to be a global financial services supermarket. As I said: “Too hard.”

One financial stock we continue to like is Resource America, which is down 12 per cent since I recommended it here in mid-August. This rapidly growing company manages assets across a broad range of categories and earns attractive spreads on structured finance pools. The key to getting comfortable with this business is understanding that Resource America, unlike many of its peers, moved these pools off its balance sheet and financed them with non-recourse debt. As a result, it is the debt-holders, not Resource America, who bear nearly all of the default risk. This means the recent jump in defaults and drying up of liquidity has not materially affected Resource America’s business, which is contrary to what the stock price indicates – hence the opportunity.

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