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1st Quarter 2009

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Commentary

1<sup>st</sup> Quarter Core Value Commentary

Further Differences between Now and the Great Depression

*Authored by Steven Bregman & Murray Stahl*

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**Horizon Asset Management, Inc.**

**[www.hamincny.com](http://www.hamincny.com)**

470 Park Avenue South • 4<sup>th</sup> Floor • New York, NY 10016

(646) 495-7333

**Core Value Commentary**

*By Steven Bregman*

The composite return for the Core Value strategy year-to-date, through yesterday (April 15<sup>th</sup>), was approximately -0.1%, versus about -4.9% for the S&P 500 Index. Through the end of the quarter, at March 31<sup>st</sup>, the return was about the same as the S&P 500, at -11%. The past two weeks, then, have accounted for about 11% points of return, and the last six weeks for over 20%. Of course, this kind of dicing of time is precisely the manner of thinking in which we do not wish to engage. Nevertheless, these are the figures to date.

The year-end review, written three months ago, discussed at some length the enormous divergence between the token yields available in U.S. Treasuries and the exorbitant rates investors have been demanding of most other borrowers. I do not wish to belabor the point, merely to get to the notion of common stock pricing and why this may well be one of the most productive periods for investing that we will ever experience in our lifetimes – but I believe we have to start here. These credit spreads, beyond historical experience, are perhaps the central determinant of today’s equity valuations and the impediment to the recovery of the financial markets. The mere fact that investment grade municipalities must pay more than a taxable Treasury note to issue tax-free bonds, or that a homeowner must pay 6% for a mortgage when 20-year Treasuries are only 3%, that performing AAA-mortgage-backed securities trade at one-third of face value, or that investment grade companies must suspend their dividends in order to self-finance bond maturities for fear that the private market will not lend, evidences serious problems.

Take a moment to consider this: if money-good bonds, which are a legal claim against a known value, are priced at discounts of 20% and 50% to face value, in a low interest rate environment, no less, how egregiously must common stocks be discounted, given that no one can agree on a proper price in the best of times?

However, this was not to say that the *outlook* is grim. A modern nation such as the U.S. cannot function indefinitely under those conditions – and therefore it will not. The pessimistic viewpoint, which is the majority viewpoint, presumes a static world in which neither individuals, nor companies, nor the regulatory authorities react to or cope with their changed environment. In reality, there are in fact coping mechanisms, and every entity has a healthy (or even unhealthy) level of self-interest, so behaviors do adjust; distortions in one area create counter-distortions (and opportunities) in another.

The last review noted the intervention of the world’s central banks, unprecedented as to coordination and scale, to supply liquidity to the financial system and restore more normal, narrower credit spreads. We stated that our investment posture, which is based upon what we expect reality to be several years in the future (as opposed to several quarters) was not be at variance with the declared intentions of the world’s central banks. One of these many efforts is the U.S. Treasury’s program to buy mortgage backed securities in order to drive yields down, thereby to encourage refinancing activity. This has already commenced

in the first week of January. Our rough estimation suggested that an average family could save roughly \$3,000 per year if a 4.5% refinancing rate could be achieved. This is a very sizable incentive relative to the median U.S. household income of \$50,200. It should not, then, be surprising that with the 30-year mortgage rate now well below 5%, the mortgage refinancing index has risen sharply. Home prices being lower as well, it should not be surprising that mortgage applications have also risen sharply.

The chart below shows some data for the most recent four weeks. One set of data shows the change in mortgage applications versus the prior week. For the week of April 18<sup>th</sup>, they rose by 21% versus the prior week; at April 25<sup>th</sup>, they rose an additional 31% above the April 18<sup>th</sup> figure, by an additional 3% the following week, and an additional 5% the week of April 8<sup>th</sup>. Versus the first week of April 2008, the mortgage application figure is 68% higher.

The second set of data is for the Refinance Index, which over the last four weeks rose by 30%, 41%, 4% and 3%, each of these figures being with respect to the preceding week. Someone is adjusting their behavior.

Week	Mortgage Applications		Refinance Index
	Vs. Prior Week	Vs. Prior Year	Vs. Prior Week
4/8/09	+4.9%	+67.6%	+3.2%
4/1/09	+2.9%	+68.8%	+3.7%
3/25/09	+31.4%	+18.0%	+41.5%
3/18/09	+20.7%	+31.2%	+29.6%

Despite the newspaper headlines, the economy has hardly come to a halt. Despite a level of home sales so low as to be below replacement levels, much less accommodate population growth, there are nevertheless 4.5 million homes being sold, at the recent annual rate. That is a great deal of economic activity. However, it is insufficient. As of March, the number of new single family homes being built, on a seasonally adjusted basis, whether by reference to building permits or housing starts, is below 400,000; actual completions in March were 550,000. Yet, if there are roughly 70 million single family homes in the U.S., and if one makes the generous allowance that a home will last for 100 years before falling prey to storm or fire damage, ordinary decay, seizure under eminent domain, and so forth, then 700,000 homes must be built per year merely for replacement. The rate of home sales will eventually be much higher.

As for the banking system, as of April 1<sup>st</sup>, the aggregate assets of the nation's commercial banks are 8.6% higher than in March 2008, and balance sheet equity is 7.3% higher. That is certainly surprising information, contrary to anything read by followers of financial media. If some banks fail, the deposits and loans do not disappear; they redound to the benefit of stronger banks that will thereupon expand more rapidly. The financial ecosystem is active. It is not remarked upon much nowadays, but most companies have earnings. Accordingly, if they cannot borrow, they will eventually reduce their debt via cash flow, expand their businesses, and/or repurchase shares. Those that cannot will restructure or fail; in the latter case, stronger companies will inherit their competitors' contracts and operating assets. What cannot happen, though, is that prices contract inexorably against rising economic value.

Nor has China collapsed. Sales of automobiles in China reached an all-time record in March, 5% higher than a year earlier. Residential property sales in China during the March quarter were 8.2% higher than last year, although the price index is 1.3% lower. There are, of course, a wealth of negative statistics, but that is less the point than the financial ecosystem being far more complex and dynamic than the one-dimensional face presented by the financial media.

So, the operative question is not *whether* the recession will end – it most assuredly will. That being the case, we still wish to be invested in businesses that produce a reasonable return on capital. There is a difference now, though. Most of the time, the share prices of such companies will trade in some range modestly above or below their fair value, so that under normal circumstances (or discount rates), in order to achieve a successful investment outcome one requires a successful business outcome or successful operational outcome. Yet, once in a very long while, let us say once a generation, shares trade at great extremes above or below fair value. Our opinion is this is one of those times. The opportunity now is not the probability of a successful outcome, which is what investors and analysts ordinarily try to gauge; rather, the current opportunity is the extreme discount rate. Because the negative outlook embodied in share prices is so extreme, one does not require a “successful” outcome to do extraordinarily well.

*Further Differences between Now and the Great Depression*  
*By Murray Stahl*

In prior Commentaries, I have related a number of differences between the Great Depression and the current economic environment. Apart from the magnitude of the decline in the equity markets, I don't see any basis for a useful comparison; however, I'm taking up the subject again for emphasis, and to state some new differences with the object of making an entirely different point.

One of the differences between the current environment vis-à-vis the Great Depression is the little-known fact that in the Great Depression it was not uncommon for central banks to be privately owned. They were privately-owned banks that had the franchise to function in the manner of our current central banks. The central banks of the Great Depression era viewed their responsibilities in a bi-fold manner.

First and foremost, the central bank had the responsibility to maintain the value of the currency. In those days, the currency was linked to the value of gold. To maintain the value of the currency was not merely a badge of honor, but failure to support the value of the currency meant taking your nation off the gold standard. That result a variety of negative ramifications for the economy, so many banks were fearful of it.

The second responsibility of the central bank was to maximize profits and dividends for its own shareholders. As a result, actions like those recently undertaken by the U.S. Federal Reserve Banks or the Bank of England would have been inconceivable in the Great Depression. The central banks of that era would not have created liquidity by taking upon their own balance sheets assets that are not necessarily readily marketable as are those in Maiden Lane LLC, or Agency MBS that may be marketable, but of questionable value. Central Banks of the Great Depression era would never have contemplated buying the government bonds of their own nations for the mere purpose of sustaining the low yields. It's inconceivable that something like that would have been done.

Another big difference is that the economic statistics during the Great Depression were far less accurate and timely than today. In those days, there were well-reasoned disputes among academicians as to what might be the true unemployment rate; reasonable minds differed. Good information was not readily available, and that which was at hand would have been debated, both of which probably delayed government action during that economic crisis. Lack of timely information is not an issue in the current era.

There's another difference, which I'll only touch on, regarding the implications of the events and consequences of the World War I. Currently, there are no big reparations debts resulting from wars. At the end of the World War I, a variety of empires collapsed, including the Austro-Hungarian Empire, which had played a very important role in Europe in an economic sense, because it had provided one vast market for goods and services.

At the end of the World War I, that empire was replaced by a variety of nations, none of which made an effort to trade with one another, and all of which placed barriers upon neighboring nations vis-à-vis business activity. Even within their nations, though their intentions were not bad, they undertook actions that were a counter-stimulus to business activity.

With a view to assisting businesses, most of the nations that were formerly part of the Austro-Hungarian Empire embarked upon licensing programs for business. They thought that if they licensed fewer business enterprises, there would be less competition leading to a more profitable and stable business environment. That policy merely reduced the level of economic activity that would otherwise have taken place. Many of those nations also embarked upon a rigid policy of exchange controls, which made it very difficult to invest in other nations and for outsiders to invest in them. It was very difficult to repatriate monies once they were invested.

Another little-known consequence of the collapse of the Austro-Hungarian Empire was that none of the nations created in its wake were ethnically homogeneous. The people were accustomed to being residents and citizens of the Austro-Hungarian Empire. Many residents of the newly-created Eastern European states had great difficulty gaining citizenship in the nations they found themselves living in. Not gaining citizenship or, at best, attaining a second-class citizenship, meant that they were not permitted to work legally, engage in contracts, own land or register their children in schools. If they were involved in a legal dispute with a bona fide citizen of a nation, they had no access to the court system. All of those factors were key to what happened in Europe in those years, yet they are rarely mentioned.

Another important influence at the time was that, in addition to the collapse of the Austro-Hungarian Empire, the Russian Empire collapsed. The disintegration of the Russian Empire, the Soviet Union became a Communist state, and it became segregated from commerce with Europe. Previously, it had been an integral part of the European economic system.

Those historical facts lead to the most important difference between that era and this era, which is the robust economic development of China, India, Russia, and Brazil. During the Great Depression, those nations were in the opposite condition. China was involved in a civil war at the same time that it was defending itself from becoming a Japanese conquest. India was engaged in no serious economic development whatsoever. Russia, as noted previously, was a Communist state involved in a variety of convulsions, none of which were good. Brazil, among its other problems, had to deal with a Communist insurgency of its own. An interesting footnote of history is that at the same time that Mao Tse-Tung led the Long March into the Shaanxi desert that ultimately resulted in the Communist victory in China, a similar movement in Brazil saw the Communists moving into the Amazonian interior. Fortunately, or unfortunately, depending on your point of view, the Communists lost in Brazil.

With all of those monumental political shifts occurring around the world at the same time as the Great Depression, how the current crisis could, in any sense, be considered similar to that era is beyond my ability to understand. Where it does have relevance is in bizarre valuations on highly liquid securities in the world capital markets that I have never before seen in my 30-plus years of investment practice.

Let's look at the issuance (which is to say dilution) of American International Group (AIG) shares to the government in exchange for government aid. Based on the Friday, April 3 trading price, AIG has a \$13-plus billion market capitalization. Nevertheless, the vast range of AIG debt, and that of International Lease Finance, trades at 50 cents on the dollar, which is clearly preposterous. If AIG's CDS exposure is so vast, and if its bonds are junior to the government loans, then the value of the company's bonds might be impaired. One could make a reasoned argument for that scenario. If that were the case, then the AIG stock would be worthless. On the other hand, one could make a well-reasoned argument for the opposite case in which AIG would have residual value after it pays back the government loans. In that scenario, the AIG bonds should be money-good.

I've seen that situation regarding relatively small high-yield bond issuance pertaining to small-capitalization companies in credit crises. Generally, it's symptomatic not of the credit environment, but of the bonds being far less liquid than the stock. If it's very difficult to trade the bonds, they trade at an illiquidity discount giving the bonds a preposterously low value relative to the stock. There are arbitrageurs who specialize in that area.

It's conceivable that AIG is in a similar situation, though it shouldn't be possible since its bond issuance is so large that, in principle, its securities should be fairly liquid. The fact that they are not could be a symptom of a withdrawal from capital markets in general inspired by an understanding of the current environment that differs from my understanding of it.

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