

GREED GIVES WAY TO FEAR

A DISCUSSION OF THE CURRENT INVESTMENT MARKET ENVIRONMENT

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Fear and Greed

An old adage about the financial markets is that they are driven by fear and greed. We have observed in recent periods that in many parts of the market it appears investors have been willing to ignore or downplay risk in the search for returns. Recently, the worldwide equity and fixed income markets have been shaken as investors have transitioned from greed to fear. History is full of examples of the mercurial nature of risk appetites. In 1999 and early 2000, investors threw caution to the wind, only to become very conservative as the tech bubble imploded.

Risk

This so-called “repricing of risk” manifests itself in lower asset prices, as investors pay less for any given set of fundamentals. In many cases they also begin to question the level and direction of those same fundamentals. These changes in risk appetite can often be very fast, and the effect is like a rubber band stretched too far in one direction. The return journey can be very painful. We think we are in one of those periods where the excesses of recent history are being purged. It is a painful period, but one that we think plays to our strengths. Over the years we have seen many times when those who take excessive risk are severely penalized; this appears to be one of those times.

Tighter credit conditions, housing, the economy and corporate profits

As this risk repricing takes place, the suppliers of credit require more compensation for the credit they provide. In some cases, where creditors worry about the soundness of a business, they can decide to cut off credit entirely. We have seen this in recent weeks, as businesses reliant on funding from the capital markets ceased certain operations, slowed their growth or in some instances, filed for bankruptcy. The housing market has been particularly impacted as tighter credit conditions have taken many marginal buyers out of the market. As a result, homebuilders have been unable to sell their inventory without significant price concessions. This impacts the pricing of existing homes for sale and the perceived market value of all housing stock. Anecdotal evidence has suggested when home prices decelerate or decline, loan delinquencies increase, which ultimately may lead to a default, further increasing the supply of homes for sale.

The possible impact on the economy and profits is potentially significant for a number of reasons.

- ◆ First, the consumer has been a big driver of economic growth. If the consumer balance sheet takes a hit from declining home values or less access to credit, the economy would surely be impacted.
- ◆ Second, residential construction has provided a large stimulus to the economy in recent years. That economic tail wind is now a considerable headwind.
- ◆ Lastly, as financial institutions take losses on consumer and mortgage lending, they are often less willing to lend, further exacerbating the situation.

In the long term, this process is a positive. In hindsight, we can see that many people who should not have qualified for credit or a home loan were able to qualify. Part of this is a result of the structure of the mortgage finance system. Historically, government sponsored enterprises dictated credit standards by defining what they would buy from mortgage originators. In recent years, the private market took over. Originators and investment banks retained little or no economic interest in the mortgages they originated or packaged. Like a game of hot potato, they let the next guy worry about it. This only works so long as the ultimate holder continues to purchase the end product. The recent dislocations in the market place are a direct result of this ultimate holder of mortgage securities going on strike as they try to come to grips with what they already own (and in many cases cannot sell).

Implications to Financial Stocks

The results of these dislocations on the financial services industry may be long lasting and profound. Again, the epicenter of this storm is the residential mortgage market. The origination, funding, packaging and reselling of these loans has changed rather dramatically in recent years. The private market's creation of new mortgage products (ARM's, option ARM's, piggyback's, etc.) and new structured finance products (CDO's, CMO's, CLO's) has driven more complexity into the system and an ever wider gap between the borrower and the ultimate lender.

Moving forward, we believe this further pressures specialty lenders lacking strong funding sources as well as those capital markets firms heavily leveraged to the packaging and distribution of structured products. We have already witnessed numerous specialty mortgage REITs disappear and the secondary market for most types of structured product is retrenching radically. On the flip side, these abrupt changes have reduced competition in many areas of the mortgage finance market and clearly risk-adjusted pricing on almost all types of credit extension has improved recently. Longer term, this re-pricing of risk along with a meaningful reduction in capacity in certain areas should bode well for those disciplined lenders that have exercised prudent standards in the past and continue to enjoy stable funding sources going forward.

Our Approach to Investing

At Diamond Hill we define risk as the probability of a permanent loss of capital or an inadequate long-term investment return on that capital. Our investment philosophy is grounded in forecasting the fundamentals for the businesses we invest in, making reasonable estimates of what those fundamentals are worth, and properly accounting for the risk in these investments. These inputs are reflected in our calculation of intrinsic value. When the markets lose a sense of risk, or when investors are more focused on “what’s working” rather than on what is undervalued, our investment approach can lose some of its effectiveness. In the short term, our absolute returns could suffer if the market experiences a further correction. However, because we have been more price and risk sensitive, as the market focuses more on fundamentals, risk, and margin of safety, we expect to outperform.

In general, we are underweighted in financial stocks, which have been impacted significantly as investors try to figure out who is holding the sub-prime bag. Market environments like this are opportunities for investors with long time horizons. In times of market chaos, investors tend to “throw the baby out with the bathwater.” We are prepared to take advantage of the opportunities that are thus created.

Focus on the Long Term

As volatile as recent weeks have been, the correction we have experienced has been relatively mild. (As of the date of this letter, the large cap Russell 1000 is down 9.7% from its peak and the small cap Russell 2000 is down 12.3%.) We think it is important to remember that in the short term, the market is often driven more by emotion than fundamental value. This is very true today, as investors’ time horizons have dramatically shortened in recent years. When “investors” have a short time horizon, their decisions are generally poor decisions. It would be safe to say that if investors find the recent market volatility very stressful, they should consider if their equity exposure is too great.

We are long term investors, and we always recommend that our shareholders share our perspective. We remember the market crash of 1987, the 1998 collapse of LTCM, and the 2000-2002 implosion of the tech bubble. Many individual investors dramatically reduce their exposure when the market experiences periods like these. In general, these actions are as detrimental to long-term returns as is buying when the market is euphoric. To paraphrase Warren Buffett, investors should try to be fearful when others are greedy and greedy when others are fearful. As fellow shareholders, we try to exhibit this temperament on your behalf through market cycles. While we cannot predict with any certainty what the market will do over the near term, we do think that over the long term we will be able to deliver absolute returns that will compensate you for the risk of the asset class while outperforming our peers.

As we always remain focused on the long term, we strive to have our decisions driven by our analysis, and not by our emotions. For a perspective on recent market developments from a fixed income perspective, please see “Discussion of Current Fixed Income Market Environment,” which is available on our web site at www.diamond-hill.com.



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