



# Auxier REPORT

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For the third quarter, stocks as measured by the S&P 500 suffered their worst decline since the 1987 crash. Over 90% of stocks in the index declined.

	<u>3<sup>rd</sup> Qtr 2002</u>	<u>Year-to-Date</u>
S&P 500	-17.3%	-28.2%
NASDAQ	-19.9%	-39.9%
Morningstar Large Value Funds	-17.7%	-25.0%
Auxier Focus Fund	-8.3%	-11.5%

(Average Annual Total Return of the Auxier Focus Fund since inception, 7/9/99, is 2.06%. For the same time period the S&P 500 is down, -14.36%. See performance graph.)

The declines weren't limited to the US:

Britain	-20.1%
Italy	-22.5%
France	-28.5%
Germany	-36.8%

SOURCE: The New York Times

Market volatility has reached levels not seen in over 70 years. Between 1992 and 1996 the S&P 500 had just 10 days where it moved 2% or more. In the third quarter alone there were 26 days. Fear and volatility typically go together. As a serious investor, one of the biggest attractions to the auction market is the mispricing of exceptional assets due to occasional waves of fear, greed and general irrational behavior. The key is to know what price represents value ahead of time so when the mistakes are made you can exploit the misappraisals resulting from group folly. Independence of thought, rationality and fact-finding homework are important. The presence of compelling prices that offer a significant "margin of safety" should dictate investment actions and asset allocation. In this environment investment success will be determined by individual security selection and a tremendous amount of energy dedicated to the monitoring of operating fundamentals. We are now in the 32nd month of one of the worst stock market declines in history. Now is a much better time to start shopping carefully. Legitimate fortunes are made coming out of depressions, not by riding bubbles. From 1990-1998 the #1 performing group in the US market was the small banks. This, coming out of one of the worst banking crises in American history. Crisis creates opportunity.

## OPERATING IN A POST-BUBBLE MARKET

A key to navigating in today's market is to understand the environment we are in. We believe this environment is comparable to the US period of 1929-1940, or Japan 1989 to present. Valuable lessons can be learned from studying those two periods. As with previous technological revolutions, e.g., railroads, radio, electricity, autos, etc., excitement leads to a flood of easy money and excessive borrowing. Too much capital flows into the targeted industry, resulting in a glut of capacity, declining prices and ultimately bankruptcies. The consumer

benefits, but the result is a net profit destroyer for corporations. That is why leading companies in slow growing industries are preferable - they don't tend to attract the waves of easy money that can follow new technological advances. As a shareholder you want to own businesses with a financial moat: i.e., consistent profits, little hype, lots of free cash flow, and independence from banks and capital markets.

To further illustrate the risks in technology-driven bubbles, research firm Sanford Bernstein recently estimated that the average public life of a technology company is only five years. Companies spring up when a new product cycle starts, and they fade away when the cycle ends. The combination of declining demand and excessive debt helps to explain the suffering we have seen the past three years from a NASDAQ that peaked at 240 times earnings.

#### PROSPECTS OF WAR

Every major war in the 20th century in which the US participated, starting with World War I through the Gulf War in 1991, was followed by a material economic expansion. Defense spending acts as a tremendous stimulant, which in the longer term can benefit stocks. The increased demand and pricing are a positive in a deflating world environment.

#### THREAT OF DEFLATION

Japan and China each account for more than 10% of US imports, putting material downward pressure on prices. This, together with the globalization and deregulation of our economy, led to a very difficult pricing environment for many industries. Bankruptcy laws that permit companies to operate and extinguish their debt prolong industry downturns and act as an enabler of downward prices. Each investment needs to be carefully monitored to anticipate the negative effects of this growing wave of deflation that is becoming a larger factor each year as imports from India and China gain market share.

#### POTENTIAL PROBLEMS

The money has been easy in home mortgages and auto loans. It never makes sense to borrow for a depreciating asset, especially for consumer items. The big mistake Americans are making is the failure to value the asset they are borrowing against. If you are overpaying for any asset it does not make sense to borrow. Period. The Japanese have been borrowing at extremely low rates for years only to see their overpriced asset values plummet. Price, value, margin of safety--three concepts ignored worldwide. If the asset costs substantially less than its replacement value it can make sense to borrow, especially if the asset can be sold at a dramatically higher price. Just as easy lending and overborrowing sent telecom and utilities into depressions, the deregulation of the financial industry has led to creative securitizations that have allowed lenders to write much more business than normal and offload these loans to others. This has led to much more leverage overall. Over 80% of bankruptcies are the result of too much borrowed money.

#### HOUSING

A look back at the Los Angeles real estate market in the '80s is helpful. Home prices in Los Angeles appreciated 89% over a six-year period from the mid-1980's into the early 1990's while incomes grew 37%. The market then corrected 24% over the next five years and still took another five years to recover. Since 1998, home prices in the top 100 US markets have outpaced household incomes by 100%. According to the Financial Times, residential property prices relative to disposable incomes are at a 50-year high.

## PENSION ASSUMPTIONS

Current accounting guidelines allow corporations to make their own pension return assumptions and book them to profits. The problem is, companies have been overstating these returns for the past three years and must now adjust their earnings to compensate for the shortfall. IBM received a \$2.2 billion benefit based on overly optimistic projections. The actual loss was \$4.4 billion or a total swing of \$6.6 billion. (As of 9/30/02 The Auxier Focus Fund holds 0% IBM stock.)

## EXCESSIVE DEBT

Total private debt currently exceeds 140% of the US economy, according to The Economist. This is 100% higher than the long-term average. Corporations that have borrowed too much must now curtail capital spending and possibly dilute common shareholders to maintain valuable investment grade ratings. If consumers bring their savings rates back up to normal levels, much slower growth could result because consumer spending accounts for two-thirds of the economy.

## METHOD OF OPERATION

Our objective is to identify undervalued stocks and bonds that offer a margin of safety with significant upside potential. Ideal stocks have strong, predictable earnings power and sell at a significant discount to underlying value. If prices are too high we park money in short to intermediate-term bonds or in investments with a specific timetable that is driven by a specific corporate event, not by the general stock market. As markets go up we tend to put more money in securities that are at least partially insulated from a downturn. Our goal is to be superior to the indexes in a flat or declining environment, but performance can lag in speculative periods. In this post-bubble, mean reverting environment we believe this approach to individual security selection should outperform. The biggest area of value added is protecting against permanent capital loss. This requires the aggressive day-to-day monitoring of business fundamentals and the vigilant anticipation of factors leading to “excess supply” in the form of capital and competitors that can lead to product commoditization and an erosion in profits.

## LOOKING FORWARD

We have endured one of the worst market declines in history. Post-bubble economies normally take time to heal and require careful thought and investment selection with the emphasis on making exceptional buys based on fundamental cash flows. Managers and workers at non-financial S&P 500 businesses took home more than \$100 billion in proceeds from stock options in 2000 -- enough to wipe out most of the operating earnings from 1997-2000. If those profits were redirected to the shareholder in the form of dividends it would be a huge step in the right direction. Pension fund assumptions are still too high and this impacts a large percentage of companies in the major indexes. We are trying to be very conservative in our assumptions. Now more than ever it is important to know the intimate details of each security with appraisals emphasizing balance sheet strength. In a slow or no growth economy the danger is in asset depreciation with liabilities that stay the same.

## A FINAL ENCOURAGING WORD

Historically when we have seen drops of this magnitude in the markets, recoveries can be swift and dramatic. In late 1974 the market rose 40% in just six months. In 1982 it rose 40% in less than four months. In 1932 the market doubled in less than five months.

Thank you for your support!