Arquitos Capital Management

October 25, 2011

In the short run, the market is a voting machine, but in the long run it is a weighing machine.
Benjamin Graham

The Arquitos Value portfolio returned (19.3)% after fees in the third quarter of 2011 compared to the S&P 500's (13.9)% return.

There's only one way to say it: The third quarter was miserable. It was the worst third quarter for the S&P 500 since 1928. Our picks did even worse. It has not been a good time to be a stockpicker employing a value investing strategy. Regardless, I am disappointed that the stocks I chose for our portfolio were among the worst-hit stocks for the quarter. I've re-examined my theses behind most of the stocks in our portfolio, and I can confidently say that I continue to strongly believe in their fundamentals. This view is reinforced by the 12.5% gain for our portfolio over the first 24 days of the fourth quarter.

I'm certainly happy that we've recovered a good share of our losses, but the portfolio was not designed to see this type of volatility. I regret if it has caused you heartburn. This is a time for a strong stomach, unfortunately, but if we can work through the uncertainty I believe we'll see meaningful gains.

Take, for example, our investment in the financial sector. We have been heavily invested in financials this year and we have been burned because of it. One of our core holdings is Bank of America. We owned it from the beginning of the portfolio when it was priced at about $16 per share. At the end of the third quarter, it was below $6 and down 54% on the year. Bank of America's valuation as measured by its Price to Tangible Book Ratio is as low as it was during the 2008/2009 collapse, six times below where it was in 2005 and seven times below where it was in 2002. To put that into perspective, if Bank of America's stock traded at the same valuation level of 2002, which was historically typical, it would trade above $42 per share.

There's reason to believe that the market will assign below average valuation levels over the next few years to financials like Bank of America. Banks are struggling. Government policies are making it more difficult for them. You don't have to follow politics very closely or have a political allegiance to know that the Dodd-Frank law is very harmful to the earnings power of banks, both large and small. Even more harmful to Bank of America is the Fed's decision to hold long term interest rates low for at least the next few years, and to buy longer dated Treasury Bonds, therefore flattening the yield curve. This is not good for banks, and not good for small businesses lending.

I thought the economy would have improved dramatically by now. It hasn't. I thought Bank of America's valuation level would be beginning to normalize by now. It's gotten worse. In hindsight, it was a mistake to hold Bank of America in the beginning of the year when it was at $13. It's not a mistake to hold it right now. Bank of America is priced to go bankrupt. That won't happen.

Much of the decline in the third quarter was caused by the belief that the U.S. economy was headed towards a double-dip recession. That belief gained steam because of the debt ceiling debate in late July and early August, followed by the ratings downgrade, and punctuated by the continuing crisis in Europe. I thought those recession fears were overblown for a few reasons that, taken together, meant the economy was recovering, not declining.

The best leading indicator to watch is North American rail traffic. This coupled with some other statistics help you to get a good idea of the strength of the economy. Forget the news headlines, follow the rail traffic reports. Our investment in Ford this year has caused me to track North American auto sales more closely. They're increasing month over month. The U.S. has never entered a recession when rail traffic and auto sales have been increasing. I don't expect that to change now. If you overlay declining unemployment, you can rest assured there is no immediate threat of recession. Yes, employment growth is anemic, but it's still growth.

I watch those statistics while holding my nose. I don't want to spend my time tracking macroeconomic data. Unfortunately we're in an investing environment where the above the fold newspaper headlines mean more than the earnings and balance sheets of specific companies. I want to go back to worrying about individual companies, but the valuation side of the equation is dominated by the general news. At some point in the future, fundamentals will matter again. That day won't come soon enough. In the meantime, this macro-trading environment means there will continue to be a heightened degree of volatility. I ask for your patience in this up and down period.

Looking forward to the fourth quarter, we've already seen a strong rally so far. I attribute much of this to the realization by market participants that the economy is, in fact, slowly improving. This should force investors to apply non-recessionary valuation levels to a few of the stocks we own. I expect this to specifically apply to Ford. Of course, another macroeconomic shock could always change that. In the meantime, Ford shares are up 25% since the end of the third quarter and now trade for more than $12. I would not be surprised if they doubled in the next six months.

That may seem extreme, but Ford shares traded above $18 in in January of this year. Earnings are stronger now, they have a higher credit rating, a contract with the UAW has been signed, and a dividend will be reinstated soon. Even at $24 the stock will only trade at about 12 times earnings. And, this is an environment where North American auto sales are increasing, yet are still 15% lower than their historical average. This is a testament to how cheap the stock currently is and how out of whack investor sentiment is.

In addition to our longer term holdings, we've also initiated positions in a few stocks that should not correlate to the returns of the overall markets. One of these is a specialty finance company whose stock price is dependent on factors unrelated to the economy. Another is a specialty pharmaceutical company we were able to get on the cheap. These stocks now make up meaningful positions in the portfolio, and special is that way I would describe my expectations for them over the next year. I look forward to telling you more about these two stocks in the coming quarters.

At quarter end our four largest positions were in Citizens Republic Bancorp, Sycamore Networks, Berkshire Hathaway, and SuperValu. Thanks again for following along, and please contact me if you have any questions. I look forward to hearing from you.
Best regards,

Steven L. Kiel
Arquitos Capital Management

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