# *GREENFIELD SEITZ CAPITAL MANAGEMENT*

## *2008 Annual Letter*

***January 14, 2009***

**2008 Review**

The S&P 500 Index lost 37.0% (total return) during 2008, which was the worst year in 77 years (1931 was down 43.3%). In this difficult market, the Greenfield Seitz Core Composite declined 34.43% (after fees).

2008 was our *8th consecutive* year to outperform the benchmark S&P 500 (net of all fees). Of 6,000 stock & balanced mutual funds only one has beaten the market for more than 9 years (Wall Street Journal 1/4/09). Of 686 professional large-cap managers, we rank in the top 5% over the past 3 years and top 3% over the past 5 & 10 years (Brockhouse Cooper 1/19/09). We believe this is the product of superior stock selection through our unique process, which utilizes patience, independent thought, and fundamental research.

Our 2008 performance was driven by several critical factors. On the positive side, we (1) maintained almost no exposure to the financial sector for the entire year, which was the worst performing sector (down 52%); (2) We took profits in energy stocks while oil was above $120; (3) We avoided the big blow-up's (Blue-chips such as AIG, Bear Stearns, Lehman Brothers, Washington Mutual, Ambac, Fannie Mae, and Freddie Mac were all down more than 90% last year. Additionally Merrill Lynch, Wachovia, Sprint Nextel, Alcoa, and General Motors fell over 75%). (4) Overall stock selection was very positive with our U.S. stocks handily besting the U.S Index.

Factors that hurt our 2008 returns were (1) Exposure to international markets with the MSCI World Index down 42.1% and Emerging Markets down 54.5%; (2) We were Bearish and knew things always tend to over-shoot but failed to predict the market declining to this magnitude and scope. Investors truly became panicked and sold off shares of quality companies with little regard for fundamentals & earnings growth; (3) Despite foreseeing the problems with banks, we underestimated the extent to which credit markets would be affected and that this lack of funding would impact so many companies. (4) We hoped that gold & gold miners would provide a hedge to declining stock market as they have in the past, but the Gold Producers Index fell 30%.

**Our Time Tested Process**

Our history dates back to Eric Greenfield first managing investments for clients in 1964. Since our inception 45 years ago, we have adhered to the same investment process of buying companies with exceptional management teams operating in attractive businesses, and then owning them for the long-term. This simple discipline has been successful through many different market environments. As a sign of our conviction and commitment to our investment process, we remind investors that we are personally the largest investors in the assets managed by Greenfield Seitz Capital Management (GSCM).

As long-term investors, we use periods of panic and fear as buying opportunities. We are not traders. With this mindset, we currently see a lot of excellent companies priced at historically low valuations.

**Market History**

Over many decades, equities have provided attractive returns and there has historically been more economic expansion than contraction. However, over shorter periods, the economy and stock markets move in cycles which include bear markets. The average annual return for the S&P 500 over the last 50 years is 9.2% (BTN Research). Although, we have experienced nine Bear markets (more than 20% decline) during the last 50 years, with an average decline of 34.9%. GSCM predicted last year that the recession would be more severe than usual, which we continue to believe. Now that the market and general public seem to have priced this into the market, we believe stocks of some excellent companies are oversold.

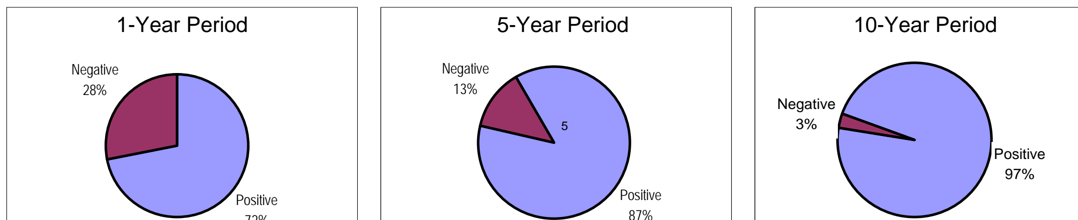
The gain for the S&P 500 in the one year following a Bear market low has averaged 36.5% for the last 50 years. We remind investors of our 2003 gain of 28.77% coming out of the Dot-Com Bear market despite our client's not losing money from 2000-2002. Many argue that it is different this time or that history will not repeat itself. But those claims were also made in past Bear markets. We believe the idea that history repeats itself is driven by the fact that humans are bound by human nature and tend to react just as previous generations have throughout history.

We are now in a Bear market based on the excesses of housing boom, easy credit, and excessive leverage. We have warned of these issues over the past three years and have tried to position GSCM-managed portfolios accordingly. No one really knows how long this recession could last. But we do know that capital markets are very resilient and always manage to overcome seemingly insurmountable problems of the time. Historically, surviving companies have become stronger and patient investors have been rewarded.

**Volatility**

2008 had more daily volatility than any period on record. In a wild market like this, it is important to remind ourselves that equities have produced attractive returns over the long-term, but come with cycles including Bull & Bear markets. The media enjoys making the most of each daily event, but we hope that investors will take a step back and try to focus on 5-10 year investment horizon. 97% of all 10-year periods have positive equity returns (past performance is no guarantee of future returns).

**Power of Time: S&P 500 Total Returns over Time Periods**




Source: Greenfield Seitz Capital Management, Forefield Inc.

**Buy When Others Are Fearful**

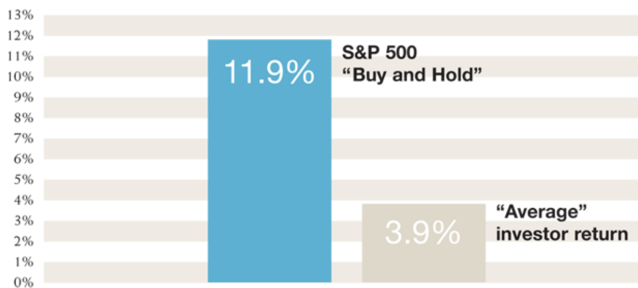
We admittedly sound like a broken record on this mantra over the years but it has rewarded us. Since the beginning of financial markets, there have been periods of great optimism & speculation accompanied by lofty valuations, which inevitably have been followed by periods of pessimism & depressed prices. The trick is to buy when the public view is dour and sell when the consensus is rosy. Armed with this simple rule, it would seem easy for professionals and rational investors to apply it and significantly outperform the masses. Except for the fact that most professionals also happen to be human. This simple truth of fund managers being human is

exacerbated by the fact most managers are controlled by the whims of their investors through redemptions and concomitant forced selling at market bottoms. Individual investors still control more than 50% of the stock market. So it should be easy to see why we actually get excited to see Bear markets. Depressed prices present great value to long-term investors.

This cycle of Bubbles has repeated itself again and again throughout history. It must be something deeply engrained in human psyche that drives us to make these same irrational decisions again and again. The emotions tied to thoughts of missing out on a bull market and conversely losing everything in a Bear market are hard for investors to overcome. We believe these natural instincts predispose investor behavior and causes history to repeat itself. As the saying goes, "*The stock market is driven by fear, hope, and greed, only loosely connected to fundamentals.*"

**Avoid Market Timing**

It is human nature for us to want to sell when the market is down and attempt to get back in once it is going up. In fact last year, we had many investors tell us "Get me out now and then when the markets start going up, get me back in." We need to fight this irrational behavior. The risk of mis-timing the re-entry into the market can have devastating impacts on long-term performance. We believe the risk of mis-timing the market is greater than the risk of staying the course with solid companies.




Source: Dalbar, Inc.

Historically, individual investors have averaged 3.9% returns, despite the overall market returning 11.9%. Why does the average individual investor produce returns of less than half the S&P 500? We believe there are two primary drivers of this fact. Individuals suffer from short term views and are often traders who constantly get in and out of positions attempting to make small gains. We are not traders and we are happy to let our stocks compound their gains for many decades. Secondly, we believe it is human nature to buy at the top of the market because people worry about missing the opportunity and seeing others profiting lures them in. The flip side of this is that most investors are also forced to sell at market bottoms because they panic and fear the downtrend will go on forever and they will lose everything. This is also a function of a short-term perspective. In similar fashion, investors also tend to chase performance by buying "hot" stocks or funds that have recently performed well.

**Behavioral Finance at work Today**

Human beings show repeated patterns of making irrational and incompetent decisions when faced with uncertainty. Behavioral Finance attempts to explain why emotions and cognitive errors effect investments leading to Bubbles and Busts. In today's sell-off we are witnessing several classic cases of irrational decision making. (1) Loss Aversion shows that humans tend to excessively avoid losses compared to gains. (2) Herd mentality is exemplified by humans' preference to conform with the crowd. When we warned of problems with housing/finance prior

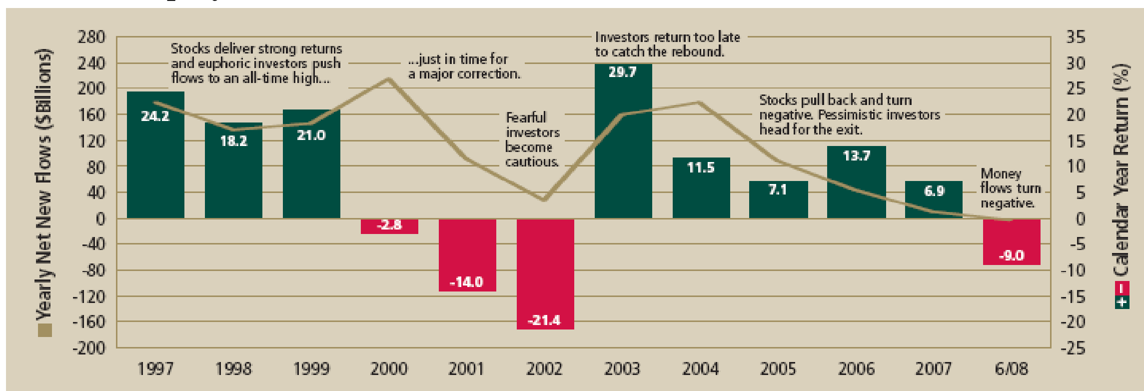
to the decline, very few people believed us. Yet, now that the recession is common knowledge, the same people are very concerned about the same issues they previously dismissed. (3) People tend to project past experiences into the future. In 2007, most people believed the market would be up in 2008 because it would continue to what it had done that year. Similarly, since it was down in 2008 many people are now expecting this downward trend to continue. (4) The final issue we are seeing is letting emotions drive investment decisions. In stressful periods, investors often times let their emotions over-ride reason. We are seeing this today with many people wanting out stocks regardless of the company's solid prospects, earnings, backlog, etc.

*"Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ…Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."--Warren Buffett*

**Advantages of Separate Accounts over Pooled Investments**

In the second half of the year, hedge funds & mutual funds had the biggest redemption in history as nervous investors pulled out their money, which caused massive forced selling. Forced liquidations from mutual funds and hedge funds have exacerbated the decline as selling begets more selling. Three years ago, we wrote a section on gscapital.net comparing separate accounts to pooled investments (mutual funds & hedge funds), which is still on our website today. The message was that pooled funds may be forced to "buy high" and "sell low" the exact opposite of an investor's goal. Historically, funds receive cash inflows at market tops and redemptions at market bottoms, forcing the manager to sell stocks at unattractive prices to raise cash for redemptions. An inherent problem is that funds are forced to buy high (when investors add money) and sell low (when investors redeem their money). In this section, we quoted Warren Buffett --*"hedge funds are a huge fad….and will underperform the S&P over the next 10 years."* As separate account managers, we can use this opportunity to our advantage and use cash to buy when others are forced to sell.

**Domestic Equity Flow vs. Performance**




Source: Morningstar Strategic Research

**Cash on Sidelines**

Money funds now represent 40% of mutual fund assets, their highest percentage since 1990, when cash accounted for 46% of all funds (Investment Company Institute ICI 1/7/09). We believe money will eventually need to be put to work and the idea of a ~3% return in bonds for the next 20 years is not appealing. In the past, we used this cash on hand statistic to help correctly forecast the 2003 rebound in equities. We believe the extremely high level of cash waiting to be put to work is bullish for riskier assets, such as equities.

**Wealth Effect**

As we have mentioned in past letters, one of our primary concerns is reduced spending by consumers since consumer spending drives ¾ of GDP. The Fed estimates U.S. homes have lost

$7.1 trillion in value over the past twelve months. Additionally, global equity market have lost more than $29 trillion in value (Bloomberg). This combined loss of roughly $40 trillion compares to just $4.2 trillion in lost value during the 2000 stock market collapse. Lastly, layoffs and tighter credit will reduce consumer's ability to spend. December marked the $12^{th}$ straight month of job losses with a 2008 total loss of 2.5 million jobs in the U.S. (7.2% unemployment). We have tried to limit our exposure to consumer discretionary stocks.

**Comparing the Current Bear Market to 2000-2002 Bear Market**

In the Dot-Com Bear market, the S&P lost 51% from March 2000 peak to October 2002. As of 12/31/08, the S&P is 45% off its October 2007 high. In the last Bear market, we significantly benefitted from completely avoiding speculative tech stocks, which resulted in GSCM composite outperforming the S&P by more than 40%. Over the past 3 years, we have correctly avoided financials, but the problems turned out to be more systemic in nature and correct stock/industry selection was not enough to save us from losing money as all industries have declined. As equity managers, we are paid to manage equities and dislike the meager long-term returns from cash/bonds. Towards the end of the Dot-Com Bear market all stocks were hit as investors simply wanted out of stocks regardless of fundamentals. We believe we are in the later innings of this Bear market because investors simply want out of stocks and are forcing funds to liquidate positions at remarkably low valuations.

**Energy**

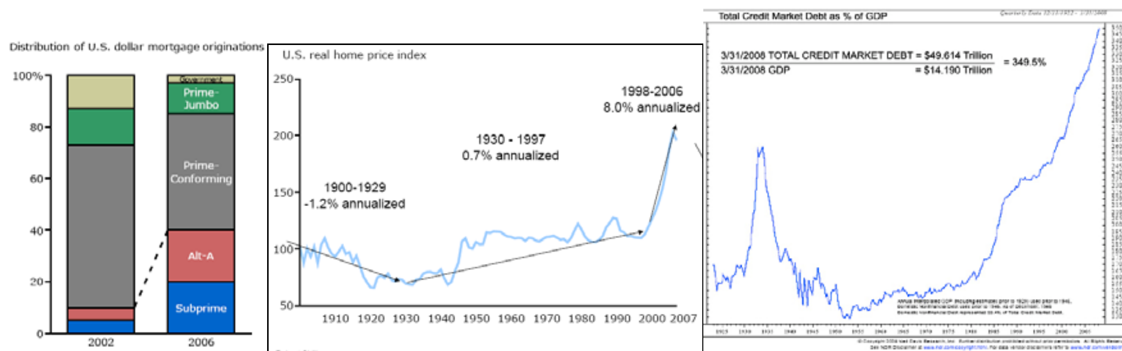
In our July letter we compared the run-up in Oil prices to the NASDAQ Bubble of 2000. Since penning that letter, oil the primary commodity, has declined from $147/barrel to $37/barrel. As we discussed in our Mid Year letter, we sold almost one third of our energy positions at significant gains in the first half of 2008 while oil was above $120/bbl. In hindsight, we wish we had sold more because the Energy sector declined more than 50% in the second half of the year. Despite seeing the bubble, we are not traders and always want to keep some core positions as long-term holdings.

By mid year, assets allocated to commodity Indexes hit $260 billion up from just $13 billion in 2003, while the prices of the 25 commodities in the Index rose 183%. Investor demand for oil futures had increased 848 million barrels in the past five years, almost equal to the 920 million barrel increase from China (Michael Masters Congressional Testimony). Last year, more than 60% of oil futures were owned by speculators with no intentions to take delivery (Petroleum Marketers Association 2008). During the run-up in oil prices, EIA actually reported that worldwide supply outgrew demand from 4Q07 – 2Q08. Once again, the popular trade was wrong and as investors exited commodity prices cratered.

We now believe the selloff has created some tremendous values as many investors seem to sell based on emotion, rather than fundamentals. For example, our favorite offshore driller trades below the cash flow it should receive from current backlog (Tudor Pickering Securities 1/7/09). Furthermore, many offshore drillers have their fleets contracted out for 4-5 years. Extremely high back-out fees should provide a stable earnings stream. This backlog is mostly with high credit quality customers such as National Oil Companies and Oil Majors. Yet these stocks dropped more than 60% last year. In the Canadian Oil Sands, one of our favorite producers traded as if it would receive less than $30/bbl for its proven reserves. A lot of attention is being spent debating at what price the Oil Sands are profitable. As usual, we prefer to take a longer term perspective and focus on the value of reserves over the next 25 years. Rather than debating what the next quarter's margins might be, we continue to believe that in the long run the supply of oil will decline faster than global demand and those with reserves will be rewarded.

## Housing/Mortgage Bubble

We have written about this for the past three years. Now that it has unfolded it is still worth reviewing how we got here. After the Tech bubble burst, the FOMC lowered interest rates to their lowest level in 40 years to help resuscitate the economy. These low rates had the unintentional consequence of creating easy financing for homeowners and fueling a speculative housing bubble. Many borrowers bought a home they could not afford with the idea that it would appreciate so much it didn't matter. But with more than 1 in 6 homes valued below their loan (negative equity) these borrowers/speculators began walking away (defaulting). In addition to lower rates, there has been increased adoption of selling mortgages into pooled investments (securitization). Mortgage brokers were now incentivized to make loans to anyone since they received their closing fees but took no risk because the loan (and its liability) was quickly sold to someone else. This gave way to a surge in lower quality loans such as: subprime, no-documentation, interest-only, pay-option/negative amortization, 100% loan-to-value, etc. The ratings agencies (S&P/Moody's) were paid by the banks that created the mortgage backed securities (not investors) and therefore were encouraged to make fraudulently positive ratings to help banks sell them. Financial institutions began using low interest rates to borrow money and buy high yielding sub-prime mortgages. Over time, this kept working and banks began using more leverage until many had over 40x leverage and Fannie/Freddie had over 100x leverage. Leveraging a balance sheet 40-fold means just a 2.5% loss will bankrupt you. If this wasn't enough risk, financial institutions also sold insurance on mortgages backed securities (credit default swaps), whereby they collected handsome fees until the music stopped and they were forced to make holders whole on huge subprime mortgage losses.




**Government's Critical Role in Financial Crisis**

In our opinion, the government's attempts to bail out the economy will only exacerbate problems. In the last twelve months, the government has (1) bailed out Countrywide Financial, National City, Washington Mutual, Merrill Lynch, Bear Stearns, AIG, etc.; (2) pushed more rate cuts; (3) continually made statements that the housing/credit problems were behind us; (4) given investment banks and Fannie Mae/Freddie Mac access to subsidized federal borrowing; and (5) instituted limits on short selling. It seems all of these are aimed at bailing out the very financial institutions that got us into this mess. There is no question that this massive support for these institutions increases the moral hazard that they will not learn from their mistakes and will again take too much risk in the future. The financing of this bailout and the FDIC ultimately comes from taxpayers, which will most likely increase our budget deficit and weaken our currency. Just as Alan Greenspan cheered the tech boom touting the miracle of productivity gains, he kept rates too low for too long creating a bubble in housing, all the while praising the ability of modern finance to reduce mortgage risk through securitization. Lastly, we believe lowering interest rates will spark inflation.

**Gold**

We continue to like gold. One of the primary reasons we have had such a large exposure to gold was our belief that the price would soar in our prediction of housing & finance crisis and provide a welcome hedge to declining stock markets. As the Scottish poet Robert Burns said, "*The best-*

*laid plans of mice and men often go awry*." Gold has not skyrocketed in the wake of this financial disaster. In fact, many gold mining shares are flat over the past 5 years and gold is well off its March 2008 high above $1,000/ounce.

The backdrop for gold is now better than any Gold bull could have imagined: (1) a collapse in the global financial system with bankruptcies of many of the world's largest banks, (2) investor fear levels at all-time highs (measured by Vix) and stock market off 45% , (3) lack of trust/lending between banks, (4) depositors making runs on banks from the U.S. (Indy Mac), U.K. (Northern Rock), India (ICICI), and (5) the Federal reserve printing unprecedented amount of money in an effort to bail out entire financial system.

So why hasn't gold soared under these circumstances. We believe gold has been hurt by its association with more economically sensitive commodities and the strengthening dollar. As the overdone commodity trade unwinds, gold has been sold off as well, despite only a fraction of gold being used for industrial applications. In the recent financial turmoil, there has been a flight to quality (U.S. Treasuries) which increases demand for the U.S. dollar. This has been amplified by unwinding of the short dollar trade. Lastly, many funds were forced to sell everything to meet redemptions and we believe gold was widely held by funds. Despite these short term factors, we believe the U.S. dollar has serious problems and are concerned that the enormous bailout will weaken the currency and possibly U.S. credit status as ultimate safety. The M1 money supply increased 10% last year (Federal Reserve 1/02/09). The socialization of credit in the U.S. will come with a high cost in the form of inflation and weakened currency. Once these short term factors play out, gold should profit from its timeless status as a safe haven asset.

## Infrastructure

It is estimated that $21 trillion will need to be spent on infrastructure in emerging markets over the next decade, 67% of which will be spent in Asia (Morgan Stanley 2008). Emerging markets have experienced an economic surge in recent years and expanding middle classes, yet many of these countries are severely lacking in infrastructure such as; power generation, power distribution, highway & rail systems, water, sewage treatment, etc. In the U.S., Barack Obama has pledged a massive infrastructure spending plan to create jobs, spur economic growth, and improve aging infrastructure. While he has not given many details, it is estimated that the plan will be roughly $1 trillion. We are attracted to companies that specialize in infrastructure for several reasons (1) Increased demand from Emerging Markets (2) Obama's Infrastructure Plan (3) The specialized nature and scale of these projects makes it difficult for competitors to enter the market (4) Infrastructure companies already have large backlogs (5) Customers tend to be well capitalized governments, which are not as fickle as consumers (who are swayed by job losses, declining wealth, mortgage payments, etc).

### India

India's stock market fell 65.07% in 2008. Despite the flight to quality and selloff in BRIC markets, we are attracted the growth in India. Beyond the technology and outsourcing jobs, there is a growing middle class. The middle class is currently 50 million people, but expected to increase to 583 million by 2025 (McKinsey 2007). We like the banking sector in India as a way to profit from the emergence of a large middle class. Credit card ownership in India has increased 4-fold since 2001 and many basic banking facilities that the U.S. enjoys are new to India. In light of the selloff, this growth story is now available at a more attractive price.

### Loyal Investor Base

We believe one of biggest advantages over competitors is our 10 year investment horizon, compared to the average fund holding period of less than 18 months. We could not have this advantageous perspective without a loyal investor base. Recently, mutual funds suffered their worst monthly redemption on record. Additionally, hedge funds have also been ravaged by huge

client exodus and the forced liquidation of their holdings. On average, our clients have been with Greenfield Seitz for more than 15 years. We believe weathering many difficult markets over our 45 year history has built confidence that is not easily rattled. We are thankful that nearly 100% of our investors kept their money fully invested in our process over the past year, which has historically been the right choice. We are pleased by the long-term perspective of our clients, which has been mutually rewarding.

**General Outlook**

As we have stated over the past two years, we expect this recession to be longer lasting than historical average (more than 11 months). Since 1970, there have been 24 housing busts around the world. This sample set experienced an average home price decline of 31% and lasted 25 quarters (6.25 years) [Global Economic Research 2008]. With so much of consumers' net worth tied to housing, it is hard to get optimistic about consumer spending, but we believe much of this has now been priced into stocks.

Buffett always says, *"Be fearful when others are greedy, and greedy when others are fearful*." This is exactly the environment that a disciplined investment process should be able to exploit. It may take time for these investments to work, but the returns should be compelling.

While we try to avoid making short-term market predictions, if history were to repeat we should have a significant throwback rally, only to be followed by another sell-off breaking previous lows. The throwback rally is fueled by those that went to cash at the bottom out of fear of losing suddenly switching into stocks out of fear of missing the run up.

We believe that many stocks have been over sold based on emotions, rather than fundamentals. A broad indicator of the value in stocks is that for the first time in 58 years the yield on the S&P 500 is higher than that of the 10-year or 30-year Treasury.

Despite the idea that we expect to possibly re-test the November lows, we continue to like certain themes such as gold, infrastructure, and energy. We also continue to hold our core positions in various industries, which are characterized by excellent management teams, strong balance sheets, recurring revenue, high barriers to entry, and significant backlog.

As always, we will continue our proven process of searching for well run companies in attractive industries, while avoiding fads.

Sincerely,

Greenfield Seitz Capital Management


1. U.S Commerce Department. 2008
2. Bank of America Research. November 24, 2007
3. Barron's interview of Charles Maxwell. October 16, 2006
4. International Energy Agency (IEA). 2003
5. BP Statistical Review. June 13, 2007
6. Lehman Brothers E&P Survey. December 24, 2007.
7. Raymond James Equity Research – Canada. December 20, 2006
8. Sharp Electric. 2006 Annual Report
9. Raymond James Equity Research. January 9, 2008

Greenfield Seitz Capital Management's ("GSCM") returns are calculated using daily valuation, are time-weighted and include cash in the total returns. For GSCM disciplines, performance is based on a size-weighted (asset-weighted) composite of all fully discretionary, wrap-fee accounts managed by GSCM in the Passport Investment Program, with the following accounts removed from the composites: i.) restricted, and ii) remit check paying accounts. Terminated accounts remain in the composites including last full quarter.

GSCM seeks to apply a consistent management style across all accounts managed within a particular strategy. However, because individual accounts contained in the composite vary by size and cash flows, the specific securities held and rates of return achieved may differ among accounts.

Net results reflect the deduction of investment management fees and any other expenses that may be incurred, but not domestic taxes. Performance includes reinvestment of all income, dividends, and capital gains. Total return is reported using accrual accounting except for dividends. GSCM's portfolios are individually managed and opened at different times and no inference should be drawn that new or existing accounts will achieve similar investment performance in the future. Rather, the above returns are presented to illustrate GSCM's portfolio management experience generally. GSCM performance measurement processes and procedures have been verified by an independent auditor. Any revisions will be promptly published.

Past performance does not guarantee future results. There is no assurance this trend will continue. The market value of securities fluctuates and you may incur a profit or a loss. This analysis does not include transaction costs and tax considerations. The material included in this presentation is for informational purposes only, and is not intended as an offer or a solicitation to buy or sell any securities.

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The S&P 500 is an unmanaged Index of 500 widely held stocks that is generally considered representative of the U.S. stock market. Indexes cannot be invested in directly.

CSFB Tremont Hedge Fund Index consists of a master Index and a series of sub-indices that represent historical returns of hedge funds.

In February 2002, Stuart Greenfield assumed responsibility for stock selection and investment management from Eric Greenfield. Yancey Seitz has shared investment management responsibility since 1995.

Special risks are involved with global and international investing related to market and currency fluctuations, economic and political instability, and different financial accounting standards. These risks are magnified by emerging markets.

Price Earnings Ration (P/E) is the price of s tock divided by earnings per share.

GDP is the annual total market value of all final goods and services produced domestically.

The companies engaged in the technology industry are subject to fierce competition and their products and services may be subject to rapid obsolescence.