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## Is it Time to Throw in the Towel?

Every March Randy and I visit the West Coast to see our grandchildren, Isaac and Vivian Anderson ages eight and seven. In the city of Santa Monica, California, you will find a majestic 5-star luxury hotel called [Casa del Mar](#) covering two blocks of expensive California beachfront.

Immediately behind Casa del Mar sits the somewhat dowdy [Archstone Citrus Suites](#), address 1915 Ocean Way, a collection of nice but not beautiful apartments built in the 1960s. Today you can rent a furnished, two bedroom apartment for about \$7,000 per month. There are plenty of vacancies from which to choose.

Two blocks north at 2000 Main Street sit another group of apartments in the Archstone collection called [Archstone Santa Monica on Main](#). These apartments, about 60 in number, were built in the 1990s and, compared with the Citrus Suites, are appreciably more upscale with exquisite amenities. The only problem is that if you're going to Santa Monica on an extended business trip this weekend, Archstone on Main has no vacancies.

The parent company to both apartment complexes, Archstone, is a company that has stakes in 77,000 apartments around the world, principally in large, metropolitan, U.S.-based cities. In 2007 at what would turn out to be the height of the real estate bubble, three of the smartest investment banking groups in the world -- Lehman Brothers, Bank of America and the British bank Barclays PLC -- led a private takeover of Archstone in a deal valued, according to the *Wall Street Journal*, at \$22 billion.

Last week Barclays and Bank of America announced that they valued their 53% combined equity interest at \$2 to \$3 billion. If we assume a mid-point valuation of their interest at \$2.5 billion, that means the entire Archstone enterprise today is worth \$4.7 billion ( $\$2.5\text{bn} * 100$  divided by 53%). That's a loss of almost 80% in four years!

That also means the smartest investment banking guys on Wall Street are now willing to lose \$9.16 billion ( $\$22\text{bn} * 53\% = \$11.66\text{bn}$  minus  $\$2.5\text{BN} = \$9.16\text{bn}$ ) or thereabouts if someone, anyone, will just take them out of their misery. In case you're interested, no buyers for that majority interest have been found as of this writing, but I'm sure Brian Moynihan would take your call.

Ladies and Gentlemen, that's a textbook, business school case of Wall Street throwing in one of those nice, fluffy, Casa del Mar towels on their Archstone investment. You could also call it "capitulation."

On the first trading day of this fourth quarter, Monday October 3<sup>rd</sup>, the S&P fell to a 13-month low of 1,099.23. On Tuesday, it officially entered bear territory, defined as a drop of 20% from the previous high which was in April, only to snap back during the last hour.

So, the question of the day is this: Has the 14% third quarter loss in the S&P 500 Index coupled with the 12% third quarter loss in the Dow Jones Industrial Index signaled stock market investor capitulation? If the answer is "Yes," then this is the market bottom and you should start to furiously shovel your hard earned dollars back into stocks. If we're not there yet and there's more pain to come, you should keep those dollars under the mattress of the bed in the apartment you rented from Archstone, or wherever it is you will sleep tonight.

Let's take a look at the macro events which have driven the markets so low, so quickly this last quarter. You know them as well as I do.

1. Unemployment remains stubbornly high at more than 9% with the underemployment number, which includes those who have stopped looking for work and those underemployed, at twice that number.

2. Washington is displaying historic paralysis and dysfunction. Think back to the debt ceiling fiasco of late July. Recent surveys place our confidence in Congress at an all time low of 11% with the President's rating as low as it has ever been during his three-year tenure.

3. U.S. government annual deficit and long term debt numbers boggle the imagination, portending potential catastrophe if not addressed in an adult fashion and soon by our nation's leaders.

4. Polarization, instead of compromise, is the modus operandi of both parties. That's not the Super Glue which traditionally holds democracy together. Democrats say any discussions of Medicare, Medicaid and Social Security entitlement reform are off the table while tax increases are fair game; Republicans take the other side of that coin, shouting "Nyet, No Way, Never" to the suggestions that tax increases are part of the solution.

I'm compelled to ask, where are Delaware's Mike Castle, New Hampshire's Judd Gregg and Indiana's Evan Bayh when we need them? Two were middle of the road Republicans, the other a moderate Democrat. Answer: Retired, voluntarily in the case of Gregg and Bayh, or involuntarily in Castle's case by his Republican Tea Party primary opponent, that infamous witch, Christine O'Donnell.

These are the sobering words the two-term Democrat Senator from Indiana used about DC politics in announcing his retirement: "The institutional inertia gripping Congress is no laughing matter. . . . There are many causes for the dysfunction: strident partisanship, unyielding ideology, a corrosive system of campaign financing, gerrymandering of House districts, endless filibusters, holds on executive appointees in the Senate, dwindling social interaction between senators of opposing parties and a caucus system that promotes party unity at the expense of bipartisan consensus;"

5. European Union miasma, with an alphabet soup of non sovereign entities -- the EU, the IMF, and the ECB -- holding significant but insufficient power to make firm and final decisions. Then, overlay that structure with governments which have centuries of being vastly disparate cultures. Think Germany and Greece.

Add in the self-interest of all of those decision making bodies pulling in different directions, then couple it with the refusal or inability of the EU to take strong action

quickly and poof, you witness Greece melting before our very eyes faster than you can cry "Watch out for Global Warming!"

Will the European banks be next? Stay tuned; that story is playing out as I write this missive.

In order to get its latest bailout, the Greek government just agreed to raise property taxes. Speaking of cultural differences, do you know that the tax collection system in Greece is so broken that in order to collect the new property taxes no tax bills will be sent to the Greek citizens? Why? Because the government knows they would be ignored. Instead, the tax owed will be added to everyone's electric bill. Think about that for a moment, and then ask how, if you were Germany's Chancellor, Angela Merkel, you could explain that mindset to your German beer-meister-in-the-street voter.

Last year, Michael Lewis, the author of *The Big Short*, *Liar's Poker*, *The Blind Side* and *Moneyball*, travelled to Greece and interviewed a Greek tax collector to gather facts for his newest book, *Boomerang*, a story about financial bubbles in different cultures. The tax collector had just been fired. The reason? He had actually tried to collect overdue and unpaid taxes. Now, you realize why "Houston, the Europeans have a problem" when it comes to getting one's arms around European budget deficits.

As for me, my guess is that for the moment the bottom has not yet been found. It would appear that we have more bad news to endure before the last man standing throws in his towel and capitulates.

I predict the macro bad news will continue for the short-term with the pessimist's theme you have just seen laid out trumping news on the other side, such as Warren Buffett's \$5 billion purchase of preferred shares in Bank of America barely a month ago and his September 26<sup>th</sup> announcement that he will, for the first time in forty years, be buying back shares in his company, Berkshire Hathaway, on the open market.

Is America's most famous and well respected investor correct? You all know the bromide that the best time to invest in stocks is when all the towels have been thrown in.

Here are some good news facts to consider going forward:

1. On September 19<sup>th</sup> the Federal Reserve Bank, headed by Ben Bernanke, announced a policy to be carried out through next June called Operation Twist. The concept is that the Fed will sell its shorter-term, maturing government bonds and use

the proceeds to buy longer-term ones. The Fed's anticipated result will be to reduce the yield investors get for those longer term instruments below even the paltry sums available today, thereby driving investors to look for riskier asset classes in which to place their money, like stocks.

2. The concept, reversion to the mean, is a statistical reality. Simply stated it means what goes down, must go up. On a relative basis, over the last ten years bonds have been up and stocks, not so much. (Plus 70% for bonds versus plus 30% for equities).

A recent study conducted by a professor at the Stern School of Business at NYU looked at market patterns from 1790 to the present. Yes, that's 1790, not 1970. "If you look at the long sweep of history", the author Richard Sylla stated to the *Wall Street Journal*, "this seems like a good time to buy because the average return is down near the bottom and is likely to go up."

3. Corporate profits and cash on corporate balance sheets are at extremely high, historic levels. Corporate P/E ratios, the talisman for most fundamental investing decisions, are at near historic lows, meaning it's a good time to invest. Laszlo Birinyi, president of an eponymous investment firm, says U.S. companies are earning "too much" to be ignored. Birinyi advised clients to buy shares before they last bottomed in March 2009, so he has more than a little street cred when he offers his thoughts today.

His prediction is that stocks won't do much for the next twelve or so months, but after that they will soar. S&P 500 earnings are predicted to reach a record, repeat a record, at \$99.98 a share this year. Birinyi says that stocks started a multi-year rally in the spring of 2009, and that there will be inevitable pullbacks along the way which is what is happening now, as the market never moves in a straight line.

While the S&P 500 peaked this April at 1363, and then has gone south, (and not to Richmond but to Atlanta) still the Index is sitting comfortably above its March 2009 low of 676. (I'd call that Key West). The end of the third quarter saw the S&P Index at 1131, 75% ahead, including dividends, of that 2009 low. Given those consensus strong earnings predictions for the rest of this year, the market trend will be upward, he asserts.

4. Here's a quiz for you and you don't even have to Listen to the Music because I'll supply the answer right now. Using the periods from 1926 through 2008 what is the

percentage risk of stock market loss for one, five and fifteen-years? Give up?

.. One-year 29%,  
.. Five-year 14%,  
.. Fifteen-year 0%.

So, if you have the time, keep that towel dry. You might need it in the short run but you likely won't need it longer term.

In the end the bull versus bear debate really comes down to this: Are you willing to take the opposite side of the bet placed by our foremost investor, Warren Buffett? How you answer that query will serve to be your guide going forward.

### **Listen to the Music**

We have two quizzes, each in two parts, to tickle your intellectual fancy this quarter. One involves music and the other an organization which has been in the sports news a lot recently.

Quiz One is for our music lovers: What do these ten artists, Bryan Adams, Paul Anka, Justin Bieber, Celine Dion, Diana Krall, Alanis Morissette, Anne Murray, Oscar Peterson, Shania Twain and Neil Young have in common? Those artists cover the musical spectrum from instrumental and vocal jazz to country to rock to easy listening to today's teenage pop stuff. What is their commonality?

Ok, now part two; associate these five songs with five of the artists named above: After the Gold Rush; That Don't Impress Me Much; Put Your Head on My Shoulder; (Everything I do) I Do It for You, and A New Day Has Come. Come to think of it, I could have used any one of those song titles as a metaphor for today's market!

The sports field is the setting for Quiz Two: Which of these two actions was determined to have been a violation of NCAA eligibility rules and, conversely, which received the green light?

A. In 2010 a football player receives tutoring help for one hour from his former tutor, a young woman who graduated from his college in 2009 and who is then teaching fifth grade. He fails to pay her \$11, the NCAA-determined value of the one hour tutoring benefit he received.

B. As his child leaves junior college, a father shops his quarterback son with an SEC school seeking \$180,000 in a pay-for-play scheme. The son allegedly never knows that Poppa's Got a Brand New Bag. (Sorry, James).

Hint: the irony in the question suggests the answer.

Part two of this sports quiz: Name the schools associated with each matter.

And if you want to read a scathing, powerful indictment of the NCAA by a Pulitzer Prize winning historian, be sure to read Taylor Branch's brand new e-book, [The Cartel: Inside the Rise and Imminent Fall of the NCAA](#). A shortened version can be found in the September Atlantic magazine, titled [The Shame of College Sports](#).

As always, the Westover Quiz Rules are in effect. \$50 goes to each winner.

Enjoy yourself and stay dry.