

Investment Outlook

Bargains Amid the Chaos

The global economy continues to contract, with no upturn in sight. U.S. housing prices, the crux of our economic woes, continue to fall. This downturn could end tomorrow if investors were to decide they are better off holding real estate than holding dollars. More likely, investors will avoid real estate until prices have declined enough for rental property investments to produce a good rate of return.

What does economic history foretell about the length and depth of the current recession? In the Great Depression, the economy contracted 25% over the course of three years, followed by a 25% expansion over the next three years. It is widely acknowledged that the Great Depression was made worse by government policies restricting credit and trade. Hopefully, with correct government policies, the current recession will be shorter and milder. The National Bureau of Economic Research recently announced the U.S. recession began in December 2007. Given that we are thirteen months into our recession, and given that the Great Depression was a thirty six month contraction, hopefully we will hit bottom some time in 2009.

Another historical precedent is the bursting of Japan's real estate and stock market bubble in 1989. Like the U.S., Japan simply ignored the fact that the decline in mortgage values rendered its banks insolvent. Because the bad debts were never dealt with, it took thirteen years, from 1989 to 2003, for Japan to recover from economic malaise. By working to prevent a collapse, the U.S. government may be trading a deeper shorter contraction for a shallower longer

one. The heartening thing about Japan is their economy never did contract, it just crept along at 1.5% annual growth for thirteen years. If the U.S. economy ceases to contract, it would mean that most stocks are great bargains right now, because current stock prices reflect an expectation of continuing deterioration in earnings.

As an appendix to this Investment Outlook, I have profiled four of our stock picks. Despite the economic uncertainty, I believe Wall Street has overreacted and knocked these stocks down to bargain levels. In recent months many investors have been forced to sell their holdings at any price, so it should be no surprise that current stock prices may not accurately reflect true worth.

Though the outlook for stocks may be cloudy, the outlook for fixed income investments is far worse. The U.S. Government is running the printing press like there is no tomorrow, creating a huge potential for inflation. The increase in the money supply has not yet spurred inflation because businesses and individuals want to hold more cash. However, this sentiment can turn around in a hurry, either because people feel more confident, or people become nervous about holding dollars.

One of my clients recently asked me to set aside some cash. He felt that if there were to be a rise in inflation, the inflation would happen slowly enough for him to get out of cash and back into tangible assets. I am not so sure. In 1946, U.S. inflation spiked from 3.31% to 9.39% in one month and up to 17.68% four months later.

Over three years, 1946 through 1948, the dollar lost 34% of its value. Germany, Brazil, and many other countries have had bouts of runaway inflation, and the usual pattern is inflation comes on fast and with little warning. There is just no way to predict when a panic may cause a run on the dollar, but we do have to acknowledge that the increase in the money supply has increased that risk. For this reason, I favor fixed income investments which are indexed to inflation, such as TIPS (Treasury Inflation Protected Securities).

In summary:

- History suggests our recession may end in 2009
- Government policies may make the recession shallower but longer
- Forced selling has created bargains in stocks
- Negative outlook for fixed income due to inflation risks

I hope you will be encouraged by reading the four company profiles which follow. Adversity truly creates opportunity.

Robert Balopole, CFA

Disclaimer:

This newsletter is informational only, and does not constitute investment advice or a solicitation. BIMC and Robert Balopole are invested in all the stocks mentioned in this newsletter at the time of publication. Certain investments may not be suitable for a particular investor. Investments can result in losses.

Appendix



Akamai (AKAM) Price \$15.74

Akamai helps customers communicate more quickly and reliably over the internet. Akamai accomplishes this by maintaining a massively distributed network of 40,000 servers in 1,500 locations at the edge of the network, close to the end user. Akamai's goal is to have a server within 10 miles of the end user.

About 20% of all internet traffic travels over Akamai servers. Akamai's largest competitor handles about 5% of internet traffic, so Akamai is clearly the industry leader. The industry is very healthy because rich media, dynamic transactions and web-IP based applications are putting more demands on networks. We believe the trend of increasing internet traffic will continue despite the global economic contraction. If anything, limited capital expenditure budgets may cause networks to lag in their capacity expansion, making Akamai's service even more necessary.

Akamai is the only company with a massively distributed network. All competitors use a smaller number of big data centers. Consequently, the competitors are 2 to 3 times slower, and 3 to 15 times less reliable. (These are Akamai's figures). Businesses are willing to pay for this improvement. By reducing transaction time, Akamai customers complete more transactions. More and more people are downloading media such as DVD's over the internet. Akamai allows a viewer to instantly watch a DVD, whereas with competitors a viewer may have to wait several hours for the content to download before they can view.

The big data centers are on the wrong side of the internet bottlenecks known as peering

points. So when there is a big news event or a hot video, the end user experiences major delays. While it may be more expensive for Akamai to maintain 1,500 locations, this is offset by the fact that collocation and bandwidth expense are lowest at the edge of the network and highest in the big city data centers. Akamai has spent ten years and billions of dollars creating software to getting their distributed network to run efficiently. This presents a substantial barrier to any competitor.

Akamai's third quarter earnings per share were \$0.40 on a non-GAAP basis. Akamai projects Q4 non-GAAP EPS of \$0.39 to \$0.40. They affirmed their guidance on Nov. 19. Based on current earnings, Akamai sells at a Price/Earnings ratio of just 9.8. Yet they have a five year annual revenue growth rate of 34%. Their capital structure is very strong with \$788 million in cash and marketable securities and only \$200 million in long term debt. The debt bears interest at just 1%. CEO Paul Sagan has been with the company since 1999, and was battle tested as COO during some very lean years.



HRPT Properties (HRP) Price \$3.37

HRP is a REIT, owning about 500 office buildings and industrial properties throughout the U.S. Third quarter funds from operations (FFO) were \$0.27 per share. The price/FFO ratio is an amazingly low 3.12. Obviously, FFO is expected to deteriorate, which is not surprising given the poor economy.

However, there are several factors in HRP's favor. The average lease maturity is 5.6 years. The tenant composition is: Government 8%, Land leases 25%, Other investment grade tenants 18%, Other 40%, Vacant 9%. So HRP

only has to worry about the "Other 40%" defaulting.

The remaining 60% of the tenant base is highly unlikely to default. I calculate HRP could withstand a 35% decrease in rents before experiencing negative cash flow. Although rents are softening, HRP continues to obtain higher rents on lease renewals.

Common shareholder's equity is about \$2.2 billion. The market value of the stock is \$863 million. Thus, in order for the stock to be worth less than \$3.37 per share, the properties market value would have to decline to \$1.4 billion below book value, which is a 26% decline from current book value. But the book value of the properties is based on a historical cost from seven years ago, on average, and even that historical cost has been depreciated by \$837 million. So it's a good bet that the real estate's market value substantially exceeds the book value. This is a long winded way of saying the current market value of the properties, net of debt, is far in excess of \$3.37 per share.

HRP's liquidity is very good. They have \$24.9 million in cash. They have only \$7.9 million of debt maturing in 2009. They have \$447 million available on their revolver, and \$303 million in property sales in the pipeline, but subject to contingencies.

While HRP may experience a few years of decline, they should be able to survive until better conditions arrive. Meanwhile, they pay a 25% dividend, which is great as long as it lasts.



Noble Corporation (NE) Price \$23.75

Noble is a leading offshore drilling contractor for the oil and gas industry. Noble earned \$1.43 per share in the third quarter, and has earned about the same over the last four quarters. This gives Noble a rock bottom price/earnings ratio of around 4. If Noble can maintain current earnings, the stock is a steal at these prices.

The stock is down almost 70% from its peak of \$68.99, yet earnings remain at record high levels. Apparently Wall Street believes lower oil prices will reduce demand for offshore drilling. Noble's management has pointed out that most of their current work was contracted when crude was \$50, so no problem there. And, crude futures are predicting a steady increase in prices, up to \$77 in 2015. I believe crude prices will rise much higher. 25% of world petroleum exports come from Iran, Indonesia, Mexico and Venezuela, four countries which have not been investing enough in new production to offset the natural decline in current production. Meanwhile, these nations' domestic consumption is rising to the point where there will be no crude available for export by 2015.

Noble has over \$12 billion of backlog. This represents almost four years of revenue. The contracts are noncancellable. The customer base is sterling: almost 75% are national oil companies and 24% are major independents. While there is some concern about the number of new jackup rigs coming out of the shipyards, credit conditions are putting a crimp in new construction.

Noble's balance sheet is very strong. Current assets exceed current liabilities by about \$400 million. Property and equipment have a book value of \$5.4 billion, whereas long term debt is only \$702 million.

Yamana Gold (AU) Price \$7.61

Yamana Gold owns and operates seven gold mines in South America, mostly in Brazil and Chile. While third quarter earnings were \$0.21 per share, cash flow was only \$0.14. Thus the price earnings ratio is 9, while the price to cash flow ratio is 13.6.

Yamana plans to double its output by 2012. Most of the development will be funded out of current earnings. Yamana's market cap is \$5.6 billion. At \$850 per ounce, Yamana has \$15 billion in proven and probable reserves, \$11 billion in measured and indicated resources, and \$12 billion in inferred resources.

We believe gold will continue to be in short supply as South African production continues to decline. Demand should continue to be strong as India and China emerge and join Saudi Arabia as cultures with traditional affinity for gold. Monetary instability should also increase desire for gold ownership, as gold provides good diversification against economic turmoil.

Besides gold prices, the big unknown for Yamana is production costs. Cost of labor, equipment, fuel and water can be highly variable. Another factor is the price of byproducts: silver, copper and zinc. Yamana predicts cash costs of \$360 per ounce over the next three years, or \$140 per ounce after profits from byproducts. This is one of the lowest production costs in the industry.

If we assume an \$850 gold price and a \$360 production cost (inferring zero income from byproduct metals), this means the proven and probable reserves alone will yield \$8.6 billion of pretax profit. With debt of only \$700 million, Yamana is easily worth more than its current market cap, assuming gold prices hold.