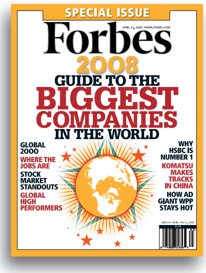
Forbes

APRIL 21, 2008 | WWW.FORBES.COM



Gold Chasers

IT'S BAD OUT THERE ON JUST ABOUT EVERY FRONT—AND GETTING WORSE. BUT FOR SOME INTREPID INVESTORS, THERE'S NEVER BEEN A BETTER TIME TO JUMP IN. WHAT THEY'RE BUYING, AND WHY.

THERE WILL BE MORE FORECLOSURES, more personal bankruptcies, more corporate writedowns, more layoffs. More companies will fail and get dismembered because they couldn't roll over their short-term debt. Consumer spending will probably fall further; home prices almost definitely will, a forecast built into derivatives prices.

For most economists and maybe most investors recession is no longer a question of if or when but how long. "One of the worst since World War II," predicts James B. Rogers Jr., a cofounder, with George Soros, of the Quantum Fund. It will be a long time, he says, before we recover from the "worst credit excesses in U.S. history."

In the credit market's flight to quality, second-tier borrowers are starved. Car rental outfits like Avis Budget Group and Dollar Thrifty rely on generous financing from automakers and off-balance-sheet entities to pay for their fleets, and neither source of capital is gushing at the moment. Businesses with sagging balance sheets include Landrys Restaurants, with $1.3 billion in long-term debt; Blockbuster, with $1.5 billion; and newspaper publisher McClatchy, with $4.7 billion at a time when its readership and ad revenue are sinking.

Wall Street and the economy are a mess. So maybe this is a good time to buy something.

As the old adage goes, "When blood is running in the streets, the way to make money is to buy assets." The California State Teachers' Retirement System is following such advice. In mid-March, as shares of Bear Stearns collapsed, Calstrs was buying stocks. "We are fishing for opportunities," says Christopher Ailman, chief investment officer. He moved $2 billion of the $165 billion fund out of fixed income into equities and equity futures, including the S&P 500 and the Russell 3000.

Wilbur Ross recently committed over $3 billion to battered assets: municipal bonds, mortgage servicing and bond insurance. "Truly distressed situations are just beginning to manifest themselves in large size," he says. Ross should know: He made a fortune buying steel companies when they were disintegrating.

"In the 17 years my partners and I have been together, we've never been this excited," says Michael Psaros, who runs KPS Capital Partners, a New York City private equity money manager. Its latest fund, with $1.2 billion to put into midtier manufacturing and industrial companies, sat on the sidelines until November, when it bought the metal manufacturing unit of Olin Corp., then picked up the brass and copper unit of Bolton Metals Products; in March it acquired Delphi's bearings subsidiary.

There is other evidence of smart money on the buy side. According to InsiderScore.com, insiders at U.S.-listed stock companies have been increasing their stakes in their own companies for 23 consecutive weeks. Buying among higher-ups, including chief executives, directors and other insiders, has been running well ahead of historic averages, even in some of the most beaten-down sectors. "The biggest stocks in the S&P are as cheap relative to everything else as they have been in 70 years," says Barton Biggs, who manages Traxis Partners, a $1.6 billion New York City hedge fund. He is buying large-cap stocks and shorting U.S. Treasurys. He is betting, in other words, that most people are overvaluing safe things and undervaluing risky things. Hindsight may someday show that Biggs turned bullish too soon (this wouldn't be the first time he made that mistake in his 40-year career). But it is certainly the case that there is more blood on the street, and stocks are cheaper, than a year ago.

You can always seek shelter from the storm, and retreat into two-year T notes paying all of 1.61% (when inflation is 4%). Or you can flirt with danger, and consider the exploits of seasoned adventurers who are taking on risk. Where the action is:

FINANCIAL SERVICES

"THIS IS AS GOOD AS IT EVER GETS," SAYS Richard Pzena, who manages $21 billion for Pzena Investment Management, including the $5 billion John Hancock Classic Value Fund. That one got smacked last year, losing 14% of its net asset value by dint of its 40% exposure to financial companies, including Citigroup, its second-largest holding. Even after Citi's scary $18 billion in writedowns and 55% plunge in market value over the last year, Pzena is doubling down on the stock, pointing to the strength of its credit card unit, wealth-management services and retail branches. "Most of the businesses are only modestly impacted by the crisis," says Pzena, who spent a decade in equities research at Sanford C. Bernstein and took over the Classic Value Fund in 1996. For those reasons, he's also buying shares of Bank of America and Lehman Brothers and acquiring bigger stakes of Freddie Mac and Fannie Mae.

Whitney Tilson, managing partner at T2 Partners Management in New York City, has been buying shares of Fairfax Financial, a Canadian insurer and a favorite target of short-sellers. Tilson says he likes the fact that Fairfax piled into credit-default swaps as a hedge against losses on its reinsurance recoverables. Fairfax now represents 13% of Tilson's four funds, a total $120 million.

John Linehan, portfolio manager of the $7.5 billion T. Rowe Price Value Fund in Baltimore, often sits on stocks for five years. Lately, with a long horizon in mind, he's bought insurance giant American International Group, and considers it cheap at a recent $42.80. This, despite AIG's $11 billion writedown related to guarantees sold to fixed-income investors. Book value, he expects, will be $50 a share by 2010. "AIG is still a very reasonable story given its earnings capability," he says. He also likes Merrill Lynch, thanks to its army of retail brokers and its stakes in investment manager BlackRock and in Bloomberg, the financial information giant. "The sun is going to come out," Linehan insists. "You have to remind yourself when it's dark out there."

Not too dark for Wilbur Ross. In early March his W.L. Ross & Co. spent $1 billion or so to buy municipal bonds—he won't specify which ones—rocked by uncertainty over the insurers, like MBIA and Ambac, that guarantee them. He got them, he says, at "substantial discounts from par."

Panic selling of some AAA-rated issues also made a shopper of William H. Gross, manager of the $124 billion Pimco Total Return Fund in Newport Beach, Calif., the world's largest bond fund. He picked up $1 billion-plus worth of munis, he says, in "a couple of hours." An unusual move, considering that the fund's many investors don't need the tax advantages of such bonds. Still, he apparently couldn't resist the yields. Examples: University of Texas munis, due August 2030, bought at 5.8% yield to maturity, and bonds issued by New York City Transitional Finance Authority, due November 2027, bought at 5.75% yield to maturity. Later, as others got cold feet and sold, Gross picked up $100 million worth of April 2018 Goldman Sachs bonds, paying a taxable 6.15%. "Goldman and Merrill are under pressure," Gross says. "There are bargains everywhere."

BETTING ON BALANCE SHEETS

Problem is, no one sees an end to the massive writedowns and spiraling losses.

TICKER	COMPANY	PRICE RECENT	PRICE 52-WEEK HIGH	YIELD %	PRICE/ BOOK
AIG	AMERICAN INTERNATIONAL GROUP	$42.80	$72.97	1.9%	1.1
BAC	BANK OF AMERICA	38.07	52.96	6.7	1.2
C	CITIGROUP	20.83	55.55	6.1	0.9
LEH	LEHMAN BROTHERS HOLDINGS	37.87	82.05	1.8	1.0
MER	MERRILL LYNCH	39.93	95.00	3.5	1.4
WM	WASHINGTON MUTUAL	10.12	44.66	5.9	0.4

Prices as of Mar 28. *Source: Reuters Fundamentals via FactSet Research Systems.*

HOMEBODIES

REITs, developers, home improvement centers—feel like betting on a turnaround?

TICKER	COMPANY	PRICE RECENT	PRICE 52-WEEK HIGH	YIELD %
AVB	AVALONBAY COMMUNITIES[1]	$95.10	$134.65	3.8%
EQR	EQUITY RESIDENTIAL[1]	40.35	52.25	4.8
HD	HOME DEPOT	27.38	41.19	3.3
SPF	STANDARD PACIFIC	4.67	23.74	0.0
JOE	ST. JOE	42.00	60.85	0.0

Prices as of Mar. 28. [1]Real estate investment trust. *Source: Reuters Fundamentals via FactSet Research Systems.*

WILLIAM DUKE FOR FORBES