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A LOOK BACK

BACKGROUND

This section will attempt to explain why we feel the timing is right for an Asset Analysis approach to stock market investing. To help substantiate our feelings, we have garnered the opinions of a number of individuals who are responsible for the management of billion of investment dollars and who also believe that a return to a basic approach to analysis is forthcoming. We have cited examples of corporations that have gone private, made tender offers or acquisitions based upon an Asset Analysis type of approach. Furthermore, we have pointed to similar periods in stock market history where, because of fear and uncertainty, companies have sold at historically low prices in relation to asset value only to recover and sell well above book value.

The bottom of a deep and prolonged bear market usually coincides with the middle phases of a severe economic contraction. None can say with any certainty how long or how deep this business slump will prove to be, but as studies of stock prices in the five previous recessions [1948-49, 1953-54, 1957-58, 1960-61, and 1969-70] indicate, investors cannot afford to turn their backs on the market during this period of economic contraction.

In two of these five periods, the stock market made its lows within the first few months after the economy had started backtracking. In 1953, the market bottomed in September, the end of the first quarter of decline in real GNP. In 1957, hardly a month of the brief, 12-month slowdown had gone by before the low in stock prices had been set. In the other three periods, the stock market lows came within a month or two of the midpoints of the business recessions - slightly later than the half-way mark in the 1960-61 setback and almost exactly in the middle of the recessions in 1948-49 and 1969-70.

We are not suggesting that the aforementioned will happen again, however, we are of the opinion that the market is constantly discounting future developments and normally moves well in advance of changes in business conditions.

During these times of economic uncertainty, earnings per share become less important as an analytical tool, while balance sheet analysis becomes more meaningful. We believe that we are currently in the early stages of this period. On a percentage basis and over the medium to longer term, we believe that, because of the severity of the current market decline, a higher rate of return will be made by investing in deeply depressed asset-rich secondary corporations than will be made by investing in moderately depressed glamour stocks.

Carl E. Hathaway, senior vice-president for Pension Fund investments at Morgan Guaranty, in an interview that appeared in the October 15, 1974 edition of Forbes, stated that Morgan still loves International Business Machines, Xerox and P & G, but it is starting to look at other, less glamorous, companies.

"Because of the low level of the market, we are now looking at companies that sell at half of book value, two-thirds of working capital, provide dividends that are well secured and are selling in the marketplace at one-half to one third of their sales volume. The market is suggesting that these kinds of companies are going out of business and we don't believe that. The break-up value of many companies just on a division-by-division basis far exceeds the market value of their securities."

Illustrative of our belief that real value exists within the underlying assets of many corporations, we only have to look at the following:

1] More and more corporations are looking at companies that are selling well below book value for possible acquisitions:

Loews Corporation, for example, recently completed a successful tender offer for the majority shares of CNA Financial. Loews paid half of stated book value for CNA. As a result of this acquisition, Loews can artificially boost their earnings by more than $100 million over a period of years because of negative goodwill. If a purchaser pays less than book value for an acquisition, the difference, or negative goodwill, is considered a profit that can be used to artificially bolster profits over a period of years.

Some other recently completed tender offers included Mobil and Marcor and International Nickel and ESB. If market values for securities don't advance significantly, we believe that this trend will proliferate.

Other companies are relying on the deft use of debt to discourage raiders. A number of companies, including Tyco Labs and Towle Inc., are making themselves less vulnerable as potential takeover candidates by embarking on their own acquisition programs and adding some debt to their balance sheet. When a company adds debt to its balance sheet, it becomes less attractive to potential acquirers.

2) Many corporate executives are attempting to make their corporations private, taking advantage of what they believe are unheard of values.

Barbara Lynn Stores recently decided to go private because it felt that it could buy back its shares below liquidating value. Shareholders received $4.40 per share, which topped the pre-offering price of 2-5/8. On the other hand, Barbara Lynn has a book value of $8.65 and $4.12 in cash or the equivalent. When market conditions were better, the company received $4.5 million and selling shareholders $6 million in 1966. In 1969 a secondary offering was completed at $26.25 a share.

A number of other companies have also elected to go private -- including a California electronics firm Bourns Inc., retailer Cornwall Equities Ltd. [the former Franklin stores], and advertising agency, Wells, Rich & Greene. Even MGM wanted to go private, but reversed its decision because of the public outcry. Meshulam Riklis, chairman of the $2.7 billion Rapid American Corp., reluctantly announced the cancellation of its plan to swap $20 principal amount, ten-year 10% debenture for each share of its common stock. The company decided on the cancellation because of recent questioning by the Securities and Exchange Commission of such offers.

Chief operating officers and merger and acquisition specialists have taken advantage of this unusually depressed period in stock market history to acquire corporations at unusually low prices. Although the investment community as a whole has not yet followed their lead, we believe that in the not too distant future, stock prices will begin to ascend and more accurately reflect the intrinsic worth inherent in many corporations. In retrospect, this period may be looked upon as one of the four or five great buying periods for common stocks.

Statements similar to the preceding one have been made during similar periods of economic adversity. Dean Witter, a founder of the investment concern of Dean Witter & Company, in a memorandum written in May of 1932 to the brokers of his concern, had this to say:

> "The stocks of many good companies facing no visible financial hazards are selling at only two or three times earnings and at under 50 percent of sound book value, disregarding such valuable intangibles as goodwill, going concern value, and trained intelligent organizations that have taken years and vast sums of money to develop. I say emphatically that in a few years today's prices will seem as ridiculously low as 1929 values were fantastically high."

To paraphrase Mr. Witter, we say emphatically that in a few years, today's prices will seem as ridiculously low as 1969 values were fantastically high.

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