

## Quarterly Newsletter

4<sup>th</sup> Quarter - 2007

### Market Overview:

For the first year since 2002, the US bond market outperformed the US Stock market. The 4<sup>th</sup> quarter contained some ugly news for stock investors and overall the stock market ended down. As would be suggested by watching the news, the decline was lead by financial companies, and followed closely by almost any company remotely associated with US consumers or the housing market. While generally the macroeconomic picture is not something I put a lot of emphasis on, it should be noted that economists are now generally predicting at least a decent chance of recession sometime in 2008. The markets are very volatile right now and I would certainly not expect that to change any time soon. While volatility brings opportunity, it also can cause a bit of heartburn.

In tough times I want to reiterate that I'm available to discuss any topics you are interested in, curious or concerned about; both within our portfolio, and in the general market. Don't hesitate to call.

Returns* ended 12/31/2007:	1 Qtr Return	1 Year Return	3 Year Return (annualized)
<b>Wilshire 5000 Index (Ticker: VTI)</b>	<b>-3.32%</b>	5.37%	9.03%
<b>MSCI World Index (Ticker: EFA)</b>	<b>-2.50%</b>	9.97%	16.18%
<b>Lehman Aggregate Bond Index (Ticker: AGG)</b>	<b>2.99%</b>	6.61%	4.27%

### Investment Updates:

I thought I would put the more relevant information in the beginning of this letter so that clients who aren't inclined to read my ramblings about the markets further down can get the meat of my commentary up front!

So with that said, below I will provide an update on a few of our investments this quarter and how they fared. Note that while many investments are held in all Remick Capital client accounts, oftentimes due to either the timing of investment cash flows, account size, or risk tolerance; some investments discussed below may not be in your account.

**Accredited Mortgage Loan REIT Trust, 9.75% Cumulative Preferred, Class A (Pink Sheets: AHHAP)** – Accredited Preferred stock is certainly the most volatile of our holdings. Even though the shares are up quite a bit from our purchases in August; for the 4<sup>th</sup> quarter the shares were a drag on account performance. As a background, Accredited Preferred is essentially the debt of a subprime lender that was taken private in the 3<sup>rd</sup> quarter. Because the parent company is now a private company, the new managers chose to use the opportunity to delist the preferred shares to save on filing expenses. While delisting has many negative connotations, in this case, the shares were delisted not due to fraud, or some other nefarious reason, but because the SEC allows for companies that have fewer than 300 shareholders of record to voluntarily delist to save on SEC filing costs. What this means for us as investors is that now the shares trade much less frequently and will likely be cheaper due to a liquidity discount that some investors will apply to them. For long term holders, this has little relevance as our dividends from these shares (which are ~\$0.60 per share, per quarter; or >20% at current prices) get deposited into our brokerage accounts just like they always have. There is a lot of uncertainty surrounding this particular holding, but at current yields, I believe we are being well compensated for the unknown.

\* The Wilshire 5000 Index is a collection of stocks that is designed to approximate the returns of the entire US Stock Market.  
The MSCI World Index is a collection of stocks that is designed to approximate the returns of the global stock market with US stocks removed.  
The Lehman Aggregate Bond Index is a collection of bonds that is designed to approximate the returns of the entire US Bond market.  
All returns are based on Exchange Traded Fund (ETF) returns to make the numbers representative of actual investor returns.

**Nicholas Financial (NASDAQ: NICK)** – Nicholas Financial took a beating this quarter. Being a subprime lender is of course the kiss of death for your stock price in the current market environment. Nicholas is no different. However, it is interesting to note that so far NICK has stayed solidly in the black with only minor deterioration in profitability. All while operating in the most extreme of lending segments; subprime auto lending. In a rather important press release, Nicholas disclosed that during the 4<sup>th</sup> quarter, their bank extended NICK's line of credit by one year, lowered the rate, and increased the capacity. On top of this, the CEO has begun to purchase shares in reasonably sized amounts for his personal portfolio and he already owns a big slug of the company. I can't guess how Nicholas's stock price will do over the coming months as the markets go through their mood swings, but I am highly confident that NICK is well prepared for the worst and will emerge from this environment a stronger company with a better market position.

**Compton Petroleum (NYSE: CMZ, TORONTO: CMT)** – After a poor 3<sup>rd</sup> quarter performance for Compton, the shares were flat-ish going through the 4<sup>th</sup> quarter as Natural Gas prices remained soft. However, two interesting developments occurred; the largest owner of Compton shares (with ~20% ownership) issued a letter to management stating their displeasure with Compton's lack of strategy to narrow the discounted valuation that the company suffers from in the market. Additionally, a rather notorious corporate agitator (Carl Icahn) has also disclosed a 2.5% stake in Compton. While I am generally indifferent to these kinds of activist investors (I am supportive of Compton's management, and I feel they are strong operators), they can help add a potential catalyst for Compton stock given the rock bottom valuation compared to many of its peers. Attention from other smart investors is rarely a bad thing.

**Fairfax Financial (NYSE/TORONTO: FFH)** – In the 4<sup>th</sup> quarter Fairfax stock continued its very strong performance. As the credit markets continued to deteriorate investors have continued to view Fairfax Financial as a hedge for serious convulsions in the financial markets. Their conservative investment portfolio and astute risk management has put them in a good position to take advantage of opportunities as they arise. I continue to feel strongly that this holding will treat us as shareholders well over time and I'm still confident to hold even at higher prices. The next quarter or two of results should bring further attention to the company as their financial strength in hard times become clear.

*NOTE: Some clients may own a Fairfax subsidiary Odyssey Re Holdings (NYSE: ORH) in place of Fairfax shares. The companies are not identical, but are very similar in many important ways. At different times, either one may present a more compelling buying opportunity than the other.*

## **The US Economy; What Went Wrong?**

I recently was sent a report that attempted to explain '*what went wrong*' in the financial markets this past year (and earlier) that allowed the instability that we are now seeing to occur. I thought it might be a good idea to share my thoughts on the subject. While 2007 will probably be remembered as the year the subprime lending crisis that caused a liquidity shortage; there are more fundamental problems behind the scenes. These problems will not go away, they are fundamental to our financial system. I'm confident that in the future, we will see these issues rear their head again:

### **Improper Reliance on Historical Data:**

A core aspect of what went wrong in my opinion is that the lending market used historical data out of context when making loans. A good example is the often quoted fact (until recently) that the US housing market had never had a down year (depending on which data you look at...). While this was true, historical housing prices were driven by historical conditions; the most important of which (in my mind) are historical lending standards. By and large, getting a mortgage in this country has become easier over time and not harder. The government even has pseudo-sponsored entities that are designed to encourage broad home ownership in this country (which I think is a good thing).

One key difference between 1998-2006 and the 75 years before it were that, while getting a mortgage had been getting *easier*, it was very difficult to get a loan without putting at least 10% down if you were a normal borrower. In the last few years, this difficulty totally disappeared. There are many who point to the fact that low interest rates were what drove home prices higher (by making mortgage payments more affordable), and that is true, but I think the real crux of the issue is that *more* people could get mortgages that only 5-10 years earlier they could not have received one at any rate.

When a reasonably staid and boring market like residential real estate is exposed to heavy new flows of cheap money, the data for that market that was gathered when times were different will no longer apply directly. Many of the equations behind the mortgage lending machine didn't just assume that a home price decline on a national scale was a low probability event; they simply ruled the possibility out entirely. Such aggressive assumptions have proven to be a recipe for disaster.

### **Incentive-caused Bias:**

The second big issue was the incentive structures in place (on multiple levels) that seriously favored risk taking over financial prudence. There have been many situations where individuals were paid well if they made money, but didn't have to give it back if they lost big. From a manager perspective, this asymmetrical '*heads I win; tails you lose*' situation can lead to some interesting decision making. Making a bet that has an 80% chance of making 20% returns, but 20% chance of losing your whole investment is a bad bet for most folks. But if your paycheck is based on a fat cut of profits but does not make you share in any losses, there is an incentive to get a little too close to the edge when taking risks unless there are strong barriers in place.

While the above is a contrived example, it is not far from reality. Bankers, Hedge Fund managers and many others have pay scales and bonuses that are largely driven by the good times, but when things go bad they don't give it back. Obviously job loss is a risk, but depending on the rewards, that may be a worthwhile chance to take for some. Overall, incentive-caused bias is a very powerful force that often subconsciously affects individuals' decisions. It's interesting to note that many of the big bank's CEOs have lost their high paying jobs because of their lack of preparation for the events that have taken place. It's also interesting to note the tremendous severance paychecks that many of these CEOs get to take with them after getting fired for screwing up so badly. This is an even worse scenario for shareholders of '*Heads I win; tails I win and you lose*'; Good gig for managers and CEOs I guess, if you can get it!

This incentive bias also worked from the consumer side of things as well. I knew many folks personally who were very aggressive with mortgage leverage on second and third homes; and they should have known better. But the banks and brokers were offering them the chance to make big paydays if property prices went up quickly. The downside was bankruptcy or very tough times for their personal finances, but the upside for some people was too great to ignore. When someone is making \$50k/year and is given the opportunity to buy a \$500k house with no money down; it is hard to fault them for taking a shot. If prices go up 10% in one year the person just doubled their salary with essentially zero work.

These kinds of asymmetrical risk/reward situations seem to occur frequently in our economy and if they are spread broadly enough can have very severe impacts on our nationwide capital allocation. Sometimes it is forgotten that our market based economy is really a tool to put money to its best and most productive uses. When this system fails for whatever reason, there are consequences that must be worked through. This credit expansion was very impressive in magnitude and duration, and we will have a bit of unwinding to go through to get back to some level of normalcy.

From my perspective, while this meltdown wasn't predictable per se, it should not be seen as surprising. This is the natural cycle of booms and busts. We try to avoid these things as a country, but there are inherent destabilizing factors that develop when times are very good... and they can only go on so long. This time is no different. As economist Hyman Minsky said; "Stability is Unstable." An odd phrase, but more true in the field of Economics than most would care to believe.

As always, my money will be invested right alongside yours so you can be sure that I will work diligently to make sure our investments will be profitable ones; regardless of the market conditions. I appreciate the trust you have placed in Remick Capital as your Investment Advisor; I will work hard to make our relationship as profitable as possible.

If you ever have any questions about this report, your investments, or anything financial in general; please do not hesitate to call.

Sincerely,

Benjamin Hacker  
Principal,  
Remick Capital, LLC  
[www.remickcapital.com](http://www.remickcapital.com)