

MAXIMUM PESSIMISM REPORT

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THE SUN WILL RISE AGAIN IN JAPAN

There can be no question that the recent market declines surrounding events in Japan are punctuated by human tragedy. With that in mind, the people of Japan have and will remain in our thoughts.

To be sure, Japan will receive support from a concerted effort of parties around the world, including humanitarians, philanthropies, governments, caring people at large, and last but not least, capitalists. This last category describes the constructive role that investors, including all of us, can and should play in the recovery of Japan.

If there is one observation that we all can agree upon, it is that most investors have been fleeing Japanese companies like no other time since the 1987 crash. This behavior, unique to short-sighted investors (which always seem to reveal themselves in a market crisis), seems ironic, as we witness countless other individuals from all walks of life descending upon Japan to help in any way they can.

Perhaps what these sellers are overlooking is that part of what makes humans so

remarkable is their ability to overcome unprecedented tragedies. There are many examples, for instance, and most relevant to the discussion, the devastation of World War II on Japan was unprecedented at the time, but the country rebuilt, and some 20-30 years it later joined a short-list of the most powerful countries in the world. The September 11 terrorist attacks were also unprecedented, and the consensus in the days that followed was that the US would enter a new recession, but it did not. Hurricane Katrina was also unprecedented in its destruction along the Gulf Coast and New Orleans in particular, and despite fears, no national recession emerged despite rising interest rates and higher oil prices. The Deepwater Horizon tragedy of 2010 was also unprecedented, but tourism in the winter of 2010 has actually outpaced 2009 in many areas on the Gulf and the companies related to the incident have also recovered.

What history tells us from these lessons and countless others is that humans are both resilient and construc-

tive by nature. Despite all of the examples from history that speak to this, the majority of investors are peculiar in their perspectives insofar as their selling behavior portends events that are much worse, or at odds with historical outcomes.

Additionally, their myopic selling behavior facilitates the further destruction of capital, savings, and wealth stored by others in the markets. In this regard, panicked sellers participate in making a tragic situation even worse by undermining the capital resources needed to rebuild.

The response we witness by many investors to sell their positions in the face of unanticipated adversity begs many questions. Some of these questions rightly dwell upon the efficacy of, and persistent practice of an investment program that periodically sells at or near the bottom of market swings, corrections and panics. The other questions deal more directly with the nature of humans and the timeless flaws they demonstrate towards investing in the financial markets. At the end of the day, these sets of questions are all inextricably connected as human nature is the common denominator. Fur-

SPECIAL POINTS OF INTEREST:

- *Unprecedented crises provide a strong precedent for investment opportunities*
- *Fight versus flight? Investors are wired for flight*
- *The virtue of buying when there is mud in the streets*
- *Opportunities arising from the recent trouble*

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FIGHT VERSUS FLIGHT AND OF MICE AND MEN

thermore, if we could target the epicenter of this behavioral response to difficult circumstances, we should probably focus on an almond shaped, tonsil-like appendage nestled within our brains called the amygdala.

The amygdala is a component of the brain's limbic system whose primary responsibilities include controlling fear responses, arousal, the secretion of hormones, as well as the formulation of emotional memories. Chief among the amygdala's longstanding role throughout the evolution of humans is its responsibility to keep us alive when we are confronted with a dangerous encounter. Perhaps it is this last function, and the amygdala's proficiency in this area that undermines many investors ability to buy in the midst of a panic, crisis or various points of maximum pessimism.

Put another way, people inhabiting the world today are generally speaking the progeny of ancestors with acutely tuned amygdalas, who knew when danger was lurking and therefore how to cut and run. By doing so successfully they could "live for another day." Is it any coincidence that traders who sell at the first whiff of a panic, often cite this as their response, 'I sold to live for another day.' Probably not.

In sum, the amygdala comes into play during many of life's critical moments, or better yet at the height of

those events where a "fight or flight" response is in order.

As the moment of truth approaches, the amygdala receives stimuli from two separate pathways in the brain, that travel at different rates of speed. The first sensory travels very quickly from the thalamus and is responsible for alerting us (and other animals) to danger before we can even process it consciously. The result is freezing up, heart pounding, sweating palms, shortness of breath, etc. Think for instance, if you were walking down a sidewalk and a large dog comes lunging and barking towards you with its teeth showing. Your amygdala would nearly instantaneously prompt the aforementioned physical response(s). Moving alongside this initial sensory at a slower pace is stimuli through the medial prefrontal cortex which can be thought of as our conscious processing of the information and decision based on the processing of this information. For example, and extending upon the model of the dog lunging at us, if we look closer at the dog and see that it is safely anchored from inflicting harm on us by the presence of a chain or a radio collar, we would take this into account with our reasoning and calm down shortly thereafter.

While we may have been calmed in this case by discovering the presence of a restraint on the dog, our response may still have been different if in the past we had been bitten or mauled by a dog. As it turns out our amygdala plays a sub-

stantial role in how emotional memories are stored. So had we been severely traumatized by an angry dog in the past, our amygdala's heightened response to the simple conditions of seeing an angry dog might be enough to send us running for our lives. A simple way to consider this is to reflect upon Pavlov's well documented experiments with a dog, a ringing bell, and a piece of meat. As we know, Pavlov first rang the bell and then fed his dog the meat several times in a row over time. Later though, Pavlov simply rang the bell and withheld the meat and in doing so observed that his dog still salivated for the expected meat even in its absence.

So, enough about brains and dogs, and what does this have to do with investing through a crisis? In our world of markets, business and commerce we have all universally accepted the role of money as a medium of exchange that measures economic activities. Likewise we have all come to believe that possessing a relative abundance of money protects us from threats to our existence and/or livelihood. Possessing enough money keeps us from going hungry, thirsty, cold, etc. Its ample presence represents safety and security to us in our modern albeit uncertain world. With that said, as investors in the stock market, we (with our amygdalas in tow) are susceptible to the feeling of impending doom to our existence as we experience losses

in the stock market. Not surprisingly, these feelings are more acute among investors who possess little information on their holdings, or have experienced heavy losses in the past where they perhaps also sold in haste and sealed their fates. Most studies have shown that the amygdala never forgets the terror of these prior experiences and is quick to reformulate the entire scope of a previous experience even if the circumstances are dissimilar. So the reliability of the amygdala served our ancestors well in their hunting and gathering, its reliability also pressures investors to sell at the bottom over and over again.

But there is hope. Science and lab experiments support the fact that the amygdala can be reconditioned to react differently at the future appearance of once frightful circumstances (even if the fright is never fully extinguished altogether). An easy example comes from lab rats who were exposed to a shrill tone and then lightly shocked afterward. Naturally, they had been conditioned to physically freeze their movement and brace themselves at the sound of a shrill tone (just as Pavlov's dog was conditioned to salivate). However, scientists found that if the tone was initiated and that the rat moved, rather than freeze, they could then cancel the tone and subsequent shock, and that upon repeating this the rats would learn to move when the tone sounded in

THE VIRTUE OF INVESTING WHEN THERE IS MUD IN THE STREETS

order to cancel the tone. In other words, the rats developed an active coping strategy to its fear. Now, we are on to something. Incidentally, most value investors may agree, maybe not exactly in these terms, that buying in the midst of a panic can be seen psychologically as an active coping strategy. With that in mind, by following the strict discipline of value investing and deploying capital when opportunities appear based on valuation and long-term prospects a value investor has the necessary means to override their evolutionary programming that pre-destined them towards investing mediocrity. To be sure, taking that first step to buy when all others are selling is not easy. However, once an investor takes this step and reaps the rewards, the reconditioning is well underway.

“To buy when others are despondently selling, and to sell when others are avidly buying requires the greatest fortitude and pays the greatest ultimate rewards.” - Sir John Templeton

These words remain timeless, and illustrate the difficulty of taking that step to buy. Still, another aspect of the amygdala that should not be forgotten is that it controls our broader emotional responses to events, not just fear, but also arousal, pleasure, aggression and so on. Here is where things can become interesting. For those investors who have reconditioned themselves to buy in the midst

of intense selling, and have experienced the subsequent pleasure of the higher long-term returns that follow, they may actually condition themselves to find pleasure or contentment in buying while others run in fear. The amygdala works both ways. Many experienced value investors “salivate” for market panics after enough conditioning by investing through them. Some even experience pleasure from these events. Warren Buffett once remarked on investing in the 1974 bear market that he “felt like an oversexed guy in a harem.” Clearly, Buffett’s amygdala has been reconditioned to find pleasure in bargain hunting. Likewise, there are ample stories of Sir John Templeton getting excited in the office during the 1987 crash, stating that the buying opportunity would make their returns for years to come in the Templeton funds.

Even so, the circumstances upon which stock prices rapidly decline can still move certain sets of our emotions in the way that they were originally designed. More specifically, often times a sharp decline in share prices can occur on the heels of tragic events, such as the Japanese earthquake, tsunami and resulting nuclear power instability. So while the buying opportunities may be cause for excitement, this is also tempered by the recognition of loss and suffering among fellow people. This is natural. Most importantly though and returning to our earlier discussion from page 1, is that buyers need to recognize that they are undertaking a positive and altogether

constructive role in the rehabilitation of the affected parties.

We see buyers in the midst of a panic as helpful to the situation. This is the case because as a buyer under these circumstances, the value investor undertakes two important actions; first, as a purchaser they are assisting against the further destruction of wealth created by short-sighted sellers, and second, they are emphatically saying to the affected party, we believe in you and your future. We hasten to add though, that this behavior is not by design an act of charity. There should be no mistake that this behavior is driven by the prospects of exceptional returns that one expects to develop over time as conditions improve. Still, it is a virtuous response within the context of investing to buy at the point of maximum pessimism, or otherwise provide a vote of confidence to a business by becoming an owner during what appears to be its darkest hour. Of course, it remains to be seen whether Japan has reached a point of maximum pessimism, but at least we can say that pessimism over Japan is as intense as it has been in any time during the past thirty years.

As value investors who are conditioned to buy as prices decline too much relative to the intrinsic value of assets we can safely count ourselves among the constructive forces at work. What this reveals, although some people might disagree, is that purchasing stocks in the wake of a tragedy can be viewed as virtuous behavior.

OPPORTUNITIES ARISING FROM JAPAN’S TROUBLE

Turning more specifically to the opportunities we see appearing in the market chaos that followed these events we believe that there is much to discuss.

To begin, there are stocks that we favored before the crisis, which we

believe have become increasingly compelling following these events.

This first category we might classify as the fundamental beneficiaries of the crisis, or the businesses that will be most helpful to Japan’s reconstruction and future.

First, we believe the Korean steelmaker Posco—whose valuation in the wake of the late 2010 North Korea – South Korea skirmish reignited our interest after a four year hiatus from the name—will eventually benefit in the physical reconstruction efforts that Japan is likely to undertake in

OPPORTUNITIES ARISING FROM TROUBLE (CONTINUED)

the years to come. Simply put, Japan's reconstruction effort will require much steel and Posco is well positioned to supply these efforts given its regional positioning as a Korean steelmaker, with a highly competitive cost structure and scale as the third largest steelmaker in the world. Most important though, with the stock trading at slightly less than its book value, very little of this potential business, or the considerable future demand for steel in surrounding Asia appears built into the current stock price. In order to add some perspective to Posco's medium to long-term market opportunity among its developing Asia neighbors it has been expanding its operations into India, Indonesia and Vietnam. These countries possess significant growth prospects given that their respective per capita rates of consumption are approximately 10%, 7% and 15% of the per capita rate in the United States based on World Steel Association data. In other words, the events in Japan simply add to the demand story for Posco, which on a stand-alone basis was already compelling.

Another company that was already relatively attractive prior to recent events that may be in an even better market position following these events is the coal producing firm Cloud Peak Energy. Cloud Peak is the only pure-play coal producer from the Powder River Basin of Wyoming, and one of the unique qualities of Powder River Basin coal is that it possesses considerably lower sulfur than the Appalachian supply, which means that it clears the impending air quality regulations coming down the pike for electricity producers in the US. More relevant to the Japan situation though, the company is one of the very few firms in the US geographically well positioned to supply

thermal coal to the Asian markets. This positioning is enhanced by its low cost of production and proximity to ports in Vancouver.

Also, recent announcements of a new port on the West Coast of the US bodes well for expanding coal export volumes as the Asian market for thermal coal is already tightening in its supply and demand balance. Growing export volumes could have a significant impact on Cloud Peak's earnings over time since this business carries higher margins versus the existing mix of business that is heavily tilted towards domestic demand. We suspect this is due somewhat to the fact that exported coal is not nicked and dimed (like domestic sales) by the menagerie of regulatory charges and taxes to fund potential liabilities in the US.

Furthermore, with growing trepidation over the safety of nuclear energy, there may be an increased interest in coal fired production across Asia. Either way, coal fueled electricity production was already expected to nearly double in non-OECD Asian countries such as China in the coming two decades. In other words, while much of the western developed world tends to bad-mouth coal fueled generation, countries like South Korea feel quite differently and our concerned about their future ability to secure coal supplies given the increasing demand from its developing neighbors. Given Cloud Peak's unique position in the coal market, and the observation that it trades at a significant valuation discount to most other coal producers (i.e. 9x forward EPS and 5x cash flow versus industry multiples of 23x and 14x respectively) we believe the firm possesses medium to long-term market opportunities that are generally not being discounted by investors.

Shifting gears and turning to the other side of the spectrum of recent market

opportunities are the stocks where the selling and near-term pessimism has been the greatest.

Primarily, we are speaking of either Japanese companies or companies that are related to nuclear energy production. Incidentally, due to the sharp declines in share prices following these disasters, both groups appear attractive.

Starting with Japan, the simple fact of the matter is that valuations among well run Japanese multinational firms such as Sony and Panasonic have become much too discounted to ignore. Both of these firms have been trading well below their book values at 0.8x and 0.7x respectively following the strongest two day decline in Japanese share prices since the crash of 1987. To add some additional perspective, Panasonic shares are now trading back at their lows last seen in the depth of the financial crisis during February 2009. Now, more than two years later the world's economy is on considerably better footing, European debt levels and higher oil prices notwithstanding. At the end of the day, that is the key mismatch between the current valuations of these Japanese firms and their prospects as they are *global* firms operating around the world and their earnings are ultimately tied to global growth prospects.

Generally speaking, economic growth in the United States has continued to accelerate during the past several months, which is a positive sign for these firms. In the near-term however there is ample uncertainty surrounding the persistence of rolling blackouts in Japan and the obvious effects this will have on production over the coming months and probably EPS in the coming quar-

SALIVATING FOR VOLATILITY

ters. For those considering earnings over the next several years however, we believe these variables pose much less cause for concern.

Turning to the runner-up of recent unpopularity in the stock market, nearly all nuclear energy related companies went into a free-fall as the Fukushima-Daiichi nuclear plant became unstable following the natural disasters. Clearly, the market has become particularly concerned with the future role of nuclear energy, just as governments and policy makers had finally warmed up to the idea following respective scares and tragedies at Three Mile Island and later, Chernobyl.

One company in particular that fell into the cross-hairs of panicked sellers was the engineering and construction firm Shaw Group, which on Monday, March 14 declined 19% in intraday trading. For those on the lookout for share price fallout in the wake of these concerns, Shaw presented (and still does, an interesting opportunity). Based on a modeling of Shaw's discounted cash flows, it appeared that the stock market erased the firm's entire present value of growth opportunities within an hour or so of trading on March 14. Put another way, nuclear construction projects are only 10% of Shaw's existing business, but approximately 50% of its backlog for future growth.

With that said, as the stock price fell nearly 20%, it appeared that the market was discounting only 2-3% revenue growth going forward for the next ten years, or basically that the firm's contracts to build nuclear plants, including six in the US, would be cancelled. In the event that these projects were not cancelled, then it would logically follow that the share price would again embed the future earnings of these projects.

From our perspective, we do not believe that the US or other countries are going to abandon nuclear energy altogether. One important nod in this direction has been the US government's continued support of nuclear energy, even if it is guided by the upcoming EPA clean air requirements and these requirements future incompatibility with dirtier forms of hydrocarbon based production. Therefore Shaw shares priced with little to no growth expectations (an apparent margin of safety) but instead containing a free call option on nuclear energy as an attractive proposition. Shaw Group shares have rebounded somewhat from their initial tailspin but still trade below their pre-crisis level and a noticeable discount to their 10 year historical average multiples taken across a number of valuation metrics such as P/E (13.5x vs. 19.4x) and EV/EBITDA (5.6x versus 10.3x).

In conclusion, recent events in the world have rekindled the amount of stock price volatility that long-term investors crave. For those investors with the right perspective and conditioning, the market turmoil that has resulted from the Middle East, Japan and continued jitters over European debt all sound like the clanging dinner bell that got Pavlov's dog salivating.

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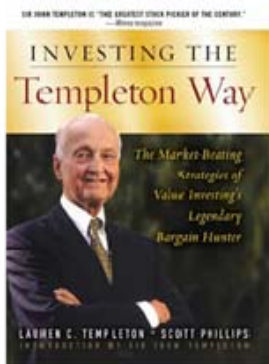
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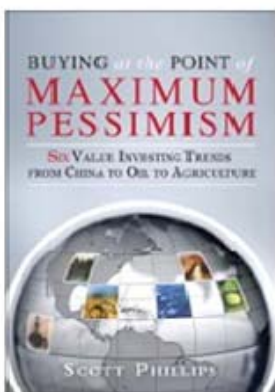
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