



## **Cambiar Investors LLC Third Quarter 2007 Investment Commentary**

### **Overview**

World equity exhibited substantial volatility in the third quarter driven by turbulence in credit markets. The market for securitized loans for practical purposes shut down in many sub-segments during late July through mid-August. Traditionally commonplace short term funding mechanisms such as asset-backed commercial paper and warehouse finance lines experienced momentous disruption, creating significant rollover problems for institutions that rely on such funding. After a multi-year feast of generous lending on generous terms for corporate and consumer borrowers, the excesses have come home to roost.

The volatility in the equity markets paled by comparison to fixed income markets where various forms of securitized debt were untradeable, and at one point in mid-August the spread between the quoted Fed Funds rate (then 5.25%) and the one month T-Bill rate exceeded 300 basis points (!), as money market funds refused to transact in commercial paper and other non-governmental short duration instruments, creating an enormous scarcity premium for government paper and thus the low yields. A spread of that magnitude between the Fed Funds rate and short term T-Bills has only occurred on one other past occasion: the October 1987 stock market crash, when a similar thirst for highly liquid and “safe” paper prevailed. As we are marking the 20<sup>th</sup> anniversary of the 1987 crash, the question inevitably rises as to whether such an event could be repeated given modern day stock market safeguards that were put in place to control the various market mechanics that failed 20 years ago. Well, it did just happen again, but not in equities!

Explosive surges in volatility tend to be associated with shifts in market leadership. Indeed, despite the flat market performance of the quarter, most financial and domestic consumer-facing stocks experienced material losses while commodity-oriented, industrial, and technology issues gained. There was a decidedly visible shift in what kinds of stocks performed in the quarter, with “growth” stocks dominating performance over “value” issues generally speaking. Value tends to be more challenged as a discipline late in the economic cycle as a general observation. Given the heightened uncertainty over what the broader economic trajectory may be exactly and the significant damage to perceived credit quality systemically, this is not altogether surprising. But it is a big change from the last seven years’ environment where more traditional value approaches tended to achieve better investment results.



## Portfolio Review

Without a doubt, this has been a frustrating time for Cambiar. In the aggregate, we are witnessing a stark shift in market sensibilities. We employ a value style of investment, which has enjoyed a very favorable market for the last seven years, as compared to growth styles. Value styles of investment tend to be challenged later in economic cycles because there is increasing angst about how business conditions will deteriorate for companies that don't enjoy secular growth or which are more cyclically dependent. We saw a similar situation in 1998 as an organization where "value" stocks were left in the dust by the technology and internet-led charge at the end of the last decade. In the current environment, investors favor stocks with unique growth drivers and very clean stories, while eschewing those that have indeterminate issues and concerns. In reality, all businesses have limitations on their growth potential and have negative or indeterminate issues and concerns, but they may not be obvious or evident. With heightened business uncertainties in some large sectors, the tone of the market has shifted sharply. For example, financial stocks are having an awful time holding value due to fears of dramatic credit losses in residential mortgage markets. Clearly, financial companies will get through this malaise and prosper, but the timetable to get through the valley remains very uncertain. This has compressed valuations across the board and has affected some of our positions. In response to the credit concerns, Cambiar re-allocated capital out of financials to more defensive areas of the market such as energy and technology. Though we were not heavily concentrated in financials relative to the market, and had prudently eschewed the homebuilders, furniture makers and related value chain, in hindsight one ought to have avoided anything remotely to do with the housing market or mortgages in any form. Our opinion is that while many financial stocks may appear to be attractively valued at first glance, we see that current earnings forecasts may be too high. They face earnings headwinds that are in our opinion, unlikely to go away over the next 3-6 months. Although Cambiar's exposure to financials has been below the benchmark all year, the active decision to underweight this sector resulted in positive contribution to performance for the quarter.

Cambiar's energy holdings contributed positively to our overall portfolio performance, however lagged the index due to a few names with exposure to the North American natural gas market. Despite this short-term underperformance, we believe the prospects for natural gas names remain compelling. As indicated by the portfolio's higher relative exposure to technology, we continue to find companies in this space that possess the desirable combination of attractive valuations in tandem with strong growth prospects. While technology issues have lagged their commodity-oriented peers within the energy and basic materials sectors in recent years, we anticipate that investor sentiment towards this sector will improve as we move into a slower economic environment.

Consumer discretionary businesses are not as weak but face a similar wall of skepticism as investors fear inevitable consumer weakness. These kinds of vague fears and anxieties create value opportunities. But if one dials the fear and anxiety up a few notches – which happened this year – the stocks can go down as holders choose to walk away. Contrary to



the broader market, our holdings within consumer discretionary resulted in the strongest performance contribution to the portfolio for the quarter. Cambiar's exposure to the consumer remains with franchises that we believe can continue to grow earnings in a slowing economic environment; given the potential for a ripple effect from the ongoing fallout in the subprime markets, our holdings are tilted towards those franchises that are less dependent on credit- reliable consumers.

In many cases we hold stocks today that discount a fairly severe economic downturn by way of their embedded valuation. The better performing stocks this year have been commodity-driven businesses and industrial businesses, both of which are economically sensitive – which makes this whole year feel like one giant conundrum. Although oil and other commodities may have their own unique dynamics one does have to believe “it's different this time” to embrace many of the leading industrial sector valuations today.

In the aftermath of the last value-to-growth shift (1998), Cambiar was very successful in generating returns in the ensuing years, though the initial phase was difficult. To some extent, the price dislocation that this process creates is a necessary condition to generate meaningful gains in the forward years. As we enter the last quarter of 2007, we are very confident about our ability to navigate through this financial storm. The Cambiar investment team continues to maintain a high degree of conviction in our holdings, as well as in the portfolio's aggregate sector exposures. As investor-owners, Cambiar's long term interests remain aligned with those of our shareholders. Cambiar's unwavering focus on delivering consistent, long-term performance for our clients remains paramount in importance.