Monday Morning Thoughts, October 24th

There's an interesting article in the Wall Street Journal highlighting that banks are increasingly the first source of funds for takeovers – providing more funds that the high yield bond market. Kinder Morgan's recent acquisition of El Paso is cited as an example, but there's increasing evidence that banks are increasing their risk appetite. The Fed's confiscatory interest rate policies are steadily squeezing people out of riskless assets where there's no return to be made. In our Fixed Income strategy we continue to own senior loan closed end funds such as Blackrock Defined opportunity Fund (BHL) and ING Prime Rate Trust (PPR). The prices on this sector had dropped more than 20% over the past six months, through lower NAVs and prices shifting from a premium to a discount.

Hedge funds are nervously waiting – not for the publication of my book, The Hedge Fund Mirage, but instead to see how big redemptions are going in to the end of the year. The WSJ has an article noting poor performance by some very large funds (Paulson, Maverick and Kingdon amongst others). Hedge fund investors are apparently maintaining their strategy of momentum investing even though it has served them so poorly over the years. Adding to winners and redeeming from losers. There aren't many hedge fund investors who seek out under-performing managers.

We invested in Transocean (RIG) on Friday in our Deep Value Equity strategy. We had previously owned the largest owner of offshore oil rigs last year following the Gulf of Mexico oil spill when its stock traded down substantially on fears of enormous legal liability. Such fears were unfounded and the stock recovered. We exited although well before its high. In recent months concerns of economic slowdown as well as BP's lawsuit have depressed the stock price which is now trading more than 30% below the market value of its rigs (according to research from JPMorgan). There's considerable room for error around such estimates, but this provides a greater margin of safety than on other names in its peer group. In addition with consensus estimates for $5.26 per share in earnings next year it appears attractively priced. BP's lawsuit will no doubt continue to be a cloud over them for some time, but with $17BN in market cap and $25BN in enterprise value they're big enough to handle even a $1BN legal settlement. It also pays a $3.16 dividend which gives it a yield of almost 6%.

We continue to own Gannett Co (GCI). It has been an unrewarding experience so far. It's true they're in the hated newspaper business which continues to shrink every quarter, but they also own broadcasting and digital franchises which look much more attractive. The problem is their publishing division is their biggest, notably the newspaper USA Today. But they are consistently profitable and trade at less than 6X earnings which are expected to grow modestly next year (helped by election-related TV advertising and continued double-digit growth in their online businesses). We'd like to see them buy back more stock but cashflow from operations regularly exceeds $700 million per year (compared with their market cap of 2.7BN), and with minimal capex needs they've been paying down debt. Perhaps the improved lending climate noted above will induce a private equity buyer to acquire what we think is a very cheap company.

Disvlosure: Author is Long BHL, PPR, RIG, GCI