



So this is what capitulation looks like?

By David Rynecki
Managing Partner

Blue Heron
Research Partners

From hedge funds to nail salons, people are running for cover. Could this be the sign of capitulation that value investors have been waiting for?

I'm a history buff. I've got an entire shelf of books at home dedicated to financial market booms and busts—Devil Take the Hindmost and Manias, Panics and Crashes, among others. Proving that this time is *never* different, these books recount when tulip bulbs were priced like rare diamonds and Internet stocks were valued like innumerable eyeballs, each follows a common narrative: First, a period of great exuberance engulfs people until even the doubters join the fun. The frequent theme is that this boom is not the same as the others. At some point, prices peak and only a few people notice. Most players “buy the dips” until some event occurs, exogenous or otherwise unexpected, and things fall apart. As the markets plunge, that era's financial titans (Billy Durant in 1929, for instance) attempt to reverse decline only to lose more of their own money. The end doesn't come until everyone has given up, or capitulated in market lingo.

Until this year, I'd only read about history. Now we're all living it. This is the year that history reminded us that it truly repeats itself. A couple years ago, most experts were spewing out facts such as how we'd never had a national real estate recession. Money was cheap—so cheap that Marcia and I bought a beachside apartment using a 0% balance transfer check. We were smart enough to know we weren't very smart and so we sold the place at a profit and thanked our stars. More telling was the number of truly mediocre people on Wall Street who became modern day versions of that little guy with the mustache on the Monopoly board. Marcia penned an article two years ago about attending a conference of wannabe hedge fund managers who had convinced themselves that they'd hit the jackpot. Wrote Marcia:

“Hanging out by the doughnuts were two guys, both in their late 20s, who had cut their teeth at the same bucket shop on Long Island years ago along with ‘93 guys doing ropes of cocaine” under the tutelage of a Mob guy with “a missing pointer finger.” They fondly recalled phone sales scripts they used in pump-and-dump schemes, e.g., “Your mind is like a parachute - it only works when it's open!” They were both starting “black box” funds.”

I can't tell you how many people I've met in the last few years who claimed to have some mysterious “black box” that would beat the market. Most are not 20-somethings but 30 and 40-something MBA-types who smooth-talked investors into believing that risks could be minimized while rewards were maximized. My running joke is that their black box is the Vanguard S&P 500 fund—minus a 2% management fee and 20% of the upside. As we might ask such people today, “How's that black box working for you?” Indeed, at the end of November, the average hedge fund was down more than 15%. The average mutual fund was down 30%. Both figures were bolstered by the performance of those investors who made successful bearish bets. Many of what were advertised as the most reliable funds are down 40% or more. What's more, the individuals and institutions who invest in these funds have been pulling out what remains of their assets, forcing further selling of what could be incredibly cheap stocks.

So where is the bottom? I'm no market technician, but I think I've seen it. No, I'm not claiming to

**Blue Heron
Research Partners**

45 Rockefeller Plaza
Suite 2000

New York, NY 10111
212-332-7187

www.blueheronrp.com

I can't tell you how many people I've met in the last few years who claimed to have some mysterious "black box" that could beat the market.

have my own black box. Nor am I suggesting anyone move cash from their mattress back into the market. I base my conclusion on the purely anecdotal. But those anecdotes are telling signs of capitulation:

- Sign #1. For years, I've tried unsuccessfully to purchase a bottle of one of *Wine Spectator's* top annual picks. I found myself competing with people who could buy up entire distributions before they found the racks. So I was surprised when my local wine shop sent me an emailing not only advertising that it had the #1 wine, Casa Lapostolle, but also offering a discount. It turns out many of the top wines are on sale.
- Sign #2. This came when Marcia went to get her nails done. We live in a Manhattan neighborhood I've affectionately called "The Bubble" because of how nimbly its residents seem to avert any financial declines. The nail salon is usually bustling with wealthy women. Yet to Marcia's surprise, the nail salon was empty. When she asked why, the owner responded, "It's the markets. No one has any money." Coincidentally, when we talked to 60 store managers of a beauty products retailer we learned that business was actually up because more consumers were purchasing professional-grade products to do their own hair rather than spend money at salons. This company's stock, by the way, soared when earnings came out showing what was happening.
- Sign #3. A neighbor who hadn't spoken a word to me since he joined a "risk-free" hedge fund decided to stop and chat. This guy is a classic "Monopoly Man." He practically "harrumphs" as he walks down the street. He and his wife replaced their late model coup with two SUVs that look more like those "monster trucks" that run over rows of rusting cars on Saturday nights at the local coliseum. And now he was asking me questions about holiday plans and kids. It turns out he is looking for a job.
- Sign #4. An investor friend—a guy who is truly an intelligent investor and whom I generally think of as an optimist—recommended a book called "The Road," by Cormac McCarthy. In this book, McCarthy writes about a father and son traveling down a desolate highway in a post-apocalyptic America. It is a truly hopeless story that left me sleepless and depressed, though I admit the story was beautifully told. What was surprising about the book was that I found myself reading page after page and feeling like this could really happen.
- Sign #5. A fellow I know who worked for one of the big investment banks is trying to rent his vacation home for Christmas week. This is a guy who would never consider renting out his palatial house. In fact, a little more than a year ago we were playing golf and he told me, rather arrogantly, that he was looking into a private jet so he could get to the house more often.
- Sign #6. At a party in mid-November when I met a Goldman Sachs employee who told me about a recent department meeting at the venerable bank's headquarters in Lower Manhattan. People were shivering because it was so cold. Naturally, it was assumed that there was some sort of problem with the thermostat. So the department head called maintenance. A man soon appeared, held up a thermometer and said the temperature was hovering at the approved level. "There must be a mistake," pressed the department head. After some fumbling for explanations, the maintenance man finally told the people in the room that the company had ordered maintenance to lower the building's average temperature to save money.

Like I said, I'm no technician. But when I start seeing signs like this all over the place, I get the feeling that we might actually be seeing the first glimmers of light at the end of the tunnel. Capitulation is a funny thing. It's at the moment of utter helplessness that we can find the greatest reasons for optimism.

Let's hope so. Happy New Year! Good luck in 2009.