

## **EXTREME OPPORTUNISM**

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*Opportunistic investing exploits mispricing, but one particular approach minimizes risk and typically delivers upside of 10 to 15% in a short time, explains Eric Uhlfelder*

If you could make a relatively low-risk investment that generates a 10% to 15% gain in a year, you would do it.

However, if the opportunity played out in a month or two, many asset managers would balk. They are they are biased toward traditional longer-term investment strategies.

That's certainly a mantra of leading investment gurus, including Warren Buffett. The Oracle of Omaha searches for well-managed, understandable businesses that generate consistent attractive earnings and returns, with prudent debt management, and whose stock is selling at a reasonable price that offers downside safety.

So does this strategy. The key difference: this form of opportunism believes windows periodically open into sound, large, profitable companies at a sharp discount and then close.

These opportunities are created by a single event, such as a trading loss, a major accident, unfounded criticism, natural disasters—any individual event that can send investors scurrying because it sounds like bad news, but where the market response may be more destructive to the stock than the event itself. The key to this strategy is investing during the time the market realizes it has overreacted.

Because stocks caught in such turbulence move sharply, investors must quickly discern if the event is an outlier or reflective of greater systemic risk that the market hadn't recognized. When it's the former, a year's worth of returns can be generated in a short time.

"Investing in large, established companies whose shares have experienced a quick, aggressive, event-driven sell-off," says Cliff Hoover, CIO of the \$5 billion Dremar Value Management, "but wherein its profit-making capacity hasn't been affected, are among the most compelling risk-reward traits of any value investment strategy. Near-term downside risk has likely been limited by the decline while substantial upside is provided by market recognition that it has overreacted."

To consistently profit from this strategy, it's essential to treat this investment as a trade. While it takes time for information to be flushed out about an event, the sell-off typically lasts only several weeks or less. The rebound may be just as brief. Holding onto shares past that point exposes the position to the traditional range of risks, changing the investment thesis.

The strategy should be avoided when the stock is also fighting broader market headwinds. Turbulence should only be surrounding the stock itself. And if the event morphs into something worse than expected, then get out of the position until there's greater clarity about what's going on.

## Opportunities

On May 10, after the market closed, Jaime Dimon told the world his bank incurred a loss of at least \$2 billion. JP Morgan shares had previously closed around \$41. The following day, they were at \$37, and ten days later, \$32.51.

More than 20% of the bank's market capitalization had been wiped out, not because of fear of the Eurozone breaking up or a sudden slew of mortgage defaults.

The trigger was a terrible trade. The loss has grown to nearly \$6 billion, which the bank can readily absorb. Exaggerated market response was due to residual fear from the banking crisis and that worse was to come.

On May 11, Oppenheimer banking analyst Chris Kotowski presciently wrote, "the damage is mainly psychological. It re-arms all the [bank] detractors . . . [and] invites people to short the stock and then issue exaggerated loss forecasts. The one fortunate thing is that the fundamental improving trend in virtually all commercial

## JP Morgan



banking indicators remains unbroken . . . JPM has a fortress balance sheet and a \$15 billion buyback authorization. If the stock were significantly pressured in coming days we are virtually certain that JPM would be buying stock, and while this is clearly a major black eye for JPM, we would be doing likewise.”

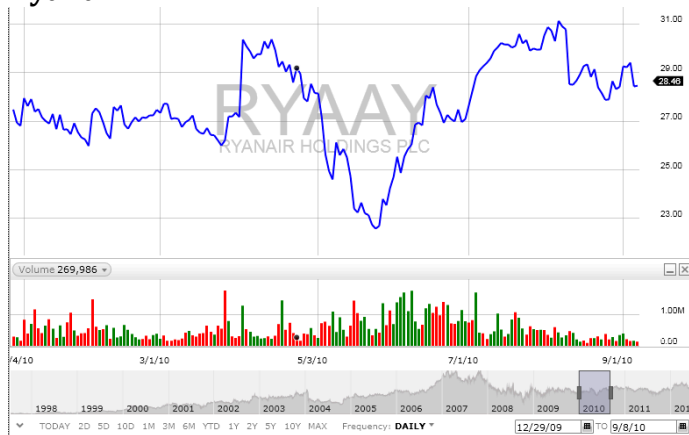
Throughout, Dimon has made sure to be as transparent as possible to mitigate concern that his bank may no longer be a paragon of risk management. So far, little has come out to suggest otherwise.

The stock bottomed near \$31 and has rebounded above \$36. How one could’ve profitably invested in this sell-off is explored at the end of this article.

Shares of Europe’s leading discount airline, Dublin-based Ryanair, plummeted with rise of volcanic ash from an Icelandic eruption in spring 2010. “The plume was so massive that it disrupted air travel across much of northern Europe for weeks because of the danger to planes,” recalls Cliff Hoover, who comanages the Dreman International Value and Market Over-Reaction Funds.

The market punished the industry, especially Ryanair, many of whose routes passed through the plume. The stock lost nearly one-third of its value between mid-April 2010 and the end of May when its Nasdaq-listed shares fell to nearly \$21 despite no fundamental change to the airline’s long-term profitability.

## Ryanair



“The market’s focus on flight suspension cut valuations from 20 times projected 2010 earnings to just 12 times, which to us, made the shares a bargain,” explains Hoover. The firm sold out by the end of September when the stock broke above \$31. In mid-July, shares were selling below \$30.

Not all event-driven sell-offs are buying opportunities.

On April 20, 2010, BP's Macondo Well in the Gulf of Mexico experienced a catastrophic blow-out that killed 11 men and resulted in the country's worst oil spill.

The stock had been trading around the post-financial crisis high of \$60. Two months after the accident, shares traded straight down to \$27. Even the most pessimistic view of liability probably suggested the selloff was excessive.

In spite of the rally that did occur, BP's poor emergency preparation, horrible public relations, bunker mentality, contentious relationship with the US government, and a very spotty safety record that dated back many years made investing in BP too uncertain a play. As of July 17, 2012, the stock was trading at \$41.60.



However, Michael Tian, Morningstar equity analyst and editor of the firm's Opportunistic Investor newsletter, found the owner of the drilling rig that sunk, Transocean, was a more compelling investment.

Despite Transocean also owning the blowout-preventer that failed to contain the spill, Tian believed the company was going to have limited exposure. In having reviewed the Oil Pollution and Clean Water Acts [which measure and assign liability], Transocean's lease with BP, which included an indemnity agreement that freed Transocean of responsibility (save for negligence), Tian had a 80-90% level of certainty early on that Transocean would escape serious harm.

Like BP, Transocean shares were at a post-financial crisis peak of around \$92 and within two months of the accident their value had been cut in half. On June 10 when shares were trading around \$46, Tian bought a position for a tracking fund he manages that captures his investment recommendations.

## Transocean



“For the next 7 weeks, shares traded sideways between \$44-\$52,” says Tian. By late summer, it seemed increasingly clear the owner of the rig wasn’t going to be held liable for the disaster. By March 2011, the stock was at \$85.

“Transocean demonstrated the ideal opportunistic investment,” explains Tian, “when a stock collapses and detaches from the market and then soars well beyond the market.”

But this example also shows the risk of holding onto certain shares after effects of an event have played out, leaving investors exposed to additional company and industry issues. In mid-July 2012, shares were back below \$50.

A negative analyst report set within lousy industry sentiment can tank a stock. Last year’s MF Global bankruptcy and scandal had hit the mid-size broker-dealer Jefferies Group. But toward the end of the year, the Egan-Jones Ratings Company added fuel to the sell-off, according to fund manager Larry Pitkowsky, when it reported Jefferies had become a risky operation whose balance sheet was compromised by illiquid sovereign European debt. Sean Egan surmised this would lead to increasing funding issues and eventually a liquidity crisis.

Pitkowsky--who had worked with noted value investor Bruce Berkowitz for a decade before setting up shop in 2011 with fellow Fairholme fund alum Keith Trauner managing the \$175 million Goodhaven fund--had followed Jefferies for 15 years. He knows the management and over the years has been invested in the stock and bonds. He felt comparisons drawn to MF Global were unfounded.

At the end of October 2011, before Egan’s report was made public, Jeffries was trading at \$14.90. Three weeks later, as the market slumped, Jeffries’ shares sank below \$10.

Pitkowsky checked company leverage, derivative exposure, counterparty risks, and material proprietary bets, and found them to be more conservative than industry norms. “The firm had offered full disclosure and our assessment of balance sheet risk—which included modest European sovereign debt exposure and leverage in the low teens--revealed nothing extraordinary. We concluded operations and management were as conservative as they always had been.”

The fund aggressively bought shares in the mid-\$12 range and continued to do so down toward \$10. By the end of November 2011, the stock had represented 5.2% of the fund.

Two subsequent earnings reports in December 2011 and March 2012 reaffirmed the broker-dealer’s sound status, propelling the stock to over \$19 by the end of March. However, by mid July, the stock had traded back below \$13.

## Jefferies Group



## The Art of Trading

Observers who don’t believe it’s possible to time the market or who may think this strategy is supported by cherry-picked facts may not appreciate that stocks have a discernable pulse that reflects both facts and market sentiment. “There is a predictability in the way the market responds to bad news,” says Morningstar’s Tian, “and understanding this is part of the art of contrarian investing.” During the three years in which he managed his opportunistic account, his average return on 28 investments, which lasted between one month and three years, was 31%.

When you’ve identified an event that has hit a large-cap, well-run, and well-followed stock, make sure you understand both the company and the event that has

happened. Note the things you don't know about the event, and see in the days ahead if the company makes it easy to fill in these blanks.

Once you've determined this is likely an isolated event, don't buy on the initial sell-off. It will take time before a stock rebounds from a serious event. Follow the news and analyst reports to confirm your sentiment and that the company is handling the fallout with transparency and persuasive clarity. If not, stay away.

If the trajectory of the price fall is sharp, accompanied with relatively high volume, don't buy yet. The stock isn't ready to turn.

Decide how much you want to ultimately invest and divide that into three tranches. As a rule, wait several trading days before considering your first investment after a decline of at least 15% to 20%. This enables sellers to bail out, reducing downward pressure on the stock. Then make your first investment.

Assuming there are no additional shocks, the second tranche should be made at a price that's at least 5% to 10% lower than the first.

The third tranche should be thought of as insurance, enabling you to move in at an even lower price in case there is a further unexpected hiccup. Or it can be made after the stock has begun to bottom out and daily trading volume has returned toward normal. These indicators suggest the bad news is now largely factored into the price.

If you've missed establishing a tranche, don't worry. Don't chase. It's far more important to invest correctly than to move in too early or too late, which can translate into higher risk. There will always be another opportunity.

Once you're fully invested, set a conservative target price. This should be based on an absolute percent [10 – 15%], which should reflect a rebound of no more than 40% to 50% of the entire selloff. A tailwind from a concurrent market rally can increase the target price.

It's critical to keep monitoring news, press releases, and analyst reports to discern when the impact of the event has played out. This may also be evident if the stock begins to move sideways.

If you're still in the stock once you've passed this point, your investment thesis has changed. With JP Morgan, for example, an investor may believe it's a solid long-term investment paying an attractive yield that's worth sticking with. But the investment has now become more exposed to industry and market risks, and the potential for an unexpected corporate event, which always seem to occur.

**END**