



R U B A L C A V A ■ C A P I T A L ■ M A N A G E M E N T

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Dear partners,

Volatility returned, with a vengeance. By now, you don't need me to tell you that August was the cruelest month for the stock market. As hedge funds imploded, mortgage lenders went bankrupt and marginal homeowners reneged on their financial obligations, the world suddenly awoke to its habit of mispricing risk over the past few years. The unwinding of the credit bubble is not over – far from it, as adjustable rate mortgages continue to reset in greater numbers. The peak of the resets will come sometime between December of this year and August of next year, depending on whose research reports you believe. Between now and then, we could be in for continued volatility, similar to August.

Nothing would make me happier.

Let me explain. At Rubalcava Capital Management, our portfolios had no exposure to the changes in the credit markets. I can't claim perfect foresight – I did not know when the credit bubble would burst, but it was evident that a burst was coming. So, over the last year or so, I made sure to avoid companies with any meaningful amounts of leverage. I kept our portfolios out of the real estate sector and out of the parts of the financial sector exposed to real estate. Coming into the August meltdown, we owned only well-financed companies with limited exposure to real estate or to debt capital markets.

But when a credit bubble bursts, or when the market goes down, it usually takes the whole market with it. Thus, our results this quarter were not great. Many of our companies trade for less today than they did at the beginning of the quarter, despite the fact that they continue to post impressive business growth. Our largest position, **Investools (SWIM)**, is a case in point. Last quarter, I shared with you some of the blistering growth statistics that the company had been posting (see the [2<sup>nd</sup> quarter letter](#) on our web site for details). In the third quarter, the company continued its impressive performance. Yet the stock trades for just \$13.50 or so today, far below its February peak above \$17.

Part of being a good value investor is knowing how to take advantage of situations like this. In July, we took advantage of investors' pessimism towards Investools by purchasing more stock, at prices below \$11.00. With the stock now at \$13.50, our investment has worked so far. More importantly, the performance of the company has continued to be impressive, and eventually the stock should reflect the intrinsic value of the company better than it does today.

So when I say I that I hope for continued volatility, I say so because it gives us the opportunity to capitalize on more opportunities like we had with Investools in July. Our other purchase this quarter, a volatile stock and a misunderstood company, is a case in point. **Fairfax Financial Holdings (FFH)** is a Canadian property & casualty insurance company run by Prem Watsa, who took control of the company in the mid 1980s. Since then, he has bought



dozens of struggling insurance companies (Fairfax is short for “fair, friendly acquisitions”), turned them around, and invested their insurance float in a disciplined value style that has produced stellar results. Inevitably, comparisons were made to a certain insurance executive from Omaha, and Watsa was soon known as “the Warren Buffett of the North.”

In 1999, Watsa’s plan went awry. In that year, Fairfax bought a pair of struggling American insurance companies, the largest acquisitions the company had ever made. Watsa had hoped to unleash the Fairfax magic on these two new divisions – buy below book value, repair operations, put unprofitable lines of business into runoff, and invest the float using Fairfax’s investment professionals. But in 1998 and 1999, there was a contagion in the world insurance acquisitions. Two other fine insurance companies – Warren Buffett’s Berkshire Hathaway, and the Markel Corporation of Virginia – made similar acquisitions, with similarly painful results. Hidden asbestos liabilities, lax underwriting in the go-go nineties, and unquantifiable derivative risk ruined all three companies’ plans for successful acquisitions.

Berkshire and Markel muddled through. With Fairfax, it was different. Though it was a strong company, Fairfax had a more leveraged balance sheet, and as losses mounted in its new units, Fairfax found itself unprepared for a series of catastrophic events that struck the insurance industry. The company incurred significant liability for insurance claims related to 9/11, and again in the disastrous hurricane seasons of 2004 and 2005. Both times, in 2001 and again after Katrina, Fairfax was forced to sell stock below book value to maintain its solvency – a humiliating and desperate bid for survival. And for much of this time, the company was a target of short sellers who argued that the company was on the brink of collapse.

Good weather saved the company. By 2006, Fairfax was rebuilding, but a third disastrous hurricane year could have sunk the company, just as the short sellers were predicting. Luckily, the wind did not blow in the Gulf of Mexico in 2006, and Fairfax posted strong profits. It also moved to strengthen its balance sheet and reduce some of the Byzantine complexity that had built up in its corporate structure over the years, complexity that was yet another argument in the bears’ thesis. Today, Fairfax is simpler, stronger, and smarter than ever before. Management, chastened by its mistakes of the past few years, is engaged in disciplined, internal growth, rather than dazzled by the prospect of transformative acquisitions.

At our purchase price, Fairfax was trading just above book value, which is cheap for a quality insurance company. More importantly, book value is going to go up this year, by a lot. First, the company is likely to post a strong underwriting year, since there have been no major hurricanes or earthquakes in areas where they write coverage against high value assets. Second, the company holds an investment in ICICI Lombard, a rapidly growing Indian insurance business that recently received an investment offer from Goldman Sachs that would value the Fairfax stake in the billions of dollars, far more than it’s currently carried on the Fairfax balance sheet. Eventually, Fairfax will recognize the increased value in its financial statements. Finally, and most intriguing, in 2006 Fairfax bought a basket of credit default swaps on subprime debt instruments and issuers. A credit default swap is a derivative security, in which Party A buys an insurance policy of sorts from Party B, protecting Party A in the case of a downgrade or default on debt issued by Party X. In essence, Fairfax made a huge, \$300 million bet in 2006 that the subprime mortgage market was heading for a fall. Right now, we have no way to know how much money they will make



on this bet, but they will certainly make a lot, given the disintegration of the subprime market in recent months.

Our existing portfolio companies continue to do well, with one notable exception. As I mentioned last quarter, **Borders Group (BGP)** has been a disappointment since we purchased the stock in December 2006. During the third quarter, I determined that the chances for the company's operational recovery were remote. Thus, I sold shares in our accounts. The loss was short term, which provides some relief in that the losses can offset some short term gains elsewhere in our portfolios (for taxable accounts), but it's nevertheless a disappointment.

Otherwise, the only cause for concern within the portfolio is **Diamond Hill Investment Group (DHIL)**, an asset management firm we first purchased about a year ago. This year, many of the firm's funds have underperformed, relative to their benchmarks. Many fund shareholders, who came to Diamond Hill based on its excellent trailing returns over the past few years, have redeemed their shares in recent months. Indeed, the small cap fund, with just over \$400 million in assets under management, was losing \$10 million a month in outflows this summer. Hot money and performance chasing is a fact of life in the mutual fund world, and there's nothing that we or Diamond Hill can do about it.

Nonetheless, I've been pleased with the company's response to their current underperformance. First, Diamond Hill is not changing their investment philosophy or methods one iota. Diamond Hill's managers are value investors like me. They understand that they will go through many periods of short term underperformance, like now, and that it's simply a part of the game. Second, the company has reacted with typical, understated competence, by initiating a large, 15% stock buyback at the beginning of the third quarter, sending the market a clear signal that management believes their shares to be undervalued. With just 3000 shares trading per day, Diamond Hill is unlikely to complete the 15% repurchase at prices near the current quote, but any purchase at today's prices will increase per share intrinsic value, so I hope the company can execute as much of the buyback as possible. Finally, Diamond Hill has recently reopened the small cap fund, which should help to offset some of the net outflows experienced by that fund.

The situation at Diamond Hill reminds me of the situation at Calamos earlier this year, and at Alliance Capital in 2002, which was a successful investment I made when I was managing nothing but my own portfolio. In both cases, I found an investment management business suffering from short term underperformance. But underneath the short term issues, the long term competitive advantages – competent executives at the corporate and portfolio management positions, strong distribution with a focus on “sticky” platforms like 401k and advisor channels, a disciplined approach to investing, and stellar balance sheets – were still in place. Alliance proved to be one of my most successful investments in my personal portfolio, and Calamos, which we purchased earlier this year under \$23 per share, has proven to be an excellent investment so far for all of us, with the stock trading at over \$29 currently. I expect similar results from Diamond Hill, over time.

Currently, I am busier than I have been at any time this year with new ideas, so I expect the fourth quarter to be eventful. You should see several new positions appear in your portfolio in upcoming weeks, as I work hard to deploy the relatively high cash levels we're currently holding. The value of having some cash available was proven this quarter, when we took advantage of volatility to make some very attractive purchases. So, if the coming months are



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anything like August – with wild volatility and fearful investors pushing great companies down to low prices – we'll do very well indeed.

As always, thank you for reading, and if you have any questions, please give me a call.

Sincerely,

A handwritten signature in blue ink, appearing to read "Alex Rubalcava".

Alexander F. Rubalcava