Sand Spring Advisors LLC

Dark Cloud Cover & Places to Hide

by,

Barclay T. Leib

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To a foreign investor looking in at America, the last few days must have carried certain elements of déjà vu. Just as such certain icons of American big business such as Enron and Worldcom fell from grace in 2002, now in 2004, some of America's financial services and insurance sector behemoths such as Fannie Mae, AIG, AON, and Marsh & McLennan are suddenly under attack and falling from grace. In between, within the big pharma sector, Merck of course got pummeled on its withdrawal of VIOXX, and Pfizer seems to be in some trouble as well. Meanwhile, on a longer-term basis, old mainstream American companies such as Ford and Coca-Cola face an ongoing struggle.

It's all enough to make any big cap bull on America to least wince, and leave all equity investors with that horrible feeling that traditional long-only investing has increasingly become somewhat akin to "Russian Roulette" where the entire market may not go anywhere fast, but one by one, individual stocks get picked off, and drop in sudden "jump" moves.

As reported this weekend in *Barron's*, it is no wonder that hedge funds – despite soft but still positive returns in 2004 – are still attracting more and more investment attention. And yet hedge funds have their problems too. Some of the larger firms now have so much money being thrown at them by pension investors, that they are raising fees, not lowering them. They are doing this simply because they can get away with it. Finding a hedge fund manager still charging the traditional fee structure of a 1% management fee and 20% incentive fee has now become more the exception than the rule as "fee creep" up to 2/20% (and even 3.5/35% in some cases) has increasingly surfaced.

While a fund of funds such as the one that we manage here at Sand Spring Advisors LLC continues to offer some potential protection to investors seeking steady returns, even these products are not perfect. While our Wimbledon Sand Spring Class L Fund has specifically advanced by a net +32% since its launch in July 2000, with 84% profitable months, while the S&P declined by –24% over the same period, the WSS Fund has only advanced by a scant +2.4% in 2004 (through mid-October). Why? Because hedge fund managers are human, and when they hit pockets where both stocks and bonds go down together, they don't tend to fire on all cylinders. 2004 has shown a touch of this – particularly after rate hike fears entered the market back in April. Hedge fund managers have nicely protected capital within a choppy and difficult year, but no outsized returns are to be witnessed.

As an aside, and simply to add a bit of precision to this discussion, let us consider the HFRI Fund of Funds Index and the statistics in the table below. Within this table, we have divided the past 126 months (through July 2004) into periods where both stocks (as measured by the S&P 500) and bonds (as measured by the Salomon Smith Barney US Government Bond Index) both rallied during a given month; periods where both stocks and bonds fell; and other periods where one market was either flat or up, while the other market was down.

Data Points	S&P 500	SSB U.S. Govt. Bond Index 10+ year, local currency terms	HFRI Fund of Funds Composite Index
126 Months	Month Ended	Month Ended	Months Profitable
19	down	down	37%
47	down	unchanged	38%
28	down	up	39%
49	unchanged	up	61%
30	up	down	77%
49	up	up	86%

Our results show that when both stocks and bonds rally in the same month, the HFRI Fund of Funds Index is profitable 86% of the time. When both stocks and bonds fall, the HFRI Fund of Funds Index has been able to achieve a far lower 37% record of profitability. This is not an "earth-shatteringly" brilliant observation, and it is important to note that the HFRI Fund of Funds Index has more equity market correlation in its construction than certain other hedge fund indices. But our basic point remains: Even well managed fund of funds may have a tough time making much money during periods of concomitant decline for both equity and fixed income markets.

So the question remains, where can one hide? Once upon a time a few years ago, metal and energy stocks were dirt-cheap. Gold may well keep on rallying from here, and we remain positively disposed towards it, but no one can assert that gold stocks are exactly cheap today. Ditto the energy sector. Various Canadian oil sands trust companies (such as SU and COSUN) may be long-term winners with attractive current yields, but jeez, they too have rallied a long way of late.

And as far as fixed income is concerned, who wants to own 10-year notes at a paltry yield of 4.05% with an increasing amount of price volatility and inflationary pressures building within the U.S. economy? Even high yield corporate bonds at currently "tight" +360 bp spread levels aren't exactly the best deal in town, although money is still being attracted to this sector for longer than most people (including this author) expected.

But how about looking at one of the least sexy assets that one can find: water.

As has recently been brought to my attention by a variety of articles by John Dickerson of Summit Global Management (see www.summitglobal.com), water companies have quietly been some of the best performing companies of the past 20-years, while also being some of the least volatile. Specifically, Mr. Dickerson presents the interesting statistics below (that do not even include the returns from water companies that have been bought out, mostly at premium prices), and show water ultility stocks beating the 5-year and 20-year total returns for all the major stock indices:

	5-Year Returns (1998-2003)	**20-Year Returns (1983-2003)**
Water Utility Stocks	108.96% (15.77% avg per annum)	1733.18% (15.65% per annum)
S&P 500 Index	-2.81% (-0.57% avg per annum)	1045.68% (12.96% per annum)
DJIA	24.97% (4.56% avg per annum)	1375.95% (14.39% per annum)
NASDAQ Composite	-7.04% (-1.45% avg per annum)	619.08% (10.36% per annum)

On an individual stock basis, it may surprise some that amidst the best performing growth stocks of the past 20-years such as Home Depot, Walmart, Disney, Procter & Gamble, General Electric, American Express, and McDonalds, one can also find names with comparable or even higher total returns such as Aqua America (formerly Philadelphia Suburban) and San Jose Water Company.

Taking a step back to look at this area in general, there is a "big picture" defense for favoring "water" as an investment, as well as more of a "micro case."

The big picture defense if that while our planet is covered in water, 98.5% is salinated and thus non-potable without expensive processing. The remaining 1.5% of fresh water is mostly tied up in the polar ice caps and inaccessible places like the Amazon, such that only .01% of the world's water is readily available for consumption and commercial use. Moreover, while no more water exists on our planet today than was the case ions ago, 6 billion more people do! Some portion of fresh water is thus increasingly being polluted. Indeed, as amazing as it may sound, only 20% of the world currently has access to clean running water, so as foreign countries modernize, one can easily imagine the demand for clean water to be on a steady rise.

On a more micro bottoms-up basis, much of the water in the Western U.S. is currently misallocated to farming (at less than market prices due to old government rules). We also have a six-year-old drought in the West. Meanwhile, the U.S. pipe delivery infrastructure is increasingly in need of repair – thereby allowing water utilities a valid excuse to raise prices. 90% of America's water utilities are still privately owned by individual municipalities, and when they get hit with EPA upgrade requirements, they often lack the resources or will to raise the required funds to make the needed repairs themselves. Often these small municipalities simply elect to sell their municipal water system to private water companies that agree to make the required upgrades – but with the private companies generally getting attractive franchise purchase prices in the bargain.

Meanwhile, the elasticity of demand for water is also very low. If a monthly water bill goes up from $20 per month to $50 per month, people don't tend to stop running the dishwasher or taking showers. Maybe the lawn just gets watered a bit less. If times get tough, the cable television bill will fall by the wayside before the water bill ever gets left unpaid.

The overall story that water is likely to go from an asset considered almost "free" today to an asset "with more value" in the future is quite compelling. The Europeans seem to see this, having snapped up several U.S. water utility companies in recent years. General Electric has also already announced that they are trying to get into the water business in a big way – regularly buying up smaller companies. On a purely anecdotal basis, media moghul Ted Turner has even said that if he were to start his career from scratch today, and get into one single business, it would be the water business.

Of course, the government may over time try to regulate the water industry even more than it does today – and this is certainly a risk to investing in this area. In addition, if water companies literally don't have a product to sell (due to a drought for example), one can also imagine certain water utilities experiencing revenue declines in the short term if water rationing is imposed.

But overall, water supply and delivery continues to be a growth industry, as will water infrastructure repair (although spending for such can be cyclical, and easily shoved under the rug during recessions). And yet valuations within the water supply industry are not outlandish (P/Es mostly in the high teens to low 20's), with dividend yields generally residing above 3%, and the betas of most of these stocks versus the S&P being next to nil.

We specifically think that it makes sense to favor companies involved in water filtration and transportation. While we do not consider ourselves experts at all in this area, and would encourage readers to do their own research (and report back to us!), two names that might be particularly attractive include:

Consolidated Water Co., Ltd (CWCO) – a company involved in the desalination of water and transportation of water throughout the Caribbean that has experienced strong earnings growth in recent years, sports approximately a 2% dividend, and a reasonably clean balance sheet.

CUNO Incorporated (CUNO) – a company involved in water filtration equipment and pollution control. This company is more on the growth end of the spectrum, with no dividend, and a relatively high 29.5 P/E, but we like their space, as well as their balance sheet that shows next to no debt.

Within the water utility side of the spectrum, nice conservative names that are potentially worthy of inspection include: SJW Corp (SJW); Aqua America (WTR); Southwest Water (SWWC); California Water Service Company (CWT -- pictured below with a possible Fib rhythm); Connecticut Water (CTWS); and York Water (YORW). Others most certainly exist. Send us a note if you find a particularly compelling company in this "niche" space.

Lastly, some readers may ask at this point – what the hell is Sand Spring doing talking about water companies, and what is our forecast for the broader market?

On a variety of overly popular and richly valued financial and tech names, we do of course remain bearish. In part, we are simply tired of talking about all the various excesses in these areas. Meanwhile, with regard to the broader market rhythm, due to the triple whammy of an extremely choppy year so far in 2004, the upcoming presidential elections, and our looming December 30-31, 2004 PEI cycle date – our answer, quite honestly, is: "Why rush into a longer-term directional call until we see exactly what December 30-31, 2004 brings." We certainly can imagine a variety of paths into this date – some that may make more investment sense than others.

Our best advice for now is simply to be very defensive, and the water industry – as discussed here today – certainly fits this bill.

Send us your comments at information@Sandspring.com.

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