

## The Credit/Building Bubble (2004-2007)

### *From Our Quarterly Letters*

Letter Date	Quote from Quarterly Letter	After-Events Comment
Q1, 2005	<p>“our primary message .... has been that the economic recovery has been unbalanced, overly dependent on unsustainable debt-based spending (from consumers and the U.S. government) and an aggressively stimulative monetary policy from the Federal Reserve. <b>These policies have created once-in-a-lifetime earnings in certain sectors (homebuilding, lending, building materials)</b> that have been the mainstay of the markets during this time. However, our view remains that these sectors’ earnings and prices are at risk when the monetary and credit-driven stimulus diminishes, which it inevitably must.”</p>	Trade deficits and borrowing led to excess consumption and building, resulting in once-in-a-lifetime earnings in certain sectors (building and lending). We felt such earnings carried low quality, and should not be capitalized.
Q2, 2005	<p>“We do know growth in recent years has been unusually imbalanced, achieved through reliance on increasing debt by U.S. consumers and government. <b>It is this imbalance that we are trying to protect against..... Earnings derived from short-lived or undependable sources should not be “capitalized” in determining value.</b> Yet we believe this is occurring in some industries today.”</p>	The unbalanced growth continued, while investors capitalized unsustainable earnings driven by easy credit.
Q1, 2006	<p>“<b>We accept this difference between our holdings and those of the indices</b> as part and parcel of what we do for clients. To be clear, we do not believe our role is to simply generate the highest returns for clients in a given quarter or year...nor is it our role to track a style-box index...<b>Instead, our goal is to provide strong absolute and relative returns over a market cycle, while doing so with relatively low risk, as defined by frequency and magnitude of loss.</b>”</p>	Our under-performance versus the market indices meant we had to explain the differences between our performance and the market’s, and why we were not at the party.
Q3, 2006	<p>“Short-term, however, the ability of the economy to sustain growth is the greater issue. <b>Consumer and government borrowing have been too high, and in each case, the <i>reality of risk</i> and the consequent <i>relevance of prudence</i>, have been disregarded.</b> This is why we have sought to own stable companies whose earnings are less dependent on debt-based spending.”</p>	We continued to warn about debt-based growth and the loss of prudence.
Q1, 2007	<p>“Meanwhile, economic strength was built upon strong monetary and spending stimulus by the government, along with consumer borrowing based on low interest rates and rising house prices. None of these seem likely to be as stimulative going forward when compared to the last 5 years.... <b>Our experience has shown that protection has to be built into portfolios long before it is needed.</b>”</p>	Rather than predict when it would end, we tried to protect against the inevitable.
Q3, 2007	<p>“We often say that 95% of our decisions are never seen, because they are decisions not to buy something that looks cheap. Among these was our decision not to buy companies whose earnings were benefiting from excessive consumer borrowing, or whose balance sheets were contingently exposed to <b>credit risks</b> through either their investing or lending activities. We viewed the borrowing boom as unsustainable and potentially dangerous, and sought to minimize our exposure. That is why <b>we decided <i>not</i></b> to buy subprime lenders such as Countrywide, Citigroup and H&amp;R Block, <b>asset-backed guarantors</b> such as Ambac and MBIA, and investment banks such as Bear Stearns and Goldman Sachs.....we sold our position in <b>Allstate</b> due to concerns regarding the quality of their investment portfolio”</p>	In 2007, the sins of the past years finally began to surface, and we stressed the importance of avoiding those sectors in the eye of the storm, despite the fact that prices <i>looked</i> cheap.

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