October 2011 – Volume 1, Issue 4



The Essence

Coney Island

AH-OOO-GA!! AH-OOO-GA!! blared the horn from the reproduction Model-T car as it meandered around the small winding track. The ten-year-old boy driving the vehicle was truly in his element, happy as a clam without a care in the world. He had tokens left for two more rides and would spend them both on this one. He established his record last summer, when he went for nine rounds (including the two free ones the attendant allowed). Where should I go after the "ah-ooo-ga" ride, he thought? How about the penny arcade? Would Dad allow it?

It was the summer of 1969. The place was Coney Island, at the southern tip of Brooklyn, New York. It was a balmy summer evening on a Tuesday, when fireworks were scheduled off the nearby beach for 9 pm. The boy, now grown, still likes kids' rides, yet rarely gets to partake. He is, today, one of our Portfolio Managers. He sometimes reminisces about those summers near his boyhood home. Coney Island, for many, seemed like a paradise.

Geographically, Coney Island is actually the westernmost part of the barrier islands of Long Island. Its earliest record dates back to a 1639 Dutch map of Nieuw Amsterdam, the predecessor to New York City. Originally a true island, landfill made it a peninsula in the 19th century. The earliest and original Coney Island Hotel was built circa 1829 as a destination "resort" for mobile New Yorkers. With gorgeous long and wide beaches, a burgeoning nightlife and a growing carnival along Surf Avenue, it was one of the best recreation spots along the eastern seaboard.

Nathan's Famous original hot dog stand opened in 1916 and is a landmark to the present day. It ushered in the heyday for the area that lasted for the next half century. Many amusement parks sprung up one after another to the point that by the 1940s, much of the boardwalk that extended for two-and-a-half miles along the beach was seen as one big playground. Prosperity was everywhere.

But beginning after the end of WWII, the area began to decline. One by one, the amusement parks closed, fewer people came to visit and street crime increased. A very large complex of low-income apartment buildings was erected in the late 1950s/early 1960s that cast not only a literal, but a psychological "shadow" on the neighborhood. By the summer of '69, the "ah-ooo-ga" ride was one of the last remaining remnants of Coney Island's glory days.

Since then, plan after plan to restore the area has been proposed, fought for, begun and dismantled. From NYC Mayors Koch through Giuliani through present-day Bloomberg, nobody can come up with a workable plan and see it through. Giuliani

"We are what we repeatedly do. Excellence, then, is not an act, but a habit."
~ Aristotle ~

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ARISTOTLE Capital Management, LLC

wanted to build a sports complex, but wound up with only a small stadium that today houses the minor league Brooklyn Cyclones. Fred Trump (Donald's father) fought City Hall for a decade in trying to build luxury apartments along the beautiful beach coast of Coney Island. He gave up the fight and sold his land. Gambling casinos were proposed à la Atlantic City. None were ever built. A site for a proposed 2012 Olympics died when the city was not chosen to host the games. Today, a huge rezoning plan envisions luxury hotels mixed in with high-rise condominiums, all surrounded by a reborn amusement area. We'll see.

The Brooklyn-born boy has waited for more than 40 years for that part of his hometown to realize its full potential. "*Should I just begin buying up some property in hopes that someday it will be valuable*?" he wonders. But patient (sometimes to a fault), he just waits, watches and analyzes, anticipating the ***catalyst*** that will turn Coney Island back into the paradise it is meant to be. As of the time of this writing, he still waits and wonders. Meanwhile, he thinks of the investment lessons learned from Coney Island.

Catalysts

One of the biggest traps of value investing is "jumping the gun" on a good idea. Coney Island teaches us the virtue of patience. Just because there is potential, it does not mean such will be realized. This value will perhaps go unrealized for the duration of our investment time-horizon of three-to-five years – or longer. In this quarter's report to you we highlight a critical element of the Aristotle investment methodology – the *catalyst*.

The following table lists both what we consider to be investment *catalysts* as well as some that are **not**. A *catalyst* is an action or event that will propel a company to meet its potential. The Aristotle investment philosophy is to identify good or great companies in good or great businesses that for some reason are not meeting their full potential. Typically, the reasons for the underperformance are transitory in nature. We then identify what event or set of circumstances has occurred in order for the company to meet its goals and for other investors to come to our views.

One of the themes in the list is that a *catalyst* is something over which companies have control. The economy, cyclicality and energy prices are all examples of external factors that would not qualify as *catalysts*. While company management may attempt to predict the future (and most are pretty poor at getting it consistently right), the best management teams execute well in a range of environments.

Also note that the expectation of a higher stock price is ***not*** listed as a *catalyst*. A higher stock price, we believe, would be a proof statement that the ***fundamental*** *catalysts* we anticipate are on their way to becoming realized. When fully realized, unless new ones emerge, we would consider selling our investment.

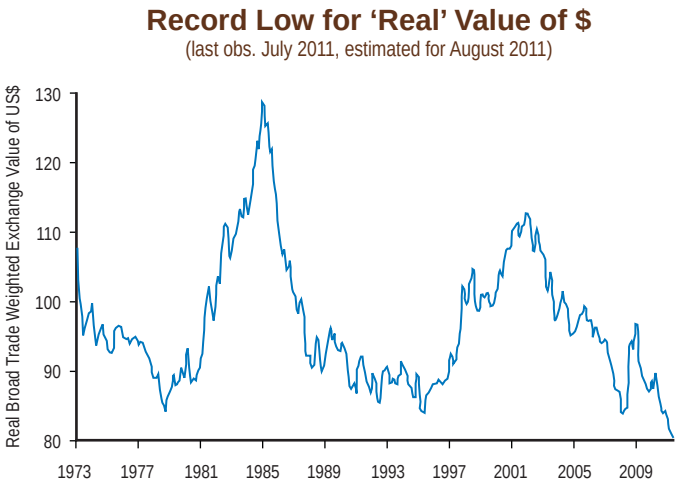
Catalysts

Are Not	Are
• Economic cycle rebound	• Doing well in a recession
• Industry cycle rebound	• Increasing market share
• Terminated management	• New leadership
• Expectation for new products	• Marketed new products
• Hope of being acquired	• Sustained FREE Cash Flow
• Hope of unlocking value	• Increasing FREE Cash Flow
• Changes in input costs (e.g., higher oil prices)	• Changes in output volumes (regardless of pricing)
• Ability to restructure	• Restructuring ongoing
• Growth industry	• Industry consolidation

The "potential" for change (new leadership, new products, etc.) is something that we, as value managers, must contain our enthusiasm for. It is better to wait until potential turns to reality. Yes, we may miss an early move in a stock price as others begin to anticipate and make "bets." This, however, is what we believe may be the difference between gambling and investing. We prefer the latter.

EQUITIES STRATEGY

Just as we look for *catalysts* in our investments, so too do we seek *catalysts* for the economy. As in Coney Island, we find few obvious ones.



Sources: Federal Reserve; Encima Global

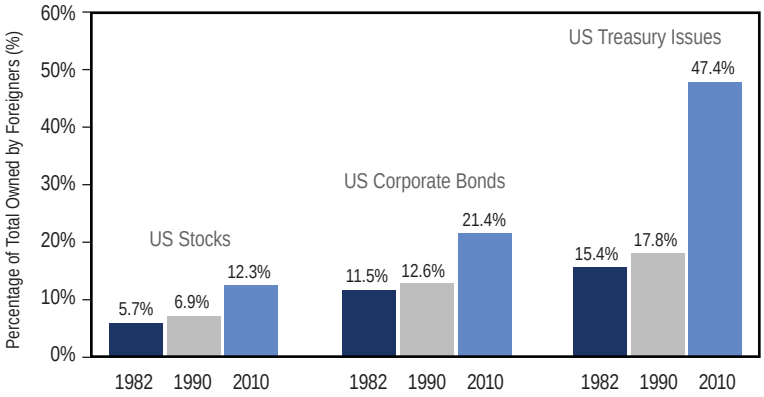
This is a graph of the long-term value of the real (inflation-adjusted) U.S. dollar. While cyclical to some extent, note the long-term decline. We believe this trend to be both purposeful and structural in nature. For most of the past

twenty years, U.S. policymakers have not been averse to this decline. They believe that a lower dollar will enable U.S. industry to become more "competitive." How has that turned out these past two decades? Not too well, in our view.

Capital projects have not found a welcoming in the U.S. High labor costs, prohibitive bureaucratic hurdles and other impediments have companies eschewing American soil as a choice to locate their factories. This reduces the need for capital and, in some cases, forces it overseas. Thus the demand for dollars is reduced and its value recedes. While the U.S. as a whole has prospered during this weak dollar period, we believe a weakened currency helps to extend the tenuous economic environment we find ourselves in today.

The weak dollar, combined with the factors presented in the next chart, is even more worrisome.

Foreign Ownership of US Financial Assets



Sources: Federal Reserve; Goldman Sachs

This chart depicts the percent of U.S. financial assets owned abroad. As globalization has occurred the past twenty years, we would expect (and even **desire**) these percentages to rise. But the nearly half of U.S. Treasuries owned by those outside the U.S. could be too extensive for the current times and, therefore, dangerous.

This puts the future of U.S. interest rates, at least to some extent, in the hands of foreigners – those whose goals and objectives may not always be aligned with our own. In past analyses we pointed out that while Japan's government deficits were higher than that in the U.S., they were financed almost entirely internally, by Japanese citizens and corporations. So, in Japan, over this same time period, the value of the ¥en has ***increased***. Other countries that historically have borrowed from abroad to fund internal deficits include Brazil, Argentina, Mexico and Greece.

There are no actions we are aware of that are even contemplated (let alone being enacted) to change the trends just described. So while not a reason to be overly pessimistic all by itself, we must believe these trends will continue.

INVESTMENT ACTIVITY

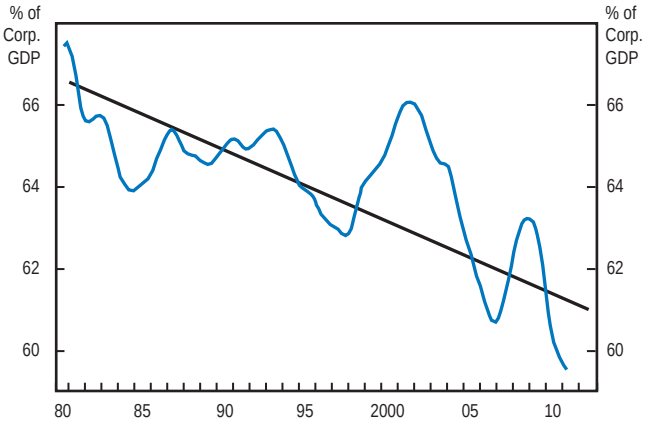
In this section we highlight changes in the investment portfolios to any or all of Aristotle Capital's equity strategies:

- **General Dynamics** is a world-class company literally without peer in many of its businesses. It has a myriad of *catalysts* that we have identified in each of its four business segments: In the Information Systems segment, new federal healthcare I.T. initiatives (designed to cut the "red tape" of Medicare and other programs) play well into GD's strengths and recent acquisitions. In Combat Systems, slowing equipment sales destined for the two wars may be offset by business wins with new international customers in other parts of the world. In Marine Systems, orders for long-lived submarines are ongoing with GD maintaining one of only a few operating shipyards in the U.S. Finally, in the Aerospace segment, the pending introduction of the new Gulfstream G650 could drive profitability higher for this highly in-demand and unique private aircraft. With a FREE cash flow yield of 10% of its market capitalization **after** a 3% dividend yield, we find the company to be a compelling long-term investment.

FIXED INCOME STRATEGY

While over the coming years we believe that interest rates will rise from their current historically low levels, we do not expect a "spiking" of rates anytime soon. The following chart is one reason for our thinking.

Compensation of Employees



Sources: Government filings; BCA Research

This is a graph of employee total compensation (including wages and benefits) as a percent of corporate "GDP"

(revenues). Note the downward slope over the past 30 years. At least in the U.S., this has been consistent with both a decline in the prevalence of labor unions as well as the significant improvement in productivity. Today, less than 60% of corporate revenues go to pay labor, an all-time low.

Other than cyclical factors (which from earlier we reiterate are not, by themselves, *catalysts*), we see few reasons to believe this long-term trend will reverse course. So with the largest component of corporate expenses likely constrained and corporate profitability at or near historically high levels, there seems little need for U.S. companies to push for sustainably higher pricing. This may remain the case even if commodity costs stay elevated. Thus, inflation (at least due to this factor) may remain at acceptable levels and interest rates, which typically move with inflation over time, can return to more "normal," but not unusually high, levels.

If inflation is at the 2% - 3% level (core, excluding food & energy), then we may expect, over time, short-term interest rates to rise to near that level from near zero today. Longer-term rates, such as 10-year U.S. Treasuries, may then return to about 4½% from under 2% presently. Therefore, the fixed income component of the portfolios we manage is invested conservatively with capital preservation as an emphasized goal.

[Caveat: As of the writing of *The Essence* this quarter, there is considerable uncertainty with regards to both the global economy and financial markets. It appears as though central banks are considering "reflating" economies (essentially driving money supply higher in hopes of the extra liquidity being put to use to drive growth). This is a risky proposition. Some believe it may even backfire causing **deflation** to take hold, as there is no way to ensure the excess capital will be used productively. Neither deflation nor excess inflation is desirable and, should either occur, it could cause us to revisit our expectations. We will carefully monitor events as they unfold but, as always, continue to focus most of our efforts on individual company analysis.]

The characters described and stories told herein are often, but not always, based on true incidents. Poetic license is taken to dramatize a point about an investment topic. Not all securities mentioned herein are necessarily owned in all Aristotle Capital portfolios. Differences due to restrictions, tax considerations, cash flows and other factors may have impacted the decisions to buy and/or sell certain securities at specific times. Inclusion does not imply that investments in these securities have been profitable. A list of at least five contributors to and five detractors from performance is available upon request.

CONCLUSION

Perhaps the relentless daily decline of stock markets toward the end of the quarter has contributed to the dour tone of this quarter's report. But make no mistake about it; our outlook for Coney Island over the very long term is quite positive indeed. With its breathtaking beaches, unparalleled beauty and inexpensive real estate in an otherwise high-priced market, we think it a matter of time before value is realized. There is much precedent for troubled areas of New York City to make a huge comeback.

Precisely seven years ago, in an October 2004 Quarterly Report authored by the same Portfolio Manager who now writes *The Essence*, "The Meatpacking District" described another section of New York City. This section of lower Manhattan is where, and we quote from that issue, "*the streets are where aproned butchers and truckers work by day and transvestite hookers work by night.*" Even though located in a prime section of the city, decade after decade, the area remained in disarray. But beginning in the very late 1990s, a transition took hold that today has made The Meatpacking District one of the toniest of the entire city.

So too can this happen in Coney Island. So too will this happen for our country. But we will not "jump the gun," instead preferring to monitor and analyze what **is** happening, and not gamble with respect to what **may** happen.

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