

Traders Notes for April 15rd 2008

Prepared by;

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It is hard not to laugh on mornings when airlines are in the headlines. I am always amazed by the number of 'smart' people who continue to get fooled into believing that a turn-around for the industry is right around the corner. The chart below shows the relative performance of an equally weighted airline composite to the equally weighted S&P 500. If one were smart enough back in 1988 to determine which airlines would still be around twenty years later and divided \$1.00 amongst them, the spending power of that dollar would have declined to \$0.27. Importantly, \$0.27 is likely the best-case scenario since it assumes one accurately identified the survivors and avoided the all the airlines that have gone bankrupt over that time period.



Chart Courtesy StockVal

The airline industry in normal economic times is a lousy business. Airlines have high fixed costs (airplanes, unionized labor force, advertising & marketing, frequent flier programs, etc.), are subject to tough regulations and have a revenue base that is highly variable. There is also little differentiation among carriers, so competitors must compete on price. To underscore that point, we recall a story a few years back about a now defunct airline that continued to operate amidst a strike by its mechanics. When passengers were interviewed about why they were willing to risk their lives flying on a plane where the mechanics had walked off the job, one passenger made a statement to the effect: 'their fares were \$20 lower than everyone else'.

If the industry is lousy in normal times it can be a disaster when times are tough. In our opinion, the airline industry today is precisely where a company does not want to be. Airlines sit in between a consumer that is weakening and costs (jet fuel) that continue to rise exponentially. We expect additional pressure to hit the industry when corporations start cutting back on discretionary expenses like travel and entertainment.

Bankruptcies put further pressures on existing participants. When an airline goes bust, they rarely go away. Instead, they often resurface as a low-cost carrier with a new and improved cost structure. The improved cost structure may include labor concessions, less debt at more favorable interest rates or fewer planes. In recent months, there have been six reported or rumored bankruptcies in the industry including ATA, Frontier, Aloha, Skybus, Champion and MAXjets. We would expect a few of these carriers to reappear with lower cost structures allowing them to undercut existing carriers and force the entire industry to lower their seat prices or accept lower yields.

Bottom Line: Mergers or not, the airline industry has been a lousy investment over-time and, in our opinion, is unlikely to change. We have avoided owning shares of airlines in our portfolios since inception and see little reason to change our biases with the economic environment worsening.

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