

Commentary - 4th Quarter 2008

The financial markets crisis may have reached its climax in the fourth quarter of 2008. We are not confident enough to make that statement emphatically, but the evidence suggests that the panic selling of October and November may have been the worst for this cycle. We may retest the lows on the Dow Jones Industrials around 7,700 in 2009, but with the new administration moving quickly to implement a stimulus plan and the Federal Reserve aggressively expanding its balance sheet to provide credit, the market is showing signs of regaining some confidence.

The stock markets suffered their worst declines since 1931, with the Dow falling 34% and the S&P 500 Index falling 37%. The difference between this bear market and the ones we have previously experienced is that there was no place to hide from the storm. All market sectors were down, with even the utility sector declining 30%. The only safe place to invest was in the U.S. Treasury bond market. The massive deleveraging by institutional investors resulted in securities valuations that made many investors wonder if the economy would be able to recover.

In our last letter, we described the bankruptcy of Lehman Brothers and the Fed's bailout of AIG. Well, those crises were just the start of many. The failure of Lehman destroyed any market confidence, beginning a series of events where all the investment banks came under extreme selling pressure. Now the banking landscape has changed irreversibly. The investment banks are gone. "Wall Street" may never be the same again. Merrill Lynch is now part of Bank of America. Goldman Sachs and Morgan Stanley are now commercial banks with much higher capital ratio requirements. Proprietary trading is going to be severely curtailed by all big financial institutions as risk taking is avoided and capital preservation is maximized. The federal government is now a shareholder in numerous financial institutions across the country. The government was the only entity that could provide the capital necessary to keep the banking system from imploding. Since banks restricted lending during the fourth quarter, the Fed became the lender of last resort. They made this official with their statement after the last Fed meeting in December when they said they would use all means possible to restart the functioning of credit markets. They have lowered the target interest rate on Fed Funds to a range of 0.0% to 0.25%, the lowest on record. Now they are starting to purchase federal agency securities and agency mortgage backed securities. The Fed's balance sheet has grown from \$400 billion to \$1,600 billion since the failure of Lehman. The Fed's aggressive moves are starting to achieve their goals as the yields on corporate bonds are beginning to decline relative to Treasuries.

When the failure of Lehman Brothers caused some money market funds to limit redemptions and lose some principal value, investors panicked. The flight to quality in Treasuries and

FDIC insured bank deposits was unlike anything we have ever seen. The yield on short term Treasury securities fell to 0.0%. Investors were only concerned with protecting principal value, not earning any interest. When this happened, economic activity screeched to a halt. Banks halted lending. Car sales dropped over 30% in the fourth quarter, putting immense liquidity pressure on the domestic auto manufacturers. Manufacturing orders dropped precipitously and commodity prices plummeted with falling demand. To make matters worse, all of this happened during a presidential election season and change of administration, slowing the government's response to the crisis. We hope we will never see a "perfect storm" such as this again in the financial markets.

Enough of the bad news. Let's put 2008 behind us and focus on the potential for improving our financial well being in 2009. The economy may have suffered its worst quarterly decline in activity since 1982 in the fourth quarter, but the factors that caused it have been arrested, and we cannot foresee another cataclysmic event causing the same kind of perfect storm in 2009. In fact, there are a few reasons to be cautiously optimistic. The first reason is that the Federal Reserve is aggressively adding liquidity to the system by purchasing securities. This will provide better liquidity to the credit markets, as evidenced by the declining yield spread between corporate bonds and Treasuries. The so-called quantitative easing efforts of the Fed are resulting in growth in the money supply, an indicator of improving economic activity. The second reason is the rapid response by the new administration to construct a stimulus package that includes tax cuts as well as infrastructure spending. The proposed tax cuts that are being proposed include a cut in the payroll tax rate that will increase take home pay immediately for all workers. The third reason is the recent drop in mortgage rates and the stated intent of the Fed and the Treasury to push mortgage rates down to 4.50%. Lower mortgage rates will make homes more affordable, expand the pool of potential purchasers, and stimulate the demand that is necessary to stop the slide in home prices. Refinancing activity is already surging as homeowners take advantage of lower rates to lower their monthly payments. The fourth reason is the pleasant drop in fuel prices since last summer. The drop in gasoline prices has a similar effect as a tax cut, providing higher levels of disposable income for other activities. The fifth reason is the enormous amount of cash (over eight trillion dollars) that is being held in money market funds, bank deposits, and currency for safety measures that could return to the market when investors gain confidence. In the first half of 2009 the Fed expects to purchase \$500 billion of mortgage backed securities and another \$200 to \$250 billion of asset backed securities. The government stimulus package is projected to have over \$300 billion in tax cuts and \$400 billion in spending. The drop in fuel prices is estimated to add \$250 billion to potential spending on other activities. The drop in mortgage rates could add another \$60 billion or more to consumers' pockets through refinancing. In total, these efforts could boost economic activity by more than 6% over the next twelve to eighteen months. Who says a trillion dollars won't buy anything these days.

Here is a look at our various asset class strategies.

Blue Chip Strategy: Our large cap stock strategy fell 18.22% in the fourth quarter versus a decline of 21.96% for the S&P 500 Index. For the full year, the Blue Chip Strategy declined 31.89% versus the S&P's decline of 37.03%. It is nice to outperform our benchmark, but it was still an ugly year. The financial stocks in the portfolio continued to weigh on performance with Citigroup leading the decliners with a 66% drop in the quarter, Bank of America falling 59%, American Express down 47%, and JP Morgan down 32%. The panic that hit the financial sector in November hurt all of our holdings and each one received a capital infusion from the government under the Troubled Asset Recovery Program. General Motors was close behind Citigroup, with a 65% decline as car sales plummeted and the company had to plead for an emergency loan from the Treasury. Verizon Communications led the gainers in the quarter, up 7%, while AT&T rose 3%. For the year, Wal-Mart led the gainers, up 20%, followed by McDonalds up 8%. Wal-Mart benefitted from consumers' search for low prices in a deteriorating economy. The worst performer for the year was AIG, the insurance giant that was bailed out by the Treasury and the Fed, and subsequently dropped from the Dow Jones Industrials after losing 96% of its value. If our cautiously optimistic outlook on the economy is correct, the Blue Chips could recover a substantial portion of last year's decline. We expect the moves to be choppy and the market to remain volatile, but if some of the cash on the sidelines returns to the market, we should at least enjoy a double digit gain.

Small Cap Value Strategy: Our small cap stock portfolio struggled in the fourth quarter but still outperformed its benchmark for the year. In the fourth quarter the portfolio declined 30.17% versus a drop of 26.12% for the Russell 2000 Index. For the full year, our small cap strategy fell 30.08% versus the Russell 2000 Index drop of 33.79%. After being one of our strongest performers in the third quarter, Xerium Technologies was the poorest performer in the fourth quarter, dropping 89%. Air Transport Services Group lost 75% of its value as DHL decided to cut its losses in the U.S. and use UPS to ship its packages and letters instead of ATSG. We sold our position in Citadel Broadcasting in December. Citadel could not recover from their ill-fated purchase of the Disney radio stations in a declining advertising market. Winn-Dixie Stores rose almost 16% in the quarter as the best performer. For the year, Arkansas Best, Jackson Hewitt, and Hawaiian Holdings generated positive returns. Hawaiian may be one of only two airlines to gain for the year. We had many poor performers for the year, but Air Transport Services Group and Citadel were the weakest. If investors' risk appetite improves, small caps should benefit nicely from fund inflows. The last two times our strategy has generated negative annual returns, the following year was up more than 25%. It would be nice to see that kind of result for 2009.

Convertible Securities/High Yield Strategy: With the credit markets frozen in the fourth quarter, high yield bonds suffered terribly. Our high yield convertible strategy fell 27.75% in the quarter for a loss of 40.99% for the year. The Merrill Convertible Index declined 18.60% in the quarter and 33.02% for the year. The Merrill High Yield Index fell 17.47% in the quar-

ter and 26.21% for the year. Both indices suffered their worst declines since inception in the 1980s. Our composite had not suffered a full year decline in value since we launched it in 1997. We were sorely disappointed by the performance of our high yield securities. A credit crisis is not a pleasant time to own high yield bonds. We were especially concerned with the performance of our master limited partnership positions that fell over 50% on average. These companies are supposed to have little or no exposure to commodity prices, but the rapid fall in energy prices from July through year end disrupted their hedging programs and caused investors to question their ability to maintain their dividends. They also depend upon access to the capital markets to fund their growth projects and the capital markets were essentially closed to them until late December. In the quarter we were especially hurt by two positions. Franklin Bank was taken over by the FDIC in November, a week after receiving a recapitalization proposal that we were anticipating. Our convertible bond position was almost worthless after the FDIC seized the bank's assets. Callon Petroleum was forced to suspend development of their highly anticipated Entrada offshore oil and gas field when energy prices fell so far as to make field development uneconomical. With oil over \$100 per barrel, this project held high expectations for the company, more than doubling their proved reserves. With oil at \$50 per barrel, it could not be completed. Additionally, convertible arbitrage hedge funds were forced to sell into a declining market due to investor redemptions and margin calls, putting more downward pressure on our bond positions. If the economy continues to deteriorate at a rapid pace, we could see more companies default on their bonds and the MLPs would have to lower their payouts because of lower throughput volumes. But if the economy stabilizes, and the credit markets continue to improve, we should see strong performance from our bond positions and MLPs will see stronger volumes as energy demand resuscitates.

Intermediate Bond Portfolios: Our Intermediate Bond Portfolio gained 2.26% in the fourth quarter and 0.09% for the year. (An asset class with a positive return!) Its benchmark, the Citigroup 1-10 Year Government/Corporate Index gained 5.02% in the fourth quarter and 5.33% for the year. We underperformed our benchmark due to our low weighting in Treasury securities. Treasuries enjoyed one of their strongest rallies ever when investors fled all other types of risk assets and demanded the safety of U.S. Treasury issues. In the second half of December we saw federal agency securities and high quality corporate bonds begin to outperform Treasuries as some confidence returned to the credit markets, spurred by the Fed's purchase of agency debt and the Treasury guarantee of FDIC backed bonds by many financial institutions. The Intermediate Tax Exempt Bond Portfolio gained 1.90% in the fourth quarter and 0.34% for the year versus the Merrill Lynch 3-7 Year Insured Bond Index gain of 4.04% in the fourth quarter and 5.67% for the year. Again, we were underweight the highest quality municipal bonds, those backed by Treasury or federal agency securities due to pre-refunding and escrow arrangements, which caused us to underperform the index. As investor fears subside, we should see the sectors with slightly more credit risk outperform the safest sectors. This ties with our outlook for the markets in general. The Federal Re-

serve's quantitative easing efforts have the objective of freeing up credit for borrowers again. The Fed is buying Treasuries, federal agency debt and mortgage backed securities, and is proposing to purchase asset backed securities and other lower credit quality issues if necessary to bring the yields on private sector securities back into a more normal relationship with Treasury securities. They are intent on lowering the cost of borrowing to consumers and businesses. With money market rates nearing 0.0%, we expect investors to gradually move into higher yielding securities and take on slightly more credit risk over time. High quality corporate bonds should be the first sector to benefit from this move. Then as investors gain confidence that the economy is not going to keep plunging, they may move into lower credit quality bonds. As the yields on lower credit quality bonds decline, we expect the stock markets to be able to sustain some improvement. This process may take the first half of the year to play out as investor confidence was shattered in October and November.

Since the subprime mortgage crisis hit in mid-summer 2007, we have underestimated the extent of leverage in the financial markets and how much damage the de-leveraging would cause. We were not alone in making this mistake. We expected many of our cash flow generating securities to offer more protection than they did. Since this is turning out to be the worst financial crisis since the 1930s, a little before our investment experience, we were not prepared for the complete disruption of the credit markets. The last year has been the most difficult, anxiety producing twelve months of our careers. We are glad to have it behind us. The reasons to expect this year to be better are numerous. Investors' confidence is still very fragile, but we have always been optimistic and we expect confidence to strengthen over the next year. Our economic system is based on the theory that the individual will seek to improve his living standards through hard work and the profit motive. As long as there is not too much interference in the free enterprise system, we expect the economy's animal spirits to revive and a brighter future will result.