

“I will miss the  
Coming of spring  
But I will not miss  
The falling of the rose petals”

*-Lord Asano Naganori  
1702*

## RONIN

California wildfires and mudslides, droughts, melting icecaps, floods, and now, the final straw—according to a study published by the Lawrence Livermore National Laboratory, in California, global warming has resulted in an increase in humidity. There will be more bad hair days for all of us.

Not that there was a shortage of bad hair days already. Financial markets are in turmoil, credit markets have seized up, and home prices have fallen. Inflation, although manipulated in its reporting by various nations, remains a continuing problem, largely due to rising commodity prices. On the political front, with the assassination of Benazir Bhutto, Pakistan, a large nuclear power with a huge population, remains in a state of flux. Kenya has joined the few other African countries (Sudan, Chad) which are experiencing turmoil (although, as discussed below, we like the position of the almost fifty other countries on the continent, which have positive momentum).

Increasing food prices have not only contributed to higher inflation throughout the world (U.S., China, Europe, Japan), but have led to political instability in some emerging markets (riots in Mexico over tortilla prices; riots in Indonesia over soyabean prices) {SEE CHART 1}. Higher food prices, as well as increased costs for other commodities, have forced China to raise export prices (Chinese imports account for 7.5% of U.S. consumer goods spending). Some of the price increases are the result of natural disasters, such as flooding or drought (in some cases, attributed to global warming),

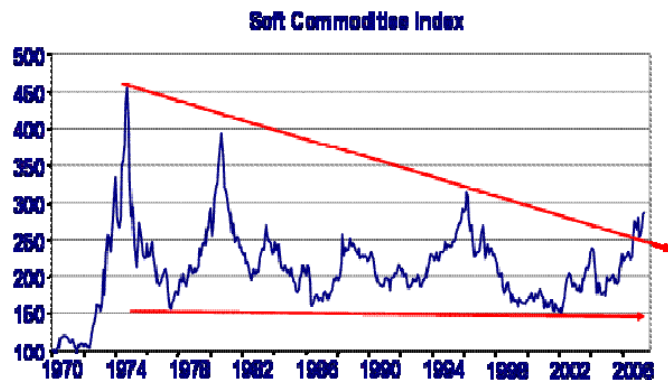


Chart 1

pollution, as well as the conversion of acreage to higher yielding bio-diesel products (corn, palm oil). In some instances (Indonesia), the rush to increase bio-diesel products has also resulted in deforestation. Deforestation is generally harmful to the environment, as trees, particularly young trees, consume carbon dioxide, while agricultural development typically produces carbon dioxide. Agricultural products generally also are a greater drain on water consumption than forests. Growing consumer classes in formerly poor countries (China, Vietnam, Russia, India) also tend to move up the food chain and consume more protein. The production of beef, pork, and chicken requires an increasing amount of agricultural products and water. To take advantage of this dislocation, we have increased our exposure to soft commodities (agricultural products), and have increased our research effort to include agricultural properties and businesses in places like Latin America and Africa. As this seems like a structural issue, in terms of inflation, we have reduced our holdings in longer term government bonds and increased our holdings in shorter term government bonds, which tend not to be as price sensitive to inflationary pressures.

The lack of potable water in many parts of the world has contributed to desperation and starvation, as well as an impediment to development and growth. Droughts in various parts of the world have been devastating to farmers, who require liquidity, forcing them to sell their water rights. The Scripps Institution of Oceanography, in a recent article in *Nature* magazine, predicted that a water supply crisis looms in the western U.S. due to climate change caused by humans. Already, river flows, snow packs, and air temperatures have been altered, according to Scripps scientists. Problems in the homebuilding industry have forced homebuilders to sell some of their land holdings (with water rights) at agricultural prices (no potential development premium), or to sell their water rights. In some cases, prices have fallen

50%. We have broadened our research effort to include investment in water rights, water storage, as well as water conservation and recycling.

Usually, financial crises have their source in the banking system. The Ronin were fierce, leaderless Samurai warriors (without a ruling Shogun) who hired themselves out to the highest bidder. Like the Ronin, banks and other financial institutions, often engage in reckless behavior, only to find themselves in difficult straits, causing crises in the financial system. Penn Central (1970's), Penn Square Bank and Latin American loan problems (1980's), Long Term Capital and the tech bubble (1990's), are just a few of the historical examples in which the financial system was in crisis due to over-investment and excess lending to inappropriate counterparties. Invariably, the Federal Reserve and the American taxpayers have been called upon to bail out the reckless warriors.

Although the precedent has its roots in the nineteenth century, the cycle of reckless behavior and bailout was more formally codified in 1907. The 1906 earthquake, which devastated California, also threatened to destroy the London insurance industry. The instability of those institutions created a global banking and financial crisis. In 1907, on the ominously titled *Jekyll Island*, James Pierpont Morgan called together representatives of the financial community. What emerged was the first major bailout of the twentieth century. Shortly thereafter in 1913, the Federal Reserve System was created. The system today consists of regional Federal Reserve Banks owned by members of the local commercial banking community. Although the system was designed to be impartial, it is somewhat uncanny how often the Fed has rescued the banking industry over the years.

The banking Ronin were free to wander the global financial landscape in search of short term profits, secure in the knowledge that, as in

the past, other than the fate of their shareholders, management would suffer little consequence. Today's situation is not dissimilar from that of the past. In the current crisis, financial institutions again originated and purchased loans made to less than credit-worthy borrowers, then levered, packaged and sold the resulting paper (CDO's) to other yield-hungry investors. This activity was not confined to the residential housing industry, but also included sub-prime customers and consumers in many sectors. One area of significant concern is the large overhang of loans made to the private equity industry, which gorged and often overpaid for public and private companies (CLO's), again, in search of short term profit and fee generation. As long as interest rates were low and risk appetite high, capital and liquidity were readily available, and the pyramid of leverage expanded exponentially. Without regulation or proper supervision by legislators or regulators (the Shogun), the financial Ronin generated tremendous fees and short term profits. As inflation and excess became noticeable, central banks around the world were compelled to raise rates and tighten liquidity. Higher cost money, in itself, did not stop the machine. Only when concern over the amount of debt and quality of credit crept into the psyche of lenders and investors, did the music slow down. It is generally not the price, but the diminished availability of credit, which causes problems.

Although Mr. Bernanke and other central bankers began cutting rates, too much damage had been done. The banks no longer trust each other's creditworthiness and investors are suspicious of the balance sheet of all financial institutions. Even the sleepy business of insuring municipal bonds was disrupted, as the insurers and rating companies also became enamored with exotic financial structured products. The financial system has been thrown into somewhat of a state of chaos, U.S. home defaults have increased to the highest levels in twenty years, and the economy is slowing. In

California, which, if separately measured, would be the world's eighth largest economy, sales of existing homes fell 36%, while in Florida, which would be ranked in the world's twenty largest economies, sales of existing homes fell 30%. The median home prices in California and Florida have fallen by 12% and 10%, respectively {SEE CHART 2}. The situation is mirrored throughout many parts of the world. The U.K. and Europe are still in the early innings of this game.

Metropolitan Area	November 2007 Level	November/October Change (%)	October/September Change (%)	1-Year Change (%)
Atlanta	131.46	-1.8%	-1.2%	-2.0%
Boston	167.40	-1.1%	-0.8%	-3.0%
Charlotte	132.68	-1.0%	-0.9%	2.9%
Chicago	161.61	-0.9%	-0.8%	-3.9%
Cleveland	113.29	-2.3%	-1.2%	-5.8%
Dallas	122.38	-1.6%	-0.8%	-1.2%
Denver	133.36	-2.0%	-1.7%	-3.1%
Detroit	105.24	-2.7%	-2.4%	-13.0%
Las Vegas	201.95	-3.2%	-2.2%	-13.2%
Los Angeles	240.43	-3.6%	-2.1%	-11.9%
Miami	237.99	-2.6%	-2.1%	-15.1%
Minneapolis	158.57	-1.7%	-1.4%	-6.6%
New York	203.88	-0.8%	-0.5%	-4.8%
Phoenix	194.45	-3.1%	-2.2%	-12.9%
Portland	183.65	-0.8%	-0.3%	1.3%
San Diego	209.60	-3.4%	-2.6%	-13.4%
San Francisco	195.49	-3.2%	-2.1%	-8.6%
Seattle	187.14	-1.4%	-0.9%	1.8%
Tampa	203.45	-1.4%	-1.8%	-12.6%
Washington	223.45	-1.7%	-0.8%	-7.8%
Composite-10	205.09	-2.2%	-1.4%	-8.4%
Composite-20	188.82	-2.1%	-1.4%	-7.7%

Source: Standard & Poor's

Chart 2

As the general economy slows, the consequences will spread to other sectors: job creation and layoffs, slowing consumer sales, and falling industrial production. The Fed, as expected, has reacted as if they are in a state of panic, cutting short term rates at a very rapid pace. Rhetoric about fiscal stimulus and tax cut packages has surfaced. In anticipation of this, we increased our exposure to short term U.S. government bonds and have avoided corporate credits and other vehicles where credit could be a major problem. As mentioned above, even the municipal bond market, long the domain of conservative investors, has fallen into disarray, as uncertainty abounds about the entities which insured the credit of many municipalities and local governments. While the packaging and syndication of these derivative instruments was hailed as a means of spreading risk among many different investors, it is interesting that much of

the problem returned to haunt the balance sheets (on or “off” the books) of U.S. and European banking institutions. Ironically, Spain, which had an excessive real estate bubble, does not appear to have as grave a situation with its banking system, as the Bank of Spain refused to let Spanish banks create “off” balance sheet derivative packages (SIV’s). The full ramifications of these problems have not yet completely manifested themselves, and more trap doors are possible. As the title of one of the current nominees for best motion picture suggests, “there will be blood.”

Interestingly, assistance to the U.S. banking system has appeared from unlikely sources: the Middle East and Asian financial institutions and investors. While this was supposed to be the decade of U.S. financial behemoths taking positions and assisting financial institutions in developing markets, the opposite turn of events is quite interesting. With huge reserves of recycled petro-dollars, or hordes of cash received from credit-extended U.S. consumer gorging, foreigners have supplied capital to fragile U.S. financial institutions. This turn of events should be perceived as somewhat grave, as household name institutions (Citibank) are paying double digit junk rates to secure this capital. It is not a coincidence that the transactions were conducted in private, so no public disclosure of the affected financial institutions’ balance sheets was made. Additional concern should be inferred from the lack of hue and cry from any left or right wing politicians, candidates, or government administration officials. In contrast to the howls of protest over the attempted purchase of certain interests in ports by some of the same Middle Eastern investors who are shoring up U.S. banks, and the swift rejection of China’s attempted purchase of Unocal (which had, ironically, Asian assets), the same investors are being warmly welcomed in acquiring positions in the financial and banking industry, which should be considered no less strategic an industry group than ports or energy companies.

Accompanying this foreign infusion of capital, the Fed will continue to keep short term interest rates low, irrespective of its mandate to prevent inflationary pressures. Lower short term rates allow banks to borrow money (selling CD’s to investors) at inappropriately low rates, while purchasing higher yielding, longer term U.S. government bonds. The difference between the two rates (the “spread”) over the course of a few years is another part of the bailout process, and it allows the banks to repair their balance sheets. Banks do much better when buying government bonds than when lending money to individuals or companies. It is a mechanism which has been repeated many times, and its only victims are U.S. savers, who are dependent on income. Others negatively impacted are social security recipients and workers, whose retirement benefits or pay increases are tied to the consumer price index (CPI), which has many modifications designed to underreport the actual rate of inflations {SEE CHART 3}. Again, in anticipation of this, we added to our holdings of short term U.S. bonds, which have benefitted from the Fed’s rate cuts.

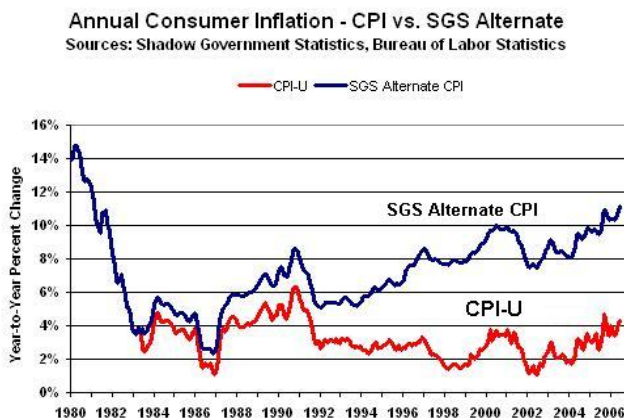


Chart 3

None of this bodes well for the dollar, as foreign investors begin to recognize that the Fed has no other option to deal with the credit and economic problems except to allow inflation and a lower dollar, so that U.S. debtors (the government included) can repay foreigners with a cheaper currency. The Chinese government

and banks, which own hundreds of billions of dollars of U.S. government debt, actually have higher internal rates of interest than those paid on U.S. holdings, as well as a currency which appreciates against the dollar. This means that the Chinese are losing billions of dollars by holding and continuing to purchase U.S. debt, an issue that is not being ignored by Chinese authorities. Several Middle Eastern nations have indicated that they are reconsidering the peg that their currencies have to the dollar. We remain negative on the intermediate and long term outlook for the dollar, and we have increased our exposures to foreign currencies, as well as to gold. At this point, gold has taken on some of the characteristics of a currency, as investors begin to doubt the ultimate strength of the Euro, as well as the dollar.

Global equity markets have not reacted well to this scenario, since it increases uncertainty and the prospects of lower corporate earnings. We have drastically reduced our exposure to equities on a global basis. We have also shifted allocations and our attention away from more expensive markets, which have increased dramatically in recent years (Asia, China, India), to markets which have not attracted as much interest and which trade at cheaper levels (Africa, the Middle East). Africa remains a very interesting story, which many investors overlook, as a few of the over fifty nations on the continent continually appear to be *in extremis*. Many African nations, however, are progressing well, with burgeoning middle classes and stable environments.

Unsuccessful Ronin, like Lord Asano, were allowed by the conquering Shogun the honor of committing a specialized form of suicide (*seppuku*). Unsuccessful bankers and Wall Street managers depart with generous

severance packages. Perhaps even if the financial equivalent of Lord Asano awaited them, the financial managers might conduct themselves differently, and consider their investors. We leave that prospect to the new Shogun, should they appear.

Fortune cookies, although long associated in American culture with China, are actually not a Chinese concept, but a Japanese one. (Dessert is not an important part of Chinese meals.) At the conclusion of the Second World War, American servicemen, returning from the war in the Pacific, would request fortune cookies at Chinese restaurants on the West Coast. An entire industry was created in the U.S., as most fortune cookies are manufactured in California. Spring is coming, and, like Lord Asano's rose petals, asset prices and economic growth are falling. The fortune for the new lunar year of the rat seems apparent: "*More of same. Could be worse.*"

We recognize that this is an anxious time for investors. After twenty three years in this business, our firm has been through this scenario, in various forms, before. We have adjusted our portfolios accordingly, and we will remain vigilant during these turbulent times. If you have any questions or concerns, do not hesitate to contact us.