



“There is no remembrance of things past,
neither shall there be remembrance of things
to come.”

-Ecclesiastes 1:11

COLLATERAL DAMAGE

2008 was a year which could not end soon enough. What began as a seemingly contained problem with subprime mortgages ended with fears of a depression and financial system meltdown. Governments around the world had to suddenly reverse inflation-fighting policies and flood financial systems with liquidity and lower interest rates. What happened? What is to come?

To a large extent, the successes and excesses of prior years had sewn the seeds of the problems experienced in 2008. Excess borrowing, fueled by low interest rates and easily accessible money, inflated all asset prices and eliminated the realistic assessment of risk. An investment bank, with 3% equity and 97% debt could not withstand much loss in its capital base. A homeowner with an unaffordable mortgage, betting on continued home price inflation, could not survive a job loss or the inability to borrow more against declining home values.

These reverberations came to a head when Lehman Brothers declared bankruptcy in September, but the system had already been slowly unwinding. Lehman accelerated the downward spiral into a few months of

deleveraging and wealth destruction, with bleeding lenders demanding that loans be immediately repaid or requiring additional collateral. The result was forced selling in all asset classes, with investors flocking into the umbrella of the U.S. government guaranteed assets. Repayments that had been made to the banks and seized collateral were essentially destroyed by write-offs by financial institutions. The magnitude of the selling was amplified by the fact that the heavily levered investment banks, some levered by as much as 30-to-1, sold assets indiscriminately, with no regard to fundamentals or value. Since so many market participants were selling, there were few buyers and prices dropped by astounding levels in a short period of time.

As it turns out, the problem was not confined to the U.S., as Europe also exhibited similar traits. Slowing U.S. and European economies, whose manufacturers and consumers had been binging on consumption, created problems for export dependent countries in Asia (most notably China) and economies reliant on exports of commodities and resources, notably many in the Middle East and in Australia. A global rush for the exits began through a

continually narrowing doorway. The beneficiary of the panic was the U.S. dollar, as investors and banks trusted no one, even though the U.S. was busily printing money to bail out its own financial system.

Our focus for 2009 is on determining what is undervalued (but not getting cheaper), what is fairly priced, and what catalysts exist to move any asset classes up or down. A bombardment of coverage of nightmarish market events in the media, ugly economic statistics, and recent market losses have caused many investors to stay on the sidelines, earning paltry returns on cash equivalents. What seemed optimal one year ago is now out of favor.

As this situation was caused by excess leverage and poor lending and risk analysis by banks and other institutions, the taxpayers have been drafted into bailing out the financial system. To accommodate this process, the Federal Reserve has essentially lowered the short term interest rate to zero. Thus far, banks have been reluctant to lend, fearing losses on existing loans (the commercial real estate market has begun to crack) and wary of making new loans. Banks also do not trust one another's balance sheets. Banks are so nervous about inevitable future write-offs that they are not taking advantage of the spread between short term and longer term interest rates on government bonds, which is the typical way in which the government helps them recapitalize. Credit markets have become almost paralyzed. The bailouts and backstops have not worked out the way the Fed had planned, so, in effect, the government has become the primary lending institution. Slowly, the system is moving toward bank nationalization.

We believe the Fed has another agenda. At some point, investors will tire of the negligible return offered by cash equivalents and wander further out on the risk spectrum. As the Biblical quotation above reminds us, investors tend to have short memories, although 2008 may take a little longer to forget. In this environment, we can take advantage by investing in many attractive opportunities through more liquid, transparent

vehicles, rather than utilizing alternative investments.

For example, we have determined that high quality corporate bonds have been sold to levels that offer attractive returns for the level of risk taken. As a result of forced selling and lack of access to capital markets, many of these same high quality corporate bonds trade at prices that imply default rates highly in excess of what we feel is even a worst-case scenario.

Similarly, high quality convertible bonds, which were decimated following the Lehman Brothers debacle, are also priced at compelling levels. Convertible bonds offer the option of being converted into common stock, at a certain price. In many cases the prices of these bonds reflect no potential upside for the conversion option. The bonds also offer attractive yields, and we can add to our convertible bond positions.

Gold mining stocks were punished last year (-38%), even though the price of gold rose approximately 5%. Many mining companies trade below the levels of cash held by the companies. We feel that government bailouts and stimulus packages will ultimately prove inflationary, with a weakening dollar also being a result. As the dollar weakens, other countries will let their currencies fall as well, so as to maintain some export market share. Investors often seek gold in times of currency debasement and inflation, and we are no different, as we have recently added to many of our gold positions.

Finally, as investors properly fear a continuing global economic softening, energy prices have fallen precipitously. However, we feel that current energy prices are unsustainable. Most of the larger oil exporters, such as countries in the Middle East and Russia, have suffered increased costs of production in excess of prevailing market prices, while simultaneously embarking on large infrastructure projects. Many exploration and production projects which seemed attractive when oil was priced at \$100 per barrel have been shelved. Alternative energy projects and fuel conservation have become less of a concern. As

demand increases, supply will not be adequately available, leading to higher prices. Because of many of these conditions, we have also recently added to positions in this sector.

2009 will likely prove to be an interesting year. The new administration in Washington will have its hands full. While attention will be focused on the economy, external political events will also keep Washington busy. With continuing problems in the banking sector, we suspect that the government will err on the side of throwing too much money at financial problems. So far, efforts like the TARP (Troubled Assets Relief Program) and other bailout mechanisms have mostly proved futile. While printing more dollars to bandage the economy will ease the current pain, the inflation piper will be paid in the end.

In the Chinese calendar, 2009 is the year of the ox. The personality traits of the ox are patience, determination and hard work. We will continue to follow those precepts.

We wish all of our clients and friends a happy and healthy New Year. If you have any questions, please do not hesitate to call.