CONWAY • JARVIS

E-Update

April 7, 2009

Scratch Another One Off the Wish List……..Maybe

With the implementation of TALF earlier in the first quarter, we were able to cross an item off our Wish List for 2009. Last week we crossed off another one when the Financial Accounting Standards Board, better know as FASB, moved to modify the Mark-to-Market Rule (FASB 157) that they implemented in late 2007. This modification, encouraged by Fed Chairman Ben Bernanke, would allow institutions to employ alternative methods of valuing assets when markets are frozen or rendered inoperable by unusual conditions. This news and the release of the details of the new TALF and PPIP programs extended the global rally of stocks from their extreme oversold levels of early March. The European Union Standards Board, not wanting to act precipitously, chose instead to initiate a study of the problem rather than immediately follow FASB's lead. Because we see the banking problem in Europe as more dire than here in the states, we think we smell smoke and hear someone fiddling. This modification is a significant step toward resuscitating the securitization markets and restoring the flow of Credit. To accomplish that, it will require **ALL** banks and brokers to participate and make a market. If Europe chooses to follow an alternative, stricter standard, it will delay and perhaps threaten the process of repairing the Financial System. We're encouraged, but believe this modification has to occur on a global scale. **Next on the list: A return to the old short-sale rules.**

Talk of a Market Bottom

Early in the first quarter, we began to see sentiment from both investors and the financial media start to catch up with the reality of what we're seeing in the economy and the markets. This has to happen in order for bearishness to approach those levels commonly associated with major market bottoms. We saw stocks approach near-term oversold levels in the first ten days of March, setting the stage for the 25% rally that followed. It was triggered by perceptions arising from some encouraging policy initiatives flowing out of, surprise surprise, Washington. On one hand, we heard a number of individual investors and cheerleaders at CNBC voice their belief that the bottom was in and warning us that we were missing the return of the Bull. At the same time, we heard an equally good number of institutional investors and analysts express their concerns that the worst was far from over and that this was simply a rally in a bear market that soon would give way to a test of the March lows. We tend to lean in the direction of the Bears. Why? Because of the unique character of this downturn and the market decline.

It's Big, Different (though not unprecedented), and both Systemic and Cyclical in nature. Consequently, we're of the opinion that this market recovery will be more of a process rather than an event. That means we are likely to see a number of false starts before we start looking for the "V" type of market recovery that so many have been calling for and are fearful of missing. That's how we view the rallies of the past several months. They have been trader-driven and the product of short-covering but they are an integral part of the bottoming process. Major market bottoms that denote changes in a secular downtrend are usually the result of rebuilding confidence and market support over time rather than any single rally or event. The bigger the downturn, the longer the process takes. We believe that a slow-growth, dish-shaped economic recovery is ahead of us and that will be reflected in the longer-term performance of the equity indexes. This recent rally raises the probability that the bottom is in but without a successful test of the March lows we're not buying it….. yet. Until we see the return of *investors* from the sidelines, we'll continue to view any such rally as just another false start.

Breaking Up Is Hard To Do

Last month we said goodbye to Microsoft, a company we'd come to regard as a member of the family. We've spent 17 or more years together through thick and thin and, up until recently, we thought we still had a lot of runway left. But then something happened that forced us to take a hard look and we realized that the vibrant, exciting, growth company we bought so long ago, had become something else under the weight of its success. It had become a lumbering giant, looking to recapture its old glory but lacking the courage and vitality to take the risks necessary to reestablish itself as a leader in its industry. It seems to have fallen victim to the tendency to defend one's empire rather than take on new challenges and explore new horizons. It's said that success breeds complacency and from outward appearances that would describe MSFT.

How else does one explain a cash-rich, supposedly innovative company, deciding to deploy that cash by paying a special dividend to shareholders as they did in 2004. Were there *no* growth opportunities in their space worthy of pursuing? Possibly. But how then does one explain that same company four years later identifying Yahoo as an acquisition target and making an offer that was, thankfully, rejected. To some, it appeared that management viewed that purchase as a key to competing with Google in contested markets. To us, it appeared to be a misguided attempt to compete in a market where the winner was already decided and they were spending billions to carve out second place and sniff Google's exhaust pipe for decades to come. We were grateful that Yahoo CEO Jerry Yang broke the arrogance meter and overplayed his hand, and the price of his company, to a level where even the ever-effusive Steve Ballmer wouldn't go. Ballmer unintentionally won by saying no, but the seeds of doubt as to MSFT's longer-term strategy had been planted.

Since then, MSFT has been frozen in place, constipated by its size and structure and seemingly unable or unwilling to deploy its cash in pursuit of bargain-priced initiatives that are everywhere in this generational economic downturn. Even though it wouldn't surprise us to see another special dividend, we've decided not to wait around for a change of management or a restructuring that would unleash the growth businesses that lurk within the company. MSFT has won the hearts and minds of the business sector, but is moving toward irrelevance as an innovator in the consumer space where Apple is defining… and winning, the game. Several years ago we sold GE for the same reason. We loved a number of their businesses but felt the shares would suffer because of the problems associated with GE Capital. We instead invested in a number of companies that offered a purer play in that sector and were rewarded with significant outperformance over that of GE. Our intent is to do the same here. We've identified a number of companies that we believe will offer significantly better relative performance on the backside of this economic downturn. Nothing is forever so we may be back someday, but not until MSFT addresses the need to reinvent itself. IBM did it successfully. So can Microsoft if they can make and execute some tough decisions.

CONWAY • JARVIS LLC
3147 Fairview Avenue E. Suite 300, Seattle, WA 98102
206.324.9765 / 800.398.9765