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E-Update

September 30, 2008

Given the sensational news and subsequent wild market ride over the past weeks we thought it a good idea to communicate with our clients on a more frequent basis. Since it is difficult to reach out personally on a regular basis, this *E-UPDATE* will hopefully prove useful in getting our thoughts and opinions concerning the rapidly changing news out to you quickly. Though sometimes hard to bear, these are certainly interesting if not fascinating times. This is a time to resist the emotional temptation to make rash or non-strategic investment decisions and if prudent, take advantage of fear-driven opportunities.

This Week

The anticipated events that we have been discussing for the last 18 months are finally upon us. Our key to long term investment success is to maintain a proper asset allocation given your risk objectives, and attempt to outperform the markets on a relative basis. To bring you up to date, we began preparing for the current market conditions in 2006 by selling WAMU near their highs and then dramatically reducing our exposure to the Financial sector in 2007, selling Citigroup, BankAmerica, and American Express, among others. We also bought gold and shorted the US dollar for a period. We then raised our cash position to their current record levels. The most recent step to further de-risk portfolios was taken several months ago when we added two ETFs that were inversely correlated to the NASDAQ 100 and S&P 500 in the event recent developments were to crash the market. We closed those positions last week in anticipation that Congress would swiftly enact legislation to restore the flow of credit to the financial system (what were we thinking!!?) Actually, the news isn't all bad. The Treasury stepped in to backstop money market fund balances and is likely to expand FDIC coverage of bank accounts up to $250k. This will hopefully stem the flow of assets from troubled banks until the details of the Rescue Plan are ironed out. We know that the current plan will not address all of the problems in the capital markets but, if properly structured and *presented*, should restore confidence in the banking community and get credit flowing again.

The Downside of a Policy-Dependent Economy

In our June Outlook, we shared our hope that Congress would find it unnecessary to take action before the election to stabilize the financial system. Unfortunately, events of the past 90 days have made that necessary and, as feared, some have placed partisan politics and ideologies ahead of the problem at hand. It's become clear that many fail to recognize the gravity of conditions in the credit markets and how they affect Main Street. This is understandable, given the level of ignorance regarding economies and markets that we've seen displayed time and again at congressional hearings. They should be reminded that this is not a bailout of Wall Street but a stabilization of the financial system that drives growth on Main Street. There will be time later to take names and lay blame. Hopefully the markets have sent a message, loud and clear, that action is needed quickly.

You Can't Have Credit Without Collateral

Credit, to the global economy, is like water to the human body. Parts of the system will shut down in its absence and, if not restored in time, the body will expire. Conventional wisdom points to the efficacy of the Treasury providing enough liquidity to the banks and brokers to get credit flowing through the system again. Our fear is that conventional wisdom will create conventional results in a time when something more is needed. We have said time and again that housing is at the root of the credit crisis. In addition to the banks, Congress has to include some form of Collateral Stabilization as part of its plan. This doesn't mean bailing out homeowners who can't pay their mortgages today. However, it could mean postponing a foreclosure on a homeowner who can't pay the increase in their ARM. This would make for one less home added to the massive housing inventory that overhangs the markets. Until home sales exceed foreclosures and housing starts by a wide margin, inventories will continue to destabilize the toxic collateral that has stopped the flow of credit. Until that happens or some pricing mechanism can be devised to value these mortgage-backed securities, all the liquidity created by this plan won't flow through the pipes. If the plan fails to include provisions for banks to temporarily defer foreclosures and stabilize collateral, we would expect some revision to be made to the FASB rules as they relate to marking these assets to the market. Stay tuned.

A Decline in the Market is a Step in the Right Direction

Monday's decline marked a 50% retracement of the market's advance from the lows of 2002 and Tuesday's rally gave notice that investors are betting wildly on what Congress does day to day. The decline was accompanied by an extreme spike in the volatility index ("VIX"), also known as the fear index. The VIX traditionally rises to extreme levels at or near market bottoms. Only time will tell whether we're nearing the end of this market cycle but it's an important step in the process of building support from which the broader market can mount a rally. Whether that advance can be sustained will hinge on what monetary and fiscal policy measures are crafted and how they affect global economic conditions over the next few months.

The Global Scene

Speaking of that, recession here at home is slowing economies around the world. Europe is spiraling down right behind us and Asia will be next, though to a lesser extent. In advance of that, their stock markets have already tumbled to levels that we find attractive. From an investment perspective, most experts are comparing this recession to more recent ones, we're betting this one will be reminiscent of the doozy we experienced in '73-'75. That period proved to be one of the great investment opportunities in history. Even though the broad market languished, money was made then by owning the right investments in the right sectors in the right markets.

The world ends only once and this is not it! Our latest "cute" analogy is: The economy is sick and we are at the doctor's diagnosing what is wrong. Next move: The cure.

Please call if you have questions.

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