CONWAY • JARVIS

E-Update

November 20, 2008

We have been crafting an update for two weeks now, but the topics and news are changing daily, making us adapt our thinking seemingly constantly on the run. In this installment, we reflect on this month's market performance as Congress and the global central banks attempt to "get it right" and restore confidence to the crashing financial system.

Dithering Over Data

The official arbiter of such things, the National Bureau of Economic Research ("NBER") defines recession as a significant decline in GDP, accompanied by declines in employment, wages, and industrial production. We've said it before and we'll say it again, the US Economy has been in recession since early this year. The data for the US and Europe confirms our view. The financial media and economists are waiting for two consecutive quarters of negative GDP before making it official. Well, here it is. Q3 was slightly negative and the economy hit the wall in the first month of Q4. Why is this important? The sooner investors accept that "it's here", the sooner the market will turn its focus to what's on the other side of this downturn. The bigger question for us is what happens to Asia. By our estimates, China's GDP is slowing from 11% to somewhere around 7-8% and is weighing heavily on the region. In our mind, that confirms our belief that the US recession has gone global. The stock market also confirmed it with a weak close in September that triggered a massive margin call and a forced liquidation of equities that sent us to the 2002 lows. What happens next depends on the actions of the Fed and Treasury and a Congress. That alone, is reason enough to maintaining a defensive posture for the portfolios.

The Root of the Problem

In our September 10 Outlook we discussed the effects of the Great De-leveraging of the financial system and highlighted the need for some form of collateral stabilization as part of the Troubled Asset Rescue Plan ("TARP"). This topic was front and center at this week's congressional hearings where FDIC head Sheila Bair spoke eloquently about the practical aspects of a policy of systematic loan modification that they employ in the wake of a bank failure. It's a policy designed to assist homeowners by altering the terms of the loan in order to postpone or prevent a foreclosure that would otherwise result in a larger loss to the lending institution. This is not only a benefit to the lender but is also a big step toward shoring up the assets of institutions who have stopped lending and are forced to sell equities to raise capital much like they did in October. Bair endorses a systematic broad-based plan, using Treasury assets, to modify home loans on a national scale. Secretary Paulson, while acknowledging the need for collateral support, remains focused on directing TARP assets to financial institutions to stimulate lending. In our opinion, you can't do one without the other. Until the collateral is stabilized through a Bair-like program, the banks will remain reluctant to lend and we will be at risk of more forced equity liquidation by insurers and hedge funds. Some in Congress say this plan creates a moral hazard. We think it's a big step toward remedying the effects of a moral hazard

already created under their stewardship.

Bailout or Bankruptcy for the Automakers?

This week the automakers and their unions appeared before congress to ask for a handout, saying that a shrinking of the Big Three to a "Two" or a "One" would be catastrophic for the country and the economy. Maybe so, but we're wondering how keeping all the automakers in the business of losing money is any different than keeping "zombie" banks alive and kicking. In the end, bailing out poor performers only extends the pain and fails to solve the problem. We'd prefer to see the autos restructure under Chapter 11. Failing that, any federal aid should have not strings, but chains, attached designed to engineer a sizeable contraction of the industry in the US and force a rebuilding of their cost structure that will allow them to compete with the more efficient foreign automakers. Japan's government tried to save everyone in the 80's and suffered what has been termed the Lost Decade. Our hope is that we don't do the same.

Market Valuation: There is Cheap and there is Really Cheap.

A generation of investors and investment professionals are licking their chops over the prices they have seen over the past several months in the equities markets. They're anticipating a market bottom like those seen during recessions of the past twenty years. Many have committed capital to the market this year, only to be disappointed by a series of failed rallies. Another, older, generation of investors see this economy differently. They remember what a consumer-based recession did to the markets in the '70s. For them, that was both the bear market of a lifetime and an opportunity. On several occasions from 1975-1982, the S & P 500 traded close to book value. Today, the S & P is selling around 1.7 times book. One of our favorites, Ned Davis, defines "cheap" as the S & P selling around 1.2x estimated book value. Using our book estimate of $525, that would put the S & P into really cheap territory at around 630, roughly 20% lower than current levels. We view this as a possibility, not a probability but consider it reason enough to remain defensive over the next 90 days and why we affirm our view that this market bottom is best viewed in the rear view mirror. Given this economy and this recession, it wouldn't surprise us to see "value" redefined for a new generation of investors. Those with dry powder will be positioned to take advantage of those values.

What's an Investor to Do?

Not a single asset class has been spared in what we believe will be the most dramatic re-pricing of assets in our lifetime. However, we know that event has a finite term and can see a time in the not too distant future when investors will be presented with some exceptional investment opportunities. The view is less clear in the very near future with regard to when and where we experience a change in trend. That's why it's just as important now as it was months ago to measure the risk of your portfolios and allocate in such a way that the market doesn't deal a near term life-changing blow to your financial plans and that you can stay in the game to recapture the returns that will accrue in the longer-term.

We have heard from many of you over the past weeks and appreciate the support and understanding from our terrific client base. We appreciate the gravity of this crisis and the effects it has on all involved. We continue to work diligently to gather, analyze data and execute strategically in all our portfolios.

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