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## LETTER FROM THE PORTFOLIO MANAGERS

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August 2008

### *Is The Worst Behind Us?*



Eric M. Kobren

Though the major U.S. stock market indices had modest total returns for the month (the Dow was up 0.4%, the S&P was down 0.9% and the NASDAQ was up 1.5%), the intra-month volatility and emotional swings were anything but modest.



Rusty Vanneman

July had many notable events. The stock market officially reached a “bear market” classification (defined as losses of 20% or more from prior market highs). Various investor and consumer sentiment measures dropped to multi-year bearish extremes. The Fed and Treasury came to the “rescue” of the major financial institutions Fannie Mae and Freddie Mac in mid-month. The crude oil market peaked at \$148 a barrel on July 11<sup>th</sup>, dropping sharply into month end. On the flip side, after starting off July by extending its losses from the worst June since 1930, the stock market (S&P 500), may have finally found some solid footing mid-month and rallied somewhat into month-end.

The stock market also witnessed some sharp sector rotations as health care and financials posted healthy returns (financials even had a +28% return one week – the largest one week gain for any sector in at least two decades) while industrial materials and energy stocks were hit hard. In addition, while large company stocks in the aggregate were modestly lower and mid-cap stocks down even more, small-cap stocks were actually able to post some solid returns.

It wasn't easy to hide from a choppy stock market either. Commodities had their worst month since 1980. Crude oil dropped over 11% for the month, which was its largest percentage price drop in the 25-year history of crude oil trading on the New York Mercantile Exchange. International equity markets lost over 3% and are now trailing the U.S. stock market in terms of total returns year-to-date – despite the dollar generally moving lower in 2008 (a weaker dollar supports international investments).

The bond market, in the aggregate, was slightly higher in July. With the exception of high-quality Treasury Inflation Protected Securities which lost ground as inflation expectations dropped sharply last month due to the large drops in commodity prices, high quality bonds outperformed low quality bonds such as high-yield bonds.

Moving forward, our outlook for the stock market has modestly improved from recent months. We still have concerns about liquidity and real estate, and acknowledge the real risk of the stock market still pushing to new lows, especially in light of the seasonal tendencies for stocks to underperform during the August/September time frame. But our optimism is starting to build nonetheless. For the long-term investor, we believe that in the current environment it is a better time to buy than to sell.

In the short-term, sentiment and technical factors suggest that prices could actually move higher in the coming weeks and months. And while valuations are still high, they are lower than in years past, and

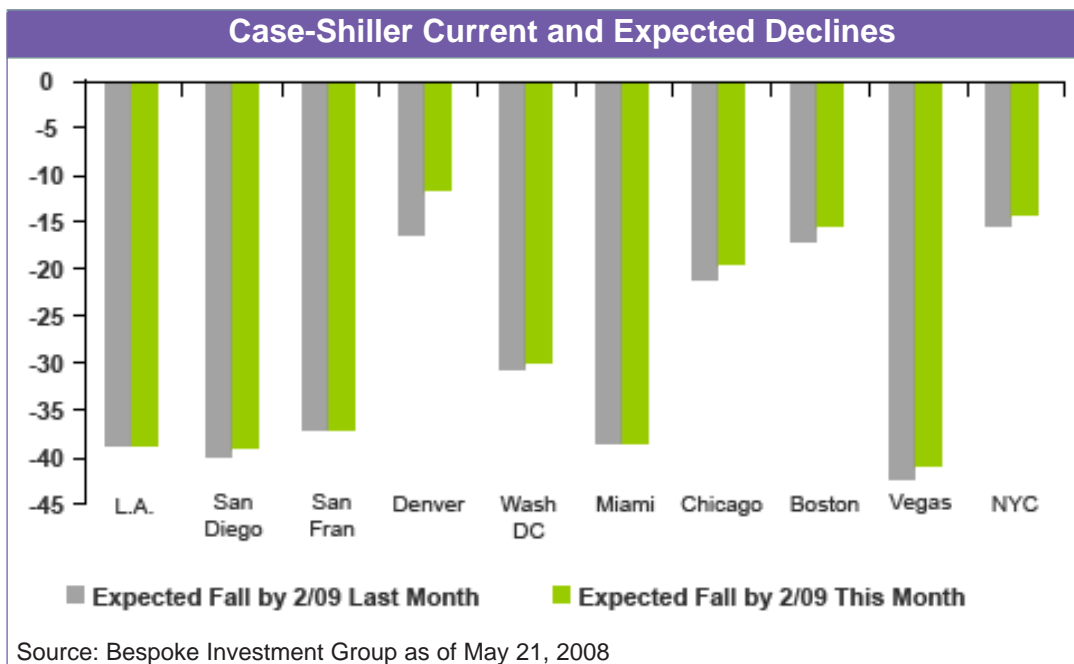
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better earnings growth (at least earnings growth that is less bad), should shift the winds back in the favor of stock market gains.

### A First Step for a Better Housing Market?

One other positive may actually come from residential housing. Residential real estate prices, which were a major driver in the economy's success earlier in the decade, are now the primary cause of economic and market weakness. There is some hope though.

While we remain concerned about a large inventory of homes for sale and a weakened consumer, we do take note in the positive development that for the first time this year the CME (Chicago Mercantile Exchange) housing futures, which are based on the S&P/Case Shiller median home prices have begun to increase. The change may be modest (and it reflects lower expected price declines, not gains), but given the free-fall earlier this year, any stabilization in expectations is a plus.



We may be jumping the gun on what may simply be a short-term stabilization in expectations, but if this is indeed a genuine first step in the right direction for the residential real estate markets, that could go a long way in helping the economy and the markets.

### When Will Financials Recover?

One economic sector that will clearly benefit from a stable real estate market is the beleaguered and battered financial sector. To put in perspective how large the stock market losses have been for this sector, the over-all bear market for stocks had witnessed a loss of 21% from its 2007 high

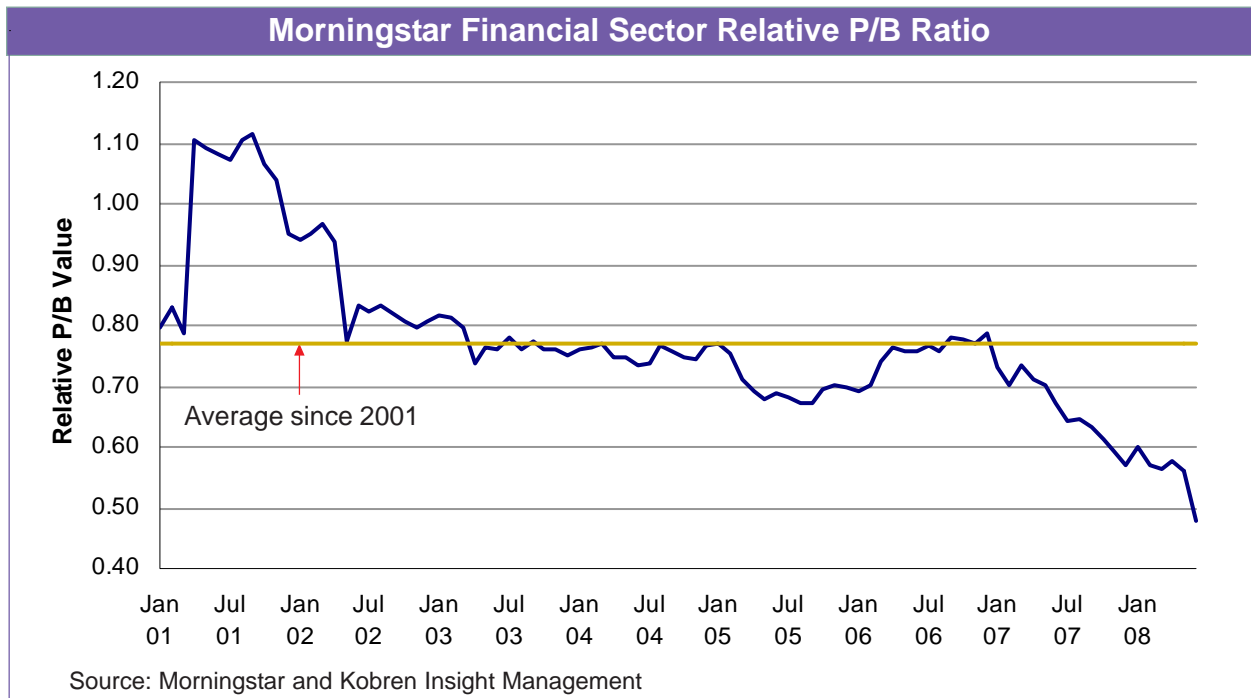
to its 2008 low (as defined by S&P 500). The financial sector meanwhile has lost 56% from its 2007 high.

Looking back at bear markets since 1940, this is already the deepest bear market for financials, even exceeding losses in the notable 1987 and 1990 bear markets where financials were also hit quite hard. Can the losses get worse? Of course they can. For a fairly recent frame of reference, the NASDAQ Index had a price return of -83.6% from its a high on March 24<sup>th</sup>, 2000 to the low on October 8<sup>th</sup>, 2002. Can financials lose that much or more? We don't think it's probable, but it is possible.

Let's review why financials have lost so much ground. In short, financials have been a victim of systemic deleveraging in the financial system due to the vicious cycle in real estate. The cycle goes something like this: as the housing market moved lower, credit losses moved higher, which lowered credit ratings, which negatively impacted demand for mortgage-backed securities, which meant that lending standards became tighter, which in turn lead to a weaker housing market. Repeat. When does it end? Nobody really knows, but what we do know is that the bottom will happen when the news flow is still negative.

Don't get us wrong. We are not bullish on real estate yet. It's just now there are some signs that the worst may be behind us. Again, seeing how important real estate values were for the real estate cycle, stabilization in housing prices should bode well for financials.

As far as relative valuations go, financials are already attractive. The chart below shows the book value of financials relative to the book value of the S&P 500. The average ratio since 2001 has been about 0.80, which means that the P/B ratio for financials is typically 20% lower than it is



for the overall stock market. Currently, however, the price/book ratio for financials is more than 50% lower than the stock market. This is a pretty dramatic discount from its average. And despite earnings plunging even the relative price/earnings ratio is quite attractive.

While many investment firms still remain negative on financials, one firm, Pzena Investment Management is actually quite bullish and their arguments are worth paying attention to:

*“Fear trumps fact in the short run. To discount the financial sector as much as it has been means you have to assume the industry is permanently impaired. It’s not. Specifically, we believe the following three points will prove to have been obvious once we look back on this environment:*

- *Contrary to prior financial cycles, accounting rules are front-loading losses and potentially leading to overstating them.*
- *The risk of failure is not significant for most leading financial companies.*
- *The future earnings power of many financial firms is not materially impaired despite the possibility of deliberating.”*

To summarize the Pzena view, most, if not all, of the worst case scenario has already been baked into stock prices.

### **Fannie and Freddie**

Talking about financials should include, of course, some discussion about Fannie Mae (Federal National Mortgage Association or FNMA) and Freddie Mac (Federal Home Loan Mortgage Corp or FRE). The mid-month moves by the Fed and Treasury to support Fannie and Freddie were instrumental in stopping the market’s bleeding, at least for the time being.

Fannie and Freddie are “government-sponsored enterprises” or GSEs, though they are privately (shareholder) owned. In short, FNMA was created in 1938 (FRE in 1970) to increase the availability of mortgage money and make homeownership more affordable for low- and middle-income Americans. The GSEs buy and guarantee mortgages that meet its funding criteria. They are then able to securitize these mortgage holdings into mortgage-backed fixed-income securities (MBS), which has grown into a significant portion of the global fixed income market.

There has always been a lot of controversy over GSEs. Since they are government-sponsored, they have carried an *implicit* guarantee that the government would protect them if they ran into trouble. As a result of this implicit support, GSEs have been able to issue debt at cheaper interest rates than other mortgage players. They exploited this advantage to grow to massive size controlling about 50% of the mortgage market and 80% of all new mortgages involve one of the two companies. As a result, private shareholders were benefiting from the implicit backing of the government and ultimately, taxpayers.

However, Fannie and Freddie, got caught up in the vicious real estate cycle just like the rest of the financial sector. Despite the government support (or perhaps because of it) their financial problems have even been worse and their shareholders have suffered the consequences with FNMA losing 91% off its stock price and FRE losing an amazing 94%.

On July 13th, a Sunday no less, Secretary of Treasury Hank Paulson finally made the implicit backing *explicit*, saying that there is unprecedented support for Fannie and Freddie. Both the Fed and Treasury will provide liquidity and other forms of support if needed. While it appears that taxpayers will indeed be on the hook to help bail out the GSEs, which arguably isn't fair, it does appear that it may be necessary for the stabilization of the economy and markets – at least in the near term. With the authorities (and taxpayers) behind the guarantee, this may protect the housing market from steeper declines. In addition to supporting the real estate market, the support of the GSE debt, otherwise known as agency debt, is critical as the default of Fannie or Freddie senior debt could be devastating to the U.S. financial system due to how much agency debt is owned by U.S. banks, insurance companies, pension funds, money market funds, and other key financial institutions and participants.

Many consider the actions of the Fed and Treasury to explicitly support Fannie and Freddie as a turning point for the real estate markets, the economy, and the stock market. There are dissenting voices to this view, but the early market reaction is encouraging.

### Portfolio Positioning

In summary, after all that, what are we specifically doing about our exposure to financials? The short answer is not much – at least not yet. While we have slightly increased our exposure to financials in more aggressive accounts, we haven't jumped in with both feet yet. The key item to note though is that we are not reducing our exposure to financials, nor are we reducing our exposure to the stock market.

In terms of positioning, our overall themes remain the same as they have all year – maintain high quality in both equity and fixed-income holdings. For the most part, this view has benefited client portfolios. The one exception has been the weak performance in large-cap stocks (which generally do better in down markets and weaker economies). Nonetheless, we are maintaining our positions in large caps as they are fortified by attractive relative valuations.

While we are also maintaining our exposure to international markets, we are more likely to decrease our positions than to add to them in coming months – including emerging markets. Emerging markets, while still an attractive long-term story, seem to be accumulating plenty of shorter-term issues such as commodity dependence and rising inflation. In addition, given many emerging market's high export ratios, an eventual turnaround in the US dollar is not likely to help.

Besides, the idea of “de-coupling” – that problems in the U.S economy (and markets) will no longer seriously impact other world markets - doesn't seem to be working. All of the 23 devel-

oped nations in the MSCI World Index (except for Canada) have experienced bear-market plunges of 20% or more since September, as have 23 out of 25 developing countries in the MSCI Emerging Markets Index (except Jordan and Morocco).

In the end, while the headlines seem sensational with news organizations often magnifying the story it to make it more interesting (and to some more actionable), our gentle reminder is that sticking with balanced, diversified portfolios (over fear- or greed-driven action) is the best course for most investors. They may not create sensational returns in the strong bull markets, but they generally won't create sensational losses in nasty down markets either.

Sincerely,



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