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## LETTER FROM THE PORTFOLIO MANAGERS

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February 2008

### *Looking Past The Short Term, The Outlook For Stocks Has Improved*

Last month was nearly the worst ever January for the stock market. It sure looked that way on the morning of the 22<sup>nd</sup> when, with the market already down about 9% for the month, the Federal Reserve announced an emergency rate cut of 75 basis points sending the Dow down over 400 points in the opening minutes.



Eric M. Kobren

But by the end of that day, the Dow made up nearly 300 points of that loss, and rose nearly 300 points the next day. And the final week of the month (including the first day of February) turned out to be one of the best for stocks in years. Still the losses for the month were painful with the Dow dropping 4.5%, the S&P 500 losing 6% and the Nasdaq falling 9%.



Rusty Vanneman

Losses like that amid such high volatility can make one agitated and nervous. How do you keep your bearings amid such sharp changes in direction?

By keeping your focus where it belongs: on the longer-term.

In such volatile times, it is important to remember our guiding principles: we treat the money you entrust to us as carefully as if it were our own; we manage appropriately balanced, diversified portfolios targeted to produce solid risk-adjusted performance and accomplish **long-term** client objectives; we do not speculate in an attempt to capture short-term gains.

While the current market may be making you uneasy, here are some other voices with timeless advice on keeping a long-term focus:

- Peter Lynch said: “The key to making money in stocks is not to get scared out of them.”
- Warren Buffett said: “We simply attempt to be fearful when others are greedy and to be greedy when others are fearful.”
- Sir John Templeton said: “Invest at the point of maximum pessimism.”
- Phil Carret (founder of one of the first mutual funds) said: “I’m a coward and I don’t have sense enough to figure out when to go into cash.”
- Chris Davis (of Selected American) cites a saying of his grandfather (another accomplished investor): “You make most of your money in a bear market, you just don’t realize it at the time.”
- Bernard Baruch said: “Don’t try to buy at the bottom and sell at the top. It can’t be done except by liars.”

Continued ...

- And one more from Sir John Templeton: “History shows that time, not timing, is the key to investment success. Therefore, the best time to buy stocks is when you have money.”

The investors cited above were all very successful. They had long-term investing orientations. They didn’t shake out of positions. If anything, when the market was down, they bought more as stocks were “on sale.” Remember, in time, all bear markets end.

But beyond that philosophical support for a long-term view to investing, we believe that hidden in today’s turmoil are the seeds necessary to produce returns over the next 10 years that are higher than those of the previous 10 years.

Let’s start with valuations. At the beginning of 1998, the P/E (price/earnings) ratio of the S&P 500 stood at 22.1. With the S&P 500 closing at 1378.55 on January 31, 2008, the P/E ratio was 16.3 based off 2007 operating earnings, and 14.1 based on forecasted 2008 earnings. While we think current 2008 earnings forecasts may be too high, the point remains the same — valuations are not as expensive as they have been in recent years. In fact, the P/E for the S&P is at its cheapest levels since the end of 1995.

In addition to more attractive valuations, dividend yields are back around 2% — compared to 1.6% at the beginning of 1998.

Why is all this important? Let’s do a “back of the envelope” calculation. A simple method of forecasting a “long-term expected return” for the stock market is to calculate the “earnings yield”

	<b>12/31/1997</b>	<b>1/31/2008</b>
P/E Ratio	22.1	16.3
Earnings Yield (1 ÷ P/E Ratio)	4.52%	6.13%
+ Dividend Yield	1.60%	2.03%
<b>= Forecasted Annual Return</b>	<b>6.12%</b>	<b>8.16%</b>
Actual 10-Year Return	5.97%	?

(which is the inverse of the P/E) and add in the dividend yield. As shown in the table, applying that formula to the S&P 500 in 1998, we get an earnings yield of 4.52% (1/22.1). Add in the dividend yield of 1.60% and we get a forecasted return of 6.12% per year. The actual 10-year average annual return (1998-2007) was 5.97%.

Using current valuations and dividends we get a forecast of 8.16%. While that is still below the historic long-term average (primarily due to dividend yields still being lower than their long-term average) it is a very respectable return, significantly better than the 6% of the past 10 years, and one that an investor can begin to build a long-term program upon.

### The Short-Term

While the future looks promising, the short-term promises to remain difficult. There is likely to be a lot of bad news in front of us yet. Given current economic and market conditions, corporate executives have every incentive to put out all the bad news that they can find now. This is fairly

typical behavior during periods of corporate earnings weakness. Earnings are expected to be negative for the last two quarters of 2007 and stand a good chance to be negative for the first two quarters of 2008 as well.

Remember though, that the news is “history,” while the markets are always looking ahead. The markets don’t look back at what happened like the news does. They don’t react to historic data like the Federal Reserve does. The markets are pro-active. While media commentators are filling a perceived need for investors to have short-term market behavior constantly “explained,” and while the Federal Reserve and government are often reacting to political pressures to do something about the current situation, the markets are already moving on to the “next thing.”

Looking ahead is healthy and rational behavior. Making an investment, as a reward for past behavior is not the way to invest, nor is waiting to invest until “things look better.” It makes sense for investors to commit funds based on what they think will succeed in the future. Making an investment to achieve future objectives is the right way to go about building a successful long term investment program.

Nobody knows for certain where the markets will go over any time period, but that is especially so in the shorter time periods. If you take money that will eventually be used to fund some goal in the next few years, and put it in the stock market, that’s not investing, it’s called gambling. Over short periods, the markets are simply too uncertain to risk failing to achieve your goals.

Volatile times like this can sometimes make the stock market feel like “gambling.” However, investing and gambling really have only one thing in common: uncertain outcomes in the short-term. In the longer-term, however, the difference couldn’t be more dramatic. In Vegas, your long-term expected return is negative. The “House” always wins over time. That’s why they buy the drinks. But the stock market has historically provided a positive long-term return. Investing in the stock market is participating in the growth of the global economy. Even investors who follow a long-term, balanced approach that may not “beat the market,” certainly fare better than “betting it all on red.”

If you have been unsettled by the last few months, and our words here haven’t done enough to soothe your frazzled nerves, by all means reach out to us. Maybe we need to re-visit your risk tolerance. Maybe your long-term objectives have been modified. While we may have discussed these issues with you recently, sometimes things look and feel a little differently after the market has a significant correction. Our aim is not just to deliver a satisfactory long-term, risk-adjusted return, but to give you sound investment counseling, as well.

### **Making Lemonade**

In sum, for the long-term investor, periods of market weakness are times to take positive action. When the markets are “on sale,” it is not only a great time to invest, it’s also a good time to clean up portfolios. In fact, at Kobren Insight Management, January was one of our most active months

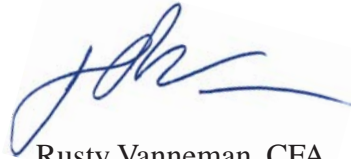
trading client accounts ever. The trading was primarily client-specific related, especially for taxable accounts. We re-balanced some positions on the market movement. We took tax losses which can be used to offset future gains. We were able to get other investors fully invested. Each of these situations was unique, but it's important to note that positive actions can be made to investment portfolios even if values are temporarily sliding the wrong way.

In addition, after talking to many of the portfolio managers of the underlying mutual funds that we currently use, and including managers of funds that we are contemplating using in the future, we have heard lots of fresh optimism. There is opportunity out there.

Sincerely,



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