
LETTER FROM THE PORTFOLIO MANAGERS

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Mixing Water and Oil



Eric M. Kobren

To get a better understanding of how investment managers select securities and build portfolios, over the years, we've visited a lot of managers in their own offices. It is useful to observe them in their working environment, and from a practical standpoint, it was often easier for us to visit them than vice-versa. We liked it that way anyway — it meant they could spend more time on research and managing portfolios, and less time on marketing!



Rusty Vanneman

It may seem trivial, but it is always interesting to see how firms decorate their offices, especially their front lobby. We have observed that a firm's decor tends to be consistent with their investment philosophy. For instance, value managers — those investment managers that primarily emphasize getting a good deal on the price of a company — often have relatively Spartan offices. Growth managers meanwhile, who emphasize concepts, stories, and glamour in their portfolios, tend to have a lot nicer-looking lobbies and conference rooms. You can also guess who provides the fanciest sandwiches for the working lunches.

Water

Regardless of their orientation, many investment firms feature nice oil paintings of famous ships and other maritime scenes on their office walls. The implied reference is that the investment firm is the vessel that can navigate the rough waters of the financial markets. The metaphor is apt as the markets can be choppy and quality professional investment management can indeed help investors reach their financial destinations.

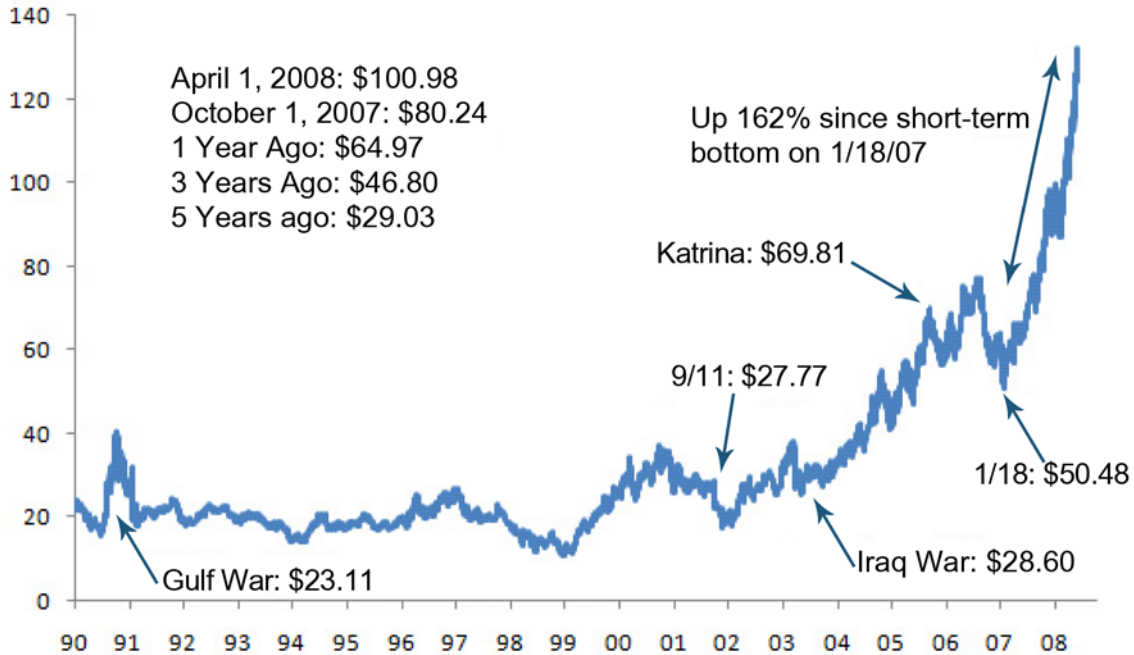
When it comes to investing, the water metaphor works in many ways. At Kobren Insight Management, we often talk about the market's cycles - and how they ebb and flow like the ocean's tides. We know that when prices are up, that they will be down again and when prices are down, they will be up again. The tide comes in and the tide goes out.

Oil

One market that has been doing a lot of flowing but not much ebbing of late is crude oil. Just look at a price chart of the commodity. Since the beginning of 2007, oil prices have steadily marched higher, nary a significant retracement, and have gone nearly parabolic in recent weeks. News flow has followed the price action (as it usually does) and as a result we are getting lots of questions on oil and commodities in general.

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Oil: 1990 - Present



Source: Bespoke Investment Group as of May 21, 2008

Can energy prices continue rising? Of course they can. The (near unanimous) belief that the per capita increase in emerging market demand, coupled with the long-term capital underinvestment in the natural resource sector (with some geopolitical factors thrown in for spice), will continue to push energy prices higher, strikes us as a valid argument. However, that little phrase in parentheses should at least serve as a red flag. As we have noted many times before, when everyone in the market believes the same thing — things are usually about to change! Let us be clear, we, too, share the belief that the long-term secular trend of oil prices is bullish. It's just that we don't necessarily expect prices to remain at their current high levels in the near-term. In fact, they could even reverse sharply; potentially eradicating any year-to-date gains in fairly short order.

Ambrose Edwards Pritchard of the *London Daily Telegraph* (among others) laid out a compelling argument for why oil prices could decline, perhaps even substantially, in the months ahead. The crux of his argument is that right now, supply is rising while demand is likely to contract, which should cause oil prices to begin to move lower. When that happens, the potential exists that the non-traditional commodity buyers who have recently entered the market — contributing to the steepness of its ascent — could leave just as quickly as they came, turning a modest decline into an outright plummet.

First, let's look at supply. Nigeria, Iraq, Saudi Arabia, Brazil, Azerbaijan and the Sudan have all boosted production of late, or are expected to in the months ahead. By next year, the US itself will be producing enough extra oil to reduce its import needs.

Demand is also likely to fall. The International Monetary Fund (IMF) cut its forecast for world

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growth to under 4%, down almost a full percent from the beginning of the year, and the United Nations (UN) is predicting sub-2% growth. Given recent growth rates, these forecasts do suggest a global economic slowdown. As a result, the major oil forecasters have cut their estimates for crude demand in half.

It should also be noted that inflation is a real problem in many emerging market countries where food and energy costs make up the bulk of living expenses. China's inflation is nearly 10%. Some countries have much higher levels than that. Many of these nations will likely actively look to slow economic growth in order to ease inflationary pressures. The important point here is that these are the very same countries who have accounted for most of the growth in oil demand over the last couple of years. Add it all up, and it doesn't seem likely that demand will accelerate in the near term.

According to a recently published report from Lehman Brothers titled, "Is It A Bubble?," in just the last two and one half years, assets in commodity index funds have more than tripled, rising from \$70 billion to \$235 billion. Since energy dominates the indices these funds track, this has meant a large flow of investment money into oil, lifting crude oil prices. These are not dedicated commodity investors, or firms hedging risks who have to maintain a position in the asset class. Rather these investors only came to embrace the "diversification benefits" of commodities recently (funny they didn't seem to care about such benefits when oil was at \$20 a barrel). What happens when this non-traditional asset class starts to underperform? Will these new buyers stick around? It's not likely.

Why Forecast?

We like to think that our success in managing money is built upon our philosophy, process and people — not our forecasts. Nonetheless, people want forecasts. The markets can also be emotional at times, and random at others, yet investors want rational answers why prices moved the way they did. Even though the markets are complex, most investors (ourselves included) prefer simple answers. In reality though, it's just not that simple.

Given that we build diversified portfolios of mutual funds, managed by portfolio managers with different mandates and mindsets, we hear lots of smart men and women take, and argue passionately for, the exact opposite positions on where a market will go next. Given that both sides of the debate are populated by educated, experienced, talented, and resourceful investment professionals — who are often right — whose side do you take?

Long-time clients know our punch line — nobody really knows. That's why we build balanced, diversified portfolios. We have our own informed opinions, too, and so build tilts into our portfolios according to our relative return and risk expectations. But, we like to think that diversified portfolios acknowledge the fact that we know we can't predict the future with absolute certainty. In sum, balanced, diversified portfolios allow you to participate in the global economy's long-

term growth, even if we miss the mark on some specific market calls.

Our Forecast

Okay, with those caveats firmly in place, our current market outlook calls for slower economic growth later this year. Those economic concerns remain centered on real estate and consumer debt which are expected to negatively impact consumer spending. With that expectation, we are staying the course with our current positioning in client portfolios, emphasizing higher quality stocks and bonds.

We do acknowledge that relative valuation measures between some “low-quality” and “high-quality” asset classes are starting to look more favorable for low-quality. In addition, we do believe that the outlook for corporate earnings growth (as opposed to GDP growth) a few quarters down the road is also improving. Nonetheless, we are not looking to get more aggressive quite yet.

Short-term, we remain defensive on the market. Over the last fifty years, June has been one of only two months of the year that has actually averaged a negative return. It is also usually negative more than half of the time (the only month to score worse on these two counts is September). Match that with our aforementioned concerns about the over-all economy, high valuations, and the uncertainty associated with the upcoming election, and we think fresh buying opportunities for riskier asset and sub-asset classes are still at least weeks or months away.

Sincerely,



Eric M. Kobren
President
Portfolio Manager



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