
LETTER FROM THE PORTFOLIO MANAGERS

September 2008

Reasons to Be Optimistic



Eric M. Kobren

There is a lot to talk about this month. Though August was a vacation heavy month and trading volumes on the exchanges were light, investors have had a lot on their minds, as well they should. In this month's report, we will address some of these topics, including: The dollar, international investing, energy and commodities and the election.

That's a lot of ground to cover in a few pages, but it is important because even though September has historically been the worst month of the year for the stock market, and investor sentiment has sunk again to bearish levels, we think there are reasons for long-term investors to be optimistic.



Rusty Vanneman

Reversal in the U.S. Dollar - A Key Factor for August Performance

The U.S. stock market had a modest rebound last month. The S&P was up 1.5%, the Dow Jones Industrials index was up 1.8% and the Nasdaq was up 1.9%. The Russell 2000, a popular benchmark for small cap stocks, was even stronger, up 3.6%. All in all, it was a solid month for the U.S. market, especially given the losses of the prior two months.

While the U.S. stock market posted gains, the reverse was true with non-U.S. markets. The Morgan Stanley EAFE index, the most common benchmark for "developed" foreign stock markets (meaning it does not include emerging markets such as India, Brazil or Russia), was down 5.4%. The MSCI Emerging Markets index meanwhile, lost 10.1%. While slowing global growth is one good reason international markets underperformed, another powerful reason was the strength in the U.S. dollar which rose 5.7% in August as measured by the Dollar Spot Index.

Within the U.S. market, not all sectors fully participated in August's gains, and a handful of sectors lost ground, including two sectors that have done well in recent years - Energy, and Industrial Materials. These two sectors were impacted by a combination of factors, but like international investments, slowing global economic growth and a stronger dollar were two leading reasons for the weakness.

Does the Buck Start Here?

The Dollar Spot Index lost approximately 40% of its value from its high, posted seven years ago (July 2001), to its low from earlier this year. With this sort of tailwind, international investments and commodity-based investments have benefited, easily outperforming the S&P Index.

The key question, of course, is did August's sharp jump in the dollar signal a reversal of this long-standing bearish trend. When it comes to explaining and forecasting currency markets (or any market for that matter), there are many variables to consider. When it comes to currencies, a common starting point is to assess "purchasing power parity," which basically means that the long-term equilibrium exchange

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rate between two currencies should equalize their purchasing power so that identical goods should have identical prices in both countries.

In other words, as *The Economist* magazine points out, it should cost as many dollars to buy a Big Mac in the U.S. as it does in other countries. (Of course there are valid reasons why this may not be the case, but it's still a good starting point to assess currency valuation.) On this basis, the dollar has been cheap for years, particularly versus currencies from other developed countries. For example, in the *Economist's* Big Mac Index as of July 24, 2008 it cost 3.37 euros to buy McDonald's signature burger, or at current exchange rates, \$5.34. But in the U.S. a Big Mac only costs \$3.57 so in purchasing power, the euro is 50% overvalued versus the dollar ($\$5.34/\3.57).

However, like any investment, a currency can remain overvalued or undervalued on a relative basis for an extended period of time, before a catalyst starts valuations moving back toward equilibrium. In the case of the dollar, there are a few on the horizon. First, despite the once fairly popular notion that the global economy may be "de-coupled" from U.S. economic woes, actual data of late has suggested otherwise as economic weakness has spread around the globe.

Another factor explaining a stronger dollar is the interest-rate differential between the U.S. and other countries. All else being equal, a country offering higher interest rates will attract more investment capital than a country with lower interest rates. For example if Germany is offering higher interest rates than the U.S. (as has been the case for several years), investors seeking those higher yields would need to sell dollars and buy euros to invest in German bonds, thus boosting the euro versus the dollar.

Currently, the (global) expectation is that the Federal Reserve will hold U.S. short-term rates steady in the near term, and that their next move when it comes is likely to be a rate hike. The expectation is the opposite for many other central banks around the world, particularly those in Europe where economic growth is slowing or negative and interest rates are much higher than our own. Thus the interest-rate gap between the U.S. and the rest of the world is expected to narrow, favoring the dollar.

A stronger dollar is beneficial to the U.S. in many ways. A stronger greenback gives U.S. consumers more purchasing power and can also lessen inflationary pressures (imports are less expensive). In addition, all else being equal, a strong dollar makes our stock and bond markets more attractive to foreign investors. One negative is that a rising dollar can hurt companies that depend on exports, which has been a huge boost to the U.S. gross domestic product in recent quarters, but the net impact of a strong dollar to our economy is still positive.

If the dollar is going to get stronger, should an investor abandon international investments in favor of U.S.-only portfolio? No, we believe that long-term investors are best served by including at least some international investments in their portfolios. Including international investments expands the investment opportunity set, which should enhance long-term returns and it also brings diversification benefits, which should reduce overall portfolio volatility. While we may

continue to trim international investments on an opportunistic basis, as we have done in recent quarters, we do not think it is prudent to abandon the asset class entirely.

Natural Resources Stocks - Where to Next?

As mentioned above, the one-two punch of slower global economic growth and a stronger dollar has really hurt natural resource stocks in recent weeks. Another contributing factor is that many non-traditional commodity and natural resource investors/speculators appear to be exiting their positions, exacerbating the move down in price. As a result of the recent declines, there is now discussion that the price of crude oil could even drop to \$70/barrel.

It wasn't that long ago when we all heard arguments why oil would reach \$200/barrel in the near future! We think the recent selling has been overdone. Just like we thought prices were starting to get ahead of themselves earlier, now we think the market is "oversold" and due for a near-term bounce. Sentiment on energy has fallen to its lowest levels since late 2006 - just before crude began a sharp and extended rally that witnessed a near tripling in the price of a barrel of oil. There is one thing for certain, volatility in the commodity markets will continue. (Commodities have historically been far more volatile than stocks.)

Though natural resource stocks have significantly lagged the overall market in recent weeks, it should be noted how well natural resource stocks performed over the last 3- and 5-years compared to the overall market as shown in the graph below.

S&P 500 vs. Natural Resources
(Cumulative Performance Sep 2003 indexed to 100)



More important is where we see natural resources heading over the next several years. While global economic growth and demand for commodities is expected to slow in the near-term, the basic story line that demand, especially from emerging countries such as China, will grow faster

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than production (supply) longer-term, remains intact. In short, over the next several years, the global appetite for commodities should remain strong, and it continues to make sense for long-term investors to own commodity-based securities as part of a balanced, diversified portfolio.

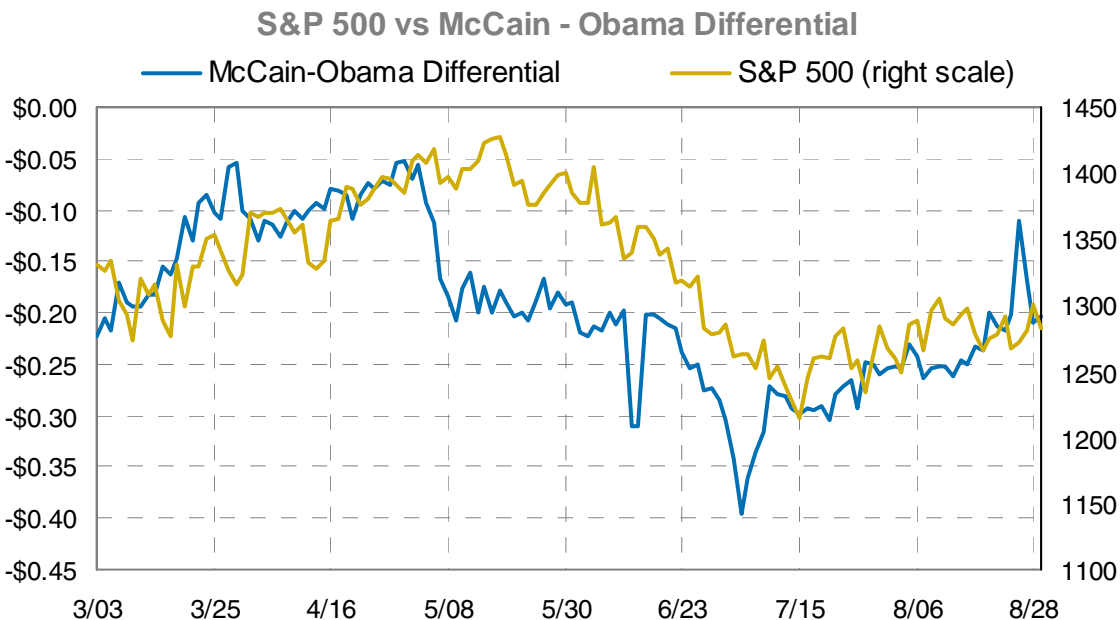
Earnings -- Bad News and Good News

Second quarter 2008 earnings are now in the books, registering a sharp drop of 23% from a year ago, roughly twice as bad as was expected at the beginning of the quarter. Since corporate executives have strong incentives to beat earnings expectations, the norm is for actual earnings to come in higher than the beginning of quarter expectations. The fact that they came in much lower isn't good. In fact, this was the fourth consecutive quarter that the actual earnings came in below estimates, and the seventh consecutive quarter of lower earnings growth period. This is a leading reason stocks have struggled in recent quarters.

The good news, however, is that going forward things look better. We have noted this key fact before, but it bears repeating: the stock market typically responds well when earnings growth starts to improve from very depressed levels - even if that improvement is only that earnings are "less bad." And earnings for the S&P 500 are expected to improve over the next several quarters. Current forecasts call for a 0.2% drop in third quarter, a 43.6% jump for the fourth quarter, and a 28.1% gain in the first quarter of 2009. Even if those expectations are reduced substantially (and we expect that they will), we still see earnings growth being a better story for the stock market than it has been.

How I Learned to Stop Worrying and Ignore the Election

The media of late has been saturated with election news and what various outcomes may mean for the economy and the stock market. In particular, it seems that the stock market is worried about a potential Obama victory in November as shown in the chart below.



The chart plots the differential between McCain and Obama (blue line) in the University of Iowa Electronic Futures market on the 2008 presidential election against the S&P 500 (gold line). Investors can buy a contract on either candidate winning the election which pays \$1.00 per contract if your candidate wins. For example, at the beginning of March, it cost \$0.60 to buy an Obama contract and \$0.38 for McCain (as in the polls, this market has been predicting an Obama victory) for a differential of -\$0.22. When that differential narrows, McCain's relative "odds" of winning are going up, and the stock market has gone up with him. Conversely, when the gap widens (blue line going down) the S&P 500 has gone down with him.

In that sense, the market seems to reflect the conventional wisdom that Republicans are better for the financial markets, but as one of our analysts, Bryan Keller, demonstrates in a recent article on our website (http://www.kobreninsightmanagement.com/Analyst_Spotlight/buckstops.html), the data does not confirm that view. In fact, the stock market generally has a higher median return during Democratic administrations.

S&P 500 Average Annual Returns (1928 - 2007)

	Median Return	Average Return
All Administrations	13.4%	11.6%
Republican Presidents	7.1%	8.3%
Democratic Presidents	19.1%	14.8%

And transitions from Republican administrations to Democratic ones have been particularly beneficial to the stock market.

Presidential Party Transitions Returns (1928 - 2007)

Average Return for Transition Period	
Republicans give way to Democrats	21.4%
Democrats give way to Republicans	-0.6%

However, before you leverage-up your stock positions, these averages were affected by two significant events:

- A positive boost for the Democrats with FDR taking over in 1933 as America was just coming out of the depths of the depression with a 58% return.
- And a negative for the Republicans as George W. Bush took over in 2001 in the middle of the fallout from the Internet Bubble bursting with a loss of 18.8%

But even with those two transitions removed the Democrats still hold sway a median return of 9.3% versus 5.5%. Some other findings from Bryan's research are as follows:

- The stock market, however, generally has a higher median return when Republicans control the Senate; and the same is true for the House
- The bond market generally has a higher median return during Republican administrations (as well as when they control congress)
- Inflation is generally lower during Republican administrations

All that said, the impact on the markets from whoever is elected President in November may be less than you think. Over the past 60 years, government spending as a percentage of GDP has averaged 19.3%, and today it stands at 21.2%. Taxes as a percent of GDP have averaged 18.1%, and today (3/31/08) the figure is 19.0%. Though these figures have wiggled about in recent decades, the overall numbers have been roughly one-fifth the size of the overall economy and this hasn't changed all that much, regardless of which political party has had the power in the Presidency, Senate or House.

Even more important, we want to stress that the future direction of the market is still much more about fundamentals, such as corporate earnings and valuations, than it is about which party is in the White House. With that perspective, we are not going to get too worked up by the upcoming elections (which is admittedly challenging), at least when it comes to making major investment policy changes. We recommend that you do the same.

Investors Take Heart

Taking all of this together, we feel that the current level of bearish sentiment on the stock market is misplaced, especially for long-term investors. The possibility for a strong U.S. dollar, improved corporate earnings, and an understanding of how the economy and markets have been historically impacted by the political party in power, suggest that the outlook should be much brighter than many investors currently believe.

Sincerely,



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