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Investment Commentary October 2008

Markets are reeling as the worst financial crisis since the Great Depression careens around the world. Major financial institutions are suffering existential, self-inflicted damages through their ownership of hundreds of billions of dollars of exotic mortgage-backed securities collateralized by rapidly declining residential real estate. In many cases, these assets have been leveraged to absurd levels using cheap short-term financing. Most of the large investment banks had ramped up their debt to equity ratios to above thirty times before this calamity began last year. It is now clear that the risk management systems these organizations touted were incapable of protecting them against a decline of this magnitude in housing prices. Federal governments worldwide are now grappling with economic rescue plans intended to support the value of these distressed securities and recapitalize the global financial system.

While it has become evident that the long-term solution to the current financial crisis is extensive deleveraging of the world's financial institutions, what we are witnessing is a rapid reduction in leverage that is creating chaotic conditions in our markets, particularly credit markets around the world. Part of this can be explained by the U.S. government's reactionary and sometimes uneven response to the crisis. In choosing to engineer a bailout of Bear Stearns, but not Lehman Brothers, by nationalizing Fannie Mae and Freddie Mac, essentially wiping out shareholders but protecting creditors, but allowing both creditors and shareholders of Washington Mutual to be eliminated at the expense of depositors, and then lending over $100 billion to AIG to keep them afloat, has collectively been devastating to market confidence. The $700 billion rescue package finally passed by Congress on September 29 is the first attempt at becoming pro-active in dealing with the stresses plaguing financial markets. Within the last few weeks it has become abundantly clear that this is no longer just an isolated problem for U.S. financial entities. The financial crisis has quickly spread throughout the world, causing European and Asian central banks to respond with massive emergency measures to sure up their markets and prevent a financial meltdown. In fact, we've finally begun to see a coordinated global effort by central banks and federal governments to stem the crisis. While a world-wide recession will likely not be averted, the measures that have been enacted should cushion the economic impact.

Panicked investors and forced selling by individuals and institutions to cover margin calls, and mutual fund and hedge fund redemption requests have led to unprecedented declines in asset prices over the past several weeks. It would be easy to go along with the crowd and panic after markets have tumbled. However, more than one hundred years of investment history has taught us that investors who capitulate at this juncture almost always end up making the wrong decision. Behavioral finance is littered with historical studies that suggest that investors who follow the crowd during extreme booms or busts inevitably make the incorrect choice. During the heyday of the internet euphoria in 1999, investors purchased record amounts of equity mutual funds in late 1999 and early 2000, just before the bubble burst. Similarly, more sub-prime loans were created in 2006 and 2007 than were created in the previous two decades, again just before the bubble burst. This follow-the-crowd instinct tends to work in precisely the same way during bear markets. Fear is just as contagious as jubilation. At the market bottom in the third quarter of 2002, mutual fund investors liquidated their investments at the highest level of the bear market. The current bear market is likely to repeat history once again as record shares have changed hands in recent weeks while markets have been pummeled. While not offering a specific prediction, recent action is indicative of the panicked selling and extreme volatility that frequently encompasses market bottoms. Reviewing the historical experience, the market eventually recovered from all shocks to the nation and threats to our nation. The table attached to the end of this report was published in the October 13 edition of Barron's. It reveals the recessions the U.S. has endured and the performance of stocks during those periods. We've rebounded from wars, threats of war, stagflation, inflation; Presidential deaths, an assassination and even one resignation; oil shocks and stock market crashes and previous asset bubbles. Sometimes these recoveries are strong and quick and other times they take longer to unfold and aren't as robust. It is hard to forecast how long or how deep this recession will be, but given the leanness of most corporations heading into this downturn, it is likely that it won't be as extensive as the two to three years the doomsayers suggest or contract as much as they may predict.

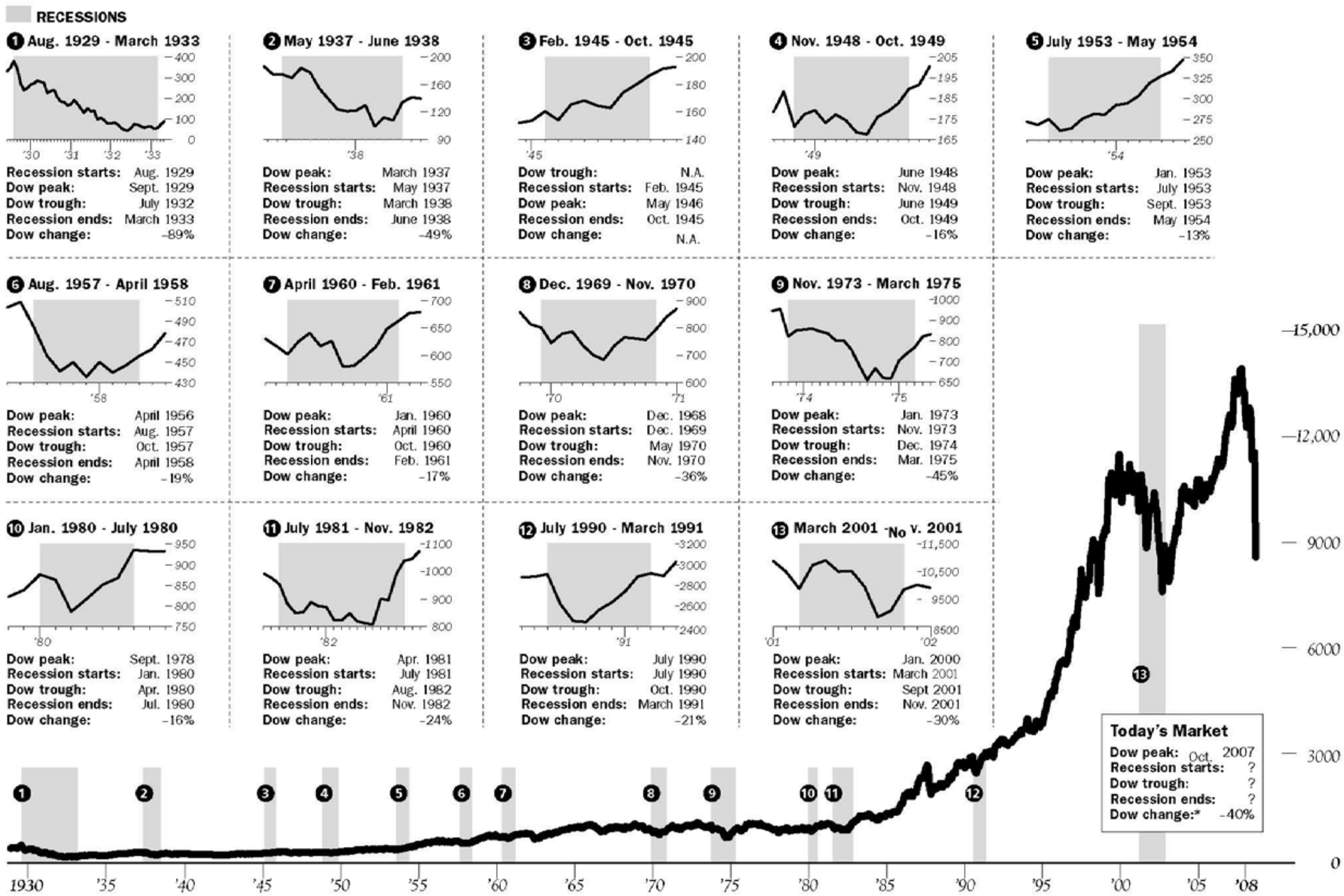
Certain members of the financial news media have likened the current crisis to the economic experience during the Great Depression. Classic economic theory labels a recession as a depression when economic activity shrinks by 10% or more. From August 1929 to March 1933 U.S. economic output contracted by more than 30%. While we may end up with a serious recession, a 1930s like depression is very unlikely. There were a myriad of fiscal and monetary policy mistakes in the aftermath of the 1929 crash which led to a decade of misery. The newly formed Federal Reserve Bank allowed the money supply to decline by 25% during the 1930s, the opposite of what the Fed is doing today by flooding the monetary system with liquidity. Also, the economy back then lacked many of today's safety nets like deposit insurance, unemployment insurance and social security. And rather than reverting to the economic isolationism that was a hallmark of the Great Depression, we now see the world economic community acting in unison.

So what do we do now? The answer depends on your circumstances. If you are still working and saving, the best recommendation is, stay the course. If you shun stocks during periods of rampant pessimism, you lose all of the benefits of dollar cost averaging by missing out on buying more shares when prices are depressed. We have always advocated gradually shifting to more conservative asset allocations as our clients' age or as individual circumstances warrant. But if you are heavier in riskier assets than you should be, we advise you not to sell when the market is in panic mode. Selling during periods like we are going through now almost never ends well because it is so difficult to discipline ourselves to get back in at lower prices. If you need to raise cash or supplement your cash flow, we advise selling on market spikes or gradually over a period of months or quarters as the market dislocations we've witnessed recently are likely to subside. If you were smart enough to sell some securities at higher prices before the market tumbled precipitously, be sure to slowly begin to invest some of the cash to take advantage of lower prices and position for the inevitable recovery. While that recovery may not be around the corner, no one will be smart enough to find the precise time or level to jump back in.

Recent experience notwithstanding, we must not forget that the U.S. economy is still the most flexible and innovative the world has ever known. And while it is true that major financial regulatory reforms are both necessary and imminent, we believe at the end of the day, the financial system will be stronger and less risky as a result of the current deleveraging and recapitalization efforts taking place. With proper oversight and a return to fundamental credit analysis, the system will be strengthened and will produce the foundation for tomorrow's innovation and wealth creation.

Stocks and Recessions: What History Tells Us

Stocks, down 40% in the past 12 months, could bottom soon if a recession started in July and proves to be of average length. Since the late1940s, recessions have lasted an average of 10 months, and stocks have hit bottom an average of three months before the economic downturn ends. The worry now is that, if the world's financial system doesn't right itself, a recession could last longer, perhaps even as long as the 16-month slump that ended in 1975. It seems unlikely the nation is headed for something much worse, like the Great Depression, which saw the economy shrink for nearly four straight years. The small charts show the Dow's moves shortly before, during and right after the 13 recessions of the past 80 years. The big chart shows the Dow over eight decades, with recessions shaded in gray.



Note: Dow change=peak to trough. N.A.=Not applicable. *From Oct. 9, '07 through Oct. 10, '08.

Sources: Bespoke Investment Group; Bloomberg; Stock Trader's Almanac