# Q3 MARKET REVIEW AND ECONOMIC OUTLOOK 2008

We had hoped to get this letter out a little bit earlier. Long-time clients have come to expect a comprehensive, quarterly commentary shortly after the end of each quarter. But, as all of you know, the market has been in a constant state of flux. We have seen the quarterly commentaries written by many of our peers that were distributed several weeks ago. Few, if any, are particularly relevant today. The forces that are moving our markets have undergone a seismic shift from fundamental to "something else." As we write this, it is abundantly clear that rational pricing mechanisms are no longer the primary determinant of individual security prices. We are caught in a vortex of forced selling that has no basis in fundamental analysis. In this letter we will try, as best we can, to explain the forces at work and the probable outcome. Please excuse us if this letter is longer than typical. This environment is anything but "typical."

Many clients have asked us how we are responding to this challenging environment. This is a unique time, and we are taking a unique approach to the rebalancing of the client portfolios. Thus, we are moving cautiously in the trading of our client portfolios. You may see that trades and rebalancing are happening on a different schedule than in the past. This is an intentional, and essential, response to a market that is being moved by non-fundamental forces. As new and valid fundamental data becomes available, we will make the trades that we believe are appropriate. We will not, however, trade into an irrational market for the sake of trading. This simply does not serve the best long term interest of our clients.

## HISTORICAL MARKET CONTEXT

> "The aspect of this bear market that is different, and unsettling, is not the magnitude, of the decline, but the ferocity."

This bear market began as a result of a series of bubbles bursting in consecutive pops. The housing market, stock market and credit market bubbles breaking at the same time was the impetus for this current turmoil. One bubble bursting would have been difficult to deal with. Handling three simultaneously has proven to be nightmarish.

As of September 30, 2008, the S&P 500 was down 8.37% for the quarter and down 23.93% from the peak of October 9, 2007. Thus far, in October alone, the market has declined by an additional 27.11%. The second week of October was truly staggering. The Dow absorbed its worst one-week percentage drubbing in its 112-year history, finishing the week down 18%. The S&P 500 also suffered its worst week ever as it fell 18%. Thus, roughly half of this bear market decline has occurred in just the last three weeks of trading. This is what we mean when we say the market is in a "state of flux."

The bear market of 2000 to 2002, which shaved 49.1% from the value of the S&P 500, ended on October 9, 2002. The S&P 500 then entered into a new bull market which lasted exactly 5 years, until October 9, 2007, after gaining 101.5%. As of October 9, 2008, this bear market was one year old and had cost us 37.1% of the value of the S&P 500. As we write this letter, we are 45% below the October 9, 2007 peak.

This is the 15th bear market since 1929, according to Standard & Poor's. This means that over the last 80 years the stock market has declined by 20% or more, an average of once every 5 years. The average decline of those 15 bear markets, including the current one, is 38%, which we have eclipsed in the current decline.

As we will discuss periodically throughout this letter, each and every one of these 15 declines was met with widespread discourse that "this time it is truly different" and "the market will never recover." In each of the 14 prior instances, this line of reasoning proved to be untrue. We see no reason to believe in a different outcome this time.

The aspect of this bear market that is different, and unsettling, is not the magnitude of the decline, but the ferocity. The only decline of similar speed and magnitude was the crash of 1987 in which the market lost a third of its value in three months.

Significant market declines often occur due to a repricing of securities given a changing fundamental backdrop. In recent history there have been only 3 other occasions where we have seen declines of this magnitude: 1973-1974, 1987 and 2000-2002. In 1973-74, the decline was a rational repricing given a backdrop of hyperinflation, double-digit unemployment, double-digit interest rates and the Arab oil embargo. The economy was in dire straits and the decline seemed appropriate. The declines of 1987 and 2000-2002 were in large part a correction of significant overvaluation in the markets. At the peak in March 2000, the price-to-earnings ratio of the S&P 500 stood at 30. In other words, although they had different root causes, all these periods had their basis in a rational repricing of securities due to economic conditions or market valuations. Put simply: fundamentals. The current decline has been unique and has taken place in two distinct stages. The first part of this decline was a rational repricing of securities given a likely global recession and an unprecedented financial crisis. Quite simply, the market needed to adjust to a slowing global economy in the wake of a financial crisis brought on by the toxic mortgage meltdown. But an interesting thing happened on the way to finding a bottom: the massive deleveraging of hedge funds.

## HEDGE FUNDS

Shell shocked investors are looking in the wrong places for the answer to the market's recent thrashing. There is a tendency for the media to spoon feed us readily available and easy to understand explanations for complicated financial events. As such, the media tells us that the wilting economy and gloomy earnings forecasts are the primary drivers behind the recent sharp market declines. There is no doubt that the prospect of recession and lower earnings are factors. The fundamental news, as we all know, is bad, but it is largely known and has been known for some time. Further, these fundamental problems are being proactively addressed by public and private sector initiatives. But the real reason, which has not until recently received nearly the media coverage it truly warrants, is the unprecedented and mammoth liquidation that is occurring at the hands of highly leveraged hedge funds.

For years, against a largely unregulated backdrop, hedge funds have implemented strategies which utilize unfathomable amounts of leverage. We are not talking about the kind of leverage with which the average investor is familiar. Anyone that has purchased stock on margin knows that you can only borrow up to 100% of the actual value of the holdings. This is leverage of 2 to 1. On the real estate front, a borrower who places 20% down controls an asset worth 5 times as much. So their leverage is effectively 5 to 1. Hedge funds typically lever their assets to the tune of 10, 20, sometimes even 30 to 1. Thus, $1 billion in redemptions at a hedge fund can lead to the liquidation of up to $30 billion in assets!

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The actual amounts involved in ongoing hedge fund deleveraging are mind boggling. Estimates vary, but the total size of the domestic hedge fund industry was approximately $1.8 trillion at the end of September. About a third of this was controlled by so-called "funds-of-funds," which are hedge funds whose holdings are other hedge funds. The almost unbelievable aspect of these funds-of-funds is that they are often leveraged themselves. Thus, we are experiencing the unwinding of not only hedge fund leverage, but the leverage of the funds that hold them.

The root of these redemptions, as investors flee these funds, is the poor performance of the funds in the third quarter. Many of these funds offered investors the "too good to be true" proposition of positive returns, albeit small, in all market environments. Unfortunately, many of these funds did not deliver on this promise in the third quarter and investors responded by fleeing in droves.

Redemptions in August and September were huge, totaling about $60 billion. The high level of redemptions, together with the negative performance, has resulted in hedge fund assets falling precipitously in the third quarter. The total decline in hedge fund assets was on the order of $160 billion. That was in the third quarter alone. Unfortunately, as demonstrated by the recent market slide, these figures are likely to be eclipsed when the data for October is released.

The constant selling creates a vicious cycle. Hedge fund liquidations cause security prices to fall. The fall in security prices causes the individual investor to panic. This fear leads the individual investor to sell their holdings, including their mutual fund shares, which adds to the downdraft. The mutual funds are then forced to liquidate their holdings to meet investor redemptions. As the market continues to fall, investors who have leveraged or margined positions are forced to sell to meet margin calls. This causes further pressure on the market and the cycle begins anew.

For now, however, it is imperative that investors realize that the selling we are seeing now is not the work of rational human beings. Rather, it is the result of the largest deleveraging in financial history. Further, it is vitally important for investors to realize that the prices of many individual securities right now are completely divorced from rational valuations because of this forced selling.

Please do not misunderstand us. We are not saying that all is well. We are certainly facing significant systemic and economic challenges. It is not our intent to whistle past the graveyard. Certainly, a discounting of the fundamental backdrop is playing some role in this decline. But, there can be no doubt that the main driver of October's incessant decline is the forced selling throughout the system.

There is an immense amount of cash currently accumulated on the sidelines. There are several trillion dollars sitting in money market funds, and several trillion additional dollars that have fled to Treasury bills. This does not include the $5 trillion in additional cash in household bank accounts, the more than $2 trillion controlled by sovereign wealth funds, the $2 trillion in private equity funds nor the $1 trillion on corporate balance sheets.

In sum, we don't mean to be trite, but the decline will end when the selling abates. This decline is not about any fundamental, rational repricing of securities. Not anymore. It is about deleveraging, forced selling, and the cascading panic that results. It is our belief that security prices have vastly over discounted any likely economic scenarios. More on this later…

The forced selling on the part of hedge funds has impacted our client portfolios in more than just the obvious manner. Many of these hedge funds look for the same high quality, undervalued attributes that we use in selecting securities for our client portfolios. Thus, with no regard to the underlying fundamentals, many of our holdings have been caught in the tsunami of hedge fund selling.

As the hedge funds are forced to liquidate assets, they have reacted by selling, in large part, the most liquid investments they own: large cap equities. According to research by Goldman Sachs, the 50 U.S. stocks to which hedge funds are most exposed, dropped 19% in September - double the loss of the S&P 500, which fell 9%. In contrast, the stocks that had a low concentration of hedge fund ownership lost just 2%. In the third quarter as a whole, these "low concentration" stocks actually rose 2%, even as the S&P fell 8%. This dynamic of high quality stocks underperforming their low quality counterparts has continued in October. This will end, and when it does, we believe the high-quality names we hold will be repurchased by the very same funds that have spent the last few months discarding them.

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Although our portfolios could not escape the impact of this massive deleveraging, we would like to point out that our client portfolios did not hold a single share of any of the financial companies which no longer exist or were taken over at gun point: Bear Stearns, Fannie Mae, Freddie Mac, Lehman Brothers, Merrill Lynch, American International Group, Washington Mutual or Wachovia.

**THE GREAT DEPRESSION II?**

People are comparing this period to the Great Depression. This could not be further from the truth. The economic conditions we are facing in no way resemble those present during a Depression. Depressions are characterized by unemployment and GDP contraction in the range of 20%. By comparison, today's unemployment is currently running around 7%, and we have yet to experience even a single quarter of negative GDP growth.

We acknowledge that unemployment will increase and GDP will contract. However, the consensus view among economists calls for the unemployment rate to peak at 10% and GDP to contract by no more than 2%-4% over the next couple of quarters.

Looking back, during the years of the Depression, the policy makers did everything wrong. The government delayed its response for too long, and the initial policy moves were incorrect. The downturn was allowed to entrench itself. In the Depression, the government raised taxes and increased interest rates. Money supply shrank by one-third between 1929 and 1933. In other words, it took money out of the economy at the worst possible time. Without money, people lost their jobs and went hungry, individuals could not finance their businesses, and banks failed en masse. This time, in response to the crisis, the government is doing the exact opposite.

The Federal Reserve also made several key policy errors during the Depression that are not being repeated in this crisis. In fact, the Fed kept lending tight during the 1930's, while today's Fed is pumping hundreds of billions of dollars into the banking system to try to restart lending and spur economic activity. Thus, today the system is being flooded with liquidity. The Fed's balance sheet started the crisis at about $900 billion and will probably be close to $2 trillion by year's end. Central banks around the world are acting in concert to provide liquidity. It is anticipated the government has, or will, put at least $2 trillion into the banking system. This does not equal $2 trillion in benefits to the economy. It actually equals $10-$20 trillion, as it is estimated that there is a 10x multiplier for every dollar the government puts into the bank system. With so much stimulus it will be very difficult to sink into a depression.

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Also, in contrast to rate hikes enacted at the onset of the Great Depression, the Fed is now aggressively lowering rates. "Don't Fight the Fed" is an old adage that is used to justify buying the stock market while the Fed is engaged on a path of lowering interest rates. Unfortunately, the effect of these lowered rates is not always immediate. Stimulus via interest rate changes typically takes 6 to 18 months to have its effect on the economy. The one thing that makes this situation different is the amount of stimulus being put into the system. It is truly global in nature.

The Fed, Treasury and FDIC have confronted the issues we face today and have taken the steps that weren't taken during the Great Depression. The globally coordinated interest rate cuts, the Troubled Asset Relief Program (TARP), the huge expansion of the Term Auction Facility, paying interest on bank reserves, a new program for the Fed to buy commercial paper directly and the ability of corporations to tap overseas cash without tax liabilities will serve to liquefy the system. In fact, the $700 billion earmarked for purchasing assets in the TARP plan represents almost two-thirds of the S&P 500 financial sector's market cap. In other words, the Treasury could open up its wallet and buy over half of the entire financial sector!

## THIS TIME IT'S DIFFERENT

The media has an agenda. They are incessant. We have never seen anything like it. Time magazine recently featured a cover photograph of Americans standing in soup lines during the Great Depression, as if this was analogous to the current situation. We think that is completely irresponsible and a perfect example of the fear mongering rife throughout the media's coverage of this decline. A recession is not a depression. We have had many recessions and even more slowdowns this century. But only one single depression. Just one.

Every downturn brings with it the inevitable chorus of predictions and self-(or media) appointed experts who explain to us with very solid arguments that the absolute worst-case scenario is the likely scenario. Thus, a recession, which has happened numerous times and from which we have emerged each time, must necessarily become "the Great Depression II." One of the most important tenets to remember regarding markets, economy and life in general, is that the possibility of the most dire outcome does not in any way equate to its probability. We, as a country and a people, over the last century have faced two World Wars, Vietnam, Korea, famine, pestilence, social unrest, the assassination of a President on our city streets, a disgraceful resignation of a President, terrorist attacks on an unimaginable scale, a Cold War which spanned for decades, and untold numbers of additional crises and challenges and yet, despite all of this, at no point was "this time it is different" truly different. We have emerged from every challenge battered but undefeated. The American economy and the stock market have always continued their march higher.

While the problems that the economy is facing are substantial, and the fear permeating the market widespread, we still remain confident that we are not headed for some sort of great calamity that will destroy the economy and stock market as we know it. One reason is that, throughout history, the economy and market have continually and repeatedly faced challenges that were deemed "unprecedented," and each time they have recovered and pushed ahead.

There is a tendency to say and believe that "this time things are different." Remember the Cold War and communism? That was supposed to last forever. We recall hearing in the 1970's how we had to get used to the oil embargo and double digit inflation as a new way of life. In the 1980s, we heard how Japan would dominate the world. In the 1990's, we heard about the "new paradigm" during the tech and internet bubble. We are now hearing that stock returns will never revert to historical long term norms (10% per year, over time). Thus, in good times and bad, people become convinced that as we swing to polar economic extremes that the world has changed forever. Fortunately, we later find out that good old-fashioned economics has a built in mean-reversion feedback process.

In the fullness of time, no other asset class can hold a candle to stocks. Over the course of the last century, stocks don't beat every other category by just a bit. Stocks outperform, by double or more, all other asset classes. If the market compounds for the rest of this century at the same rate as in the last one, the Dow Jones Industrial Average will reach 2,000,000 in the next 91 years!

The lesson of history is this: The 10 U.S. recessions since World War II have lasted an average of 10 months, and stocks typically hit their low point about three months before the recession ended. And a year after those market troughs, the S&P 500 has been up an average of 37%. Thus, if the U.S. entered a recession on July 1, as many economists now suggest, and the recession was to last until April 2009, a typical bottom for stocks would occur some time in the next couple of months.

**MR. WARREN BUFFETT**

Although no one has a crystal ball, some have been more prescient in the past than others. And although not every investment he has made has proved to be successful, there is no doubt Warren Buffett stands alone as the most successful equity investor of our time. So, when Mr. Buffett speaks, it may make sense to pay heed to his words.

The following are a few quotes from one of the most respected value investors of our times:

In 1973, at the height of the market, he said: "I feel like an oversexed guy on a desert island. I can't find anything to buy." In 1974, close to what proved to be a market bottom, he reversed his stance and said: "I feel like an oversexed man in a harem. This is the time to start investing." He was right. Over the two-year period following Warren Buffett's 1974 call, the DJIA and the S&P 500 soared by 86% and 70%, respectively.

In 1979, in an interview in Forbes magazine, Buffet stated: "Stocks now sell at levels that should produce long-term returns far superior to bonds. Yet pension managers, usually encouraged by corporate sponsors they must necessarily please, are pouring funds in record proportions into bonds. Meanwhile, orders for stocks are being placed with any eyedropper…. Can better results be obtained over, say, 20 years from a group of 9.5% bonds of leading American companies maturing in 1999 than from a group of Dow-type equities purchased, in aggregate, around 13% on that book value?...How can bonds at only 9.5% be a better buy?" Over the next two decades, the S&P achieved an annualized return of 17.3%, nearly twice the average 9.5% return for bonds.

On October 17, 2008, Buffett wrote an optimistic New York Times editorial piece. In it, he enthusiastically recommended an investment in U.S. stocks. Only with the benefit of hindsight will we know whether this latest market call will be proven right. But, what we do know is that he rarely makes this sort of pronouncement, and when he has done so in the past, he has tended to be correct.

To read the full text of Mr. Buffett's comments, go to The New York Times website and search for "Buy American. I Am." We highly recommend this to all of our readers.

In order to entice you to read the full text, we include the following excerpt:

"A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors. To be sure, investors are right to be wary of highly leveraged entities or businesses in weak competitive positions. But fears regarding the long-term prosperity of the nation's many sound companies make no sense. These businesses will indeed suffer earnings hiccups, as they always have. But most major companies will be setting new profit records 5, 10 and 20 years from now."

"Although we may not know for sure when things will turn around, we know for sure they certainly will."

"Over the long term, the stock market will be good. In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497."

"You might think it would have been impossible for an investor to lose money during a century marked by such an extraordinary gain. But some investors did. The hapless ones bought stocks only when they felt comfort in doing so and then proceeded to sell when the headlines made them queasy."

**POSITIVE CONSIDERATIONS**

Here are some additional facts that you should know:

- The price to earnings ratio at the peak of prior bull markets averaged 20 times earnings. This ratio has averaged 12 at the end of previous bear markets. According to Standard & Poor's, the price to earnings ratio of the market on projected 2009 earnings stands at 10 for the S&P 500. In fact, recently, 50% of S&P 500 companies were selling at price to earnings ratios of 10 or below. This is unparalleled in recent history.

•As compared to the October, 2002 low, many of the most widely watched valuation indicators are at much more attractive levels today than they were then. The price to earnings ratio, the price to book ratio, and the price to sales ratio for the S&P 500 are all lower now than they were in 2002. Also, dividend yields are higher and market interest rates are lower, including the Fed Funds rate and the 10-year Treasury yield.

•Historically speaking, it can be argued that stocks are the cheapest they have been in a generation. As Ken Fisher wrote in Forbes this month, "Unless you are in your late 80's and were an adult as World War II ended, stocks are cheaper, adjusted for tax rates and interest rates, than they've been at any time in your adult life. That's a simply stunning statement looking forward." Fisher's advice: "Buy great franchises at cheap prices now and be patient." We agree.

•In the past, when stock returns have been as dismal as they have been over the past ten years, it has been a great time to buy. History never repeats itself exactly, but Goldman Sachs recently conducted a study which suggests that the market's collapse has likely created a nice opportunity for long term investors. They examined U.S. large-cap ten year rolling annualized returns from 1827 to the beginning of October, 2008. They found only 5 instances over the last 180 years where the 10-year return was as low as it is today. In every one of those cases, the market was dramatically higher over the following 6 to 12 months. In point of fact, each one of the prior instances signaled the beginning of a "multi year "mega" bull market."

Although we may not know for sure when things will turn around, we know for sure they certainly will. While the Great Hedge Fund Unwind comes with a degree of uncertainty regarding the short-term outlook, we must recognize that forced selling over the course of stock market history (e.g., the end of the Nifty Fifty era in 1974, the dumping of stocks during the portfolio insurance plunge of 1987, the margin calls on tech stocks after the 2000 crash) has nearly always marked an important point leading to an upturn in stock prices.

For now, the bull market in fear, concerns regarding a "Great Depression II", and the continued deleveraging of the hedge funds and funds-of-funds remains foremost. A delay in a significant market rebound, forced selling aside, is not really surprising in light of the now deeply-rooted anxieties that exist among investors. It will take time for frayed nerves to calm and for emotions to catch up to the facts. What are these facts? The most important include: oil is down, inflation is receding, the Fed is and will remain accommodative, the credit markets are thawing, another round of fiscal stimulus may be coming, financial institutions' balance sheets are being shored up, massive amounts of liquidity are being pumped into the system, stock valuations are bordering on ludicrous, investor sentiment is at record negative levels (a fairly reliable contrarian indicator), and forced selling by executives, individuals, hedge funds and funds-of-funds has historically marked a market bottom.

More important than ever, we appreciate the continued trust and confidence as we maneuver through these turbulent times. Please do not hesitate to give us a call to discuss your investments or to schedule a personal meeting.

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