Commentary - 3rd Quarter 2008

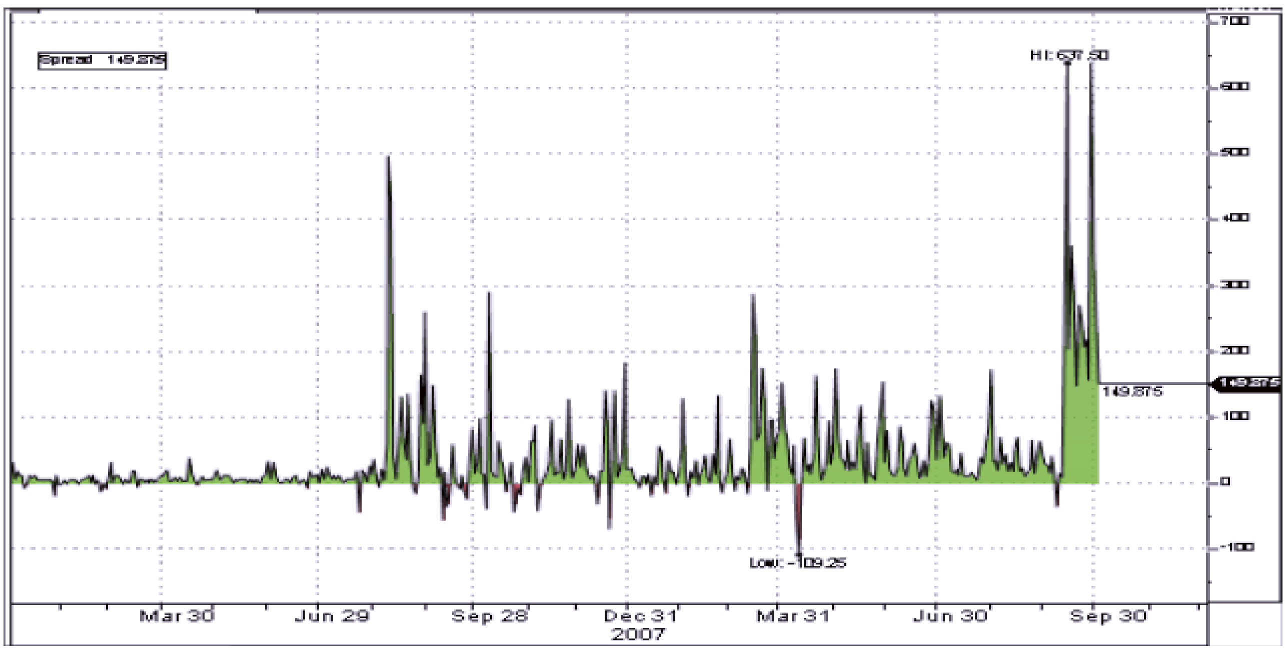
At this writing the United States House of Representatives is voting on whether or not to approve the Treasury's plan to rescue the domestic financial system by establishing a $700 billion fund to purchase poorly performing mortgage backed securities and other loans from U.S. financial institutions. It is very disappointing that the situation has come to this point. There is plenty of blame to go around to various parties involved in this mess, but the focus needs to be on fixing the mess and getting the economy back on its feet. The Dow Jones Industrials fell 3.72% for the quarter while the S&P 500 fell 8.37%. Many other sectors suffered much worse performance during the quarter. For the first nine months of 2008, the Dow is down 16.59% and the S&P 500 is down 19.28%. Both big cap indices are down over 20% from their highs last October.

The big news during the quarter consisted of the federal government's takeover of Fannie Mae and Freddie Mac, the failure of Lehman Brothers, the government bailout of AIG, and the FDIC's move to take over some of the nation's largest banks. Not much, really. The credit crisis that engulfed the markets beginning in June of 2007 has reached tidal wave proportions. Financial institution after financial institution came under selling pressure as investors feared that the persistent weakness in the housing sector would cause more losses for the banking system. There has not been a crisis like this since the Great Depression. Unfortunately, the problems in the banking system are now passing through to the broad economy because banks are not making credit available to businesses and consumers. The problems of Wall Street are now directly affecting Main Street. Car sales in September fell 27% versus last year. Non-farm payroll employment has fallen every month this year. Commodity prices are plummeting because demand is falling off a cliff.

The rescue/bailout package is an attempt by the Treasury department to acquire mortgage backed securities and other loans from financial institutions that are performing poorly and have fallen in value significantly. The lack of buyers for these types of securities has resulted in dramatic declines in their market values. Since banks have to lower their carrying value of investments to market value on a quarterly basis due to "mark-to-market" regulations, they are taking "paper" losses on a regular basis that reduces their capital and their ability to make loans. A vicious cycle ensues where banks take writedowns, their ability to lend is reduced, borrowers face more stringent lending standards, it becomes harder to finance a home purchase, home sales fall, and lower housing prices are required to clear the market. Lower home values decrease the equity a borrower has in their home so they are more likely to walk away from it or stop paying the mortgage, once again decreasing the value of the bank's portfolio. Rising job losses also result in more defaults on mortgages.

The banks are stuck with these depreciated securities on their balance sheet so their ability to make new loans is severely restricted. They have become so risk adverse, that now they are not even lending overnight funds to each other. Banks can borrow from the Federal Reserve at the Fed Funds rate of 2.00%. Banks typically lend to each other at a rate close to the Fed Funds rate. In Europe, the banks lend to each other at a rate that usually tracks very closely with the Fed Funds rate, called LIBOR (London Inter-Bank Offered Rate). The banks in Europe have lost trust in each other and the rate at which they will lend to each other has skyrocketed. The graph below shows the spread between Fed Funds and LIBOR since the end of 2006. Prior to the credit crunch the average difference in interest rates between Fed Funds and LIBOR was 0.10% (ten basis points). Since last June, the spread has averaged 0.35% and recently hit 6.375%. If banks are too scared to lend to each other, they sure aren't going to lend to consumers or small businesses.

Graph 1. Spread Between Fed Funds and LIBOR, 1/2/2007 to 10/3/2008. Source: Bloomberg



The rescue package is intended to take a large portion of these poorly performing assets off of bank balance sheets. Then banks should be able to raise new capital and begin lending again. Some experienced investment managers that are active in the mortgage backed security area think that the Treasury could make a substantial profit on their purchases as the housing market recovers and homeowners make their mortgage payments. The Treasury does not have to worry about "mark-to-market".

The financial crisis gathered momentum when Lehman Brothers was allowed to fail. Lehman was a counterparty to enormous amounts of derivatives. A derivative is a contract between two parties that is based on the change in value of some type of investment or cash flow. Interest rate swaps, total return swaps, over the counter options, and many other kinds of contracts qualify for this label. Lehman was a big player in writing and trading these contracts, as were the other major investment banks and commercial banks. When Lehman failed, many of the counterparties to contracts with Lehman were left with an unsecured creditor claim against the bankruptcy estate. They suffered huge losses. An event they never expected to happen did in fact occur. We believe many holders of derivatives scrambled to hedge or exit their other positions with investment banks after Lehman failed. This tsunami overwhelmed AIG, one of the world's largest insurance companies. The Fed and the Treasury were forced to act to keep the financial system from disintegrating.

We have always been advocates of free markets and creative destruction capitalism. Unfortunately, over-leveraging in the housing market was influenced by many political factors, poor regulation, and greed. Market discipline was not enforced because regulators and politicians kept lowering the standards of what was an acceptable borrower. Wall Street has always been driven by short term profit motivation. When they could package these low quality mortgages into securities and take a huge profit margin, they wanted more. As long as housing prices were rising, this business model worked. When housing prices stopped rising, the game ended.

Now fear and panic are driving the market. Greenspan commented about "irrational exuberance" during the tech bubble of the late 1990s. The current market is being driven by irrational behavior at the opposite extreme. Financial market valuations on many types of securities have no bearing on the fundamentals of the issuing company. A rescue package of $700 billion should take much of the "toxic" investments off of the banks' balance sheets. It should stabilize the financial sector. As markets begin to calm down, investors will begin to put some of their money market investments to work in higher returning alternatives. The most astute investor of this generation, Warren Buffet, is taking advantage of the opportunities to purchase attractively priced companies. He bought Constellation Energy, an eastern utility, and made major investments in Goldman Sachs and General Electric. He may not be able to pick the bottom of this market, but he knows that this country has tremendous assets and that they are on sale right now.

Here is a look at our asset class strategies:

Blue Chip Strategy: Our large cap stock strategy fell 3.66% in the quarter versus a decline of 8.37% in the S&P 500 Index. For the first three quarters of the year, the strategy is down 16.72% versus 19.32% for the S&P 500. The dividend yield on the portfolio is now over 3.0% with a trailing price to earnings multiple of 12.68. Amazingly, the strongest performers in the strategy during the third quarter were the big banks – Bank of America up 49%, Citigroup up 24%, and JP Morgan up 37%. How's that for an example of "survival of the fittest"? The worst performer was American International Group. AIG suffered from its exposure to derivatives called credit default swaps and had to be bailed out by the Treasury. The Treasury now owns 80% of AIG and has loaned them $60 billion to meet liquidity needs. AIG is attempting to sell some non-core assets as quickly as possible to pay off the government loan. Due to AIG's difficulties, they were dropped from the Dow Jones Industrials, upon which our portfolio is based, and they were replaced by Kraft Foods Inc. Could it be a positive sign that the banks were the strongest performers in the Dow? The financial sector led us into this debacle, maybe they will lead us out. We think it is a positive sign that Wells Fargo is making a strong bid for Wachovia that does not depend on government assistance.

Small Cap Value Strategy: Our small cap portfolio is still our best relative performer for the year to date. The strategy fell 5.99% in the third quarter versus a decline of 1.11% for the Russell 2000 Index. For the first three quarters of 2008, our small caps are virtually flat, gaining 0.12%, versus a decline of 10.38% for the Russell 2000. The strongest performer in the portfolio was Xerium Technologies, one of our purchases earlier this year that makes cloths and rollers for paper manufacturing machines. Xerium gained 62% during the quarter as they reported better than expected earnings and paid down debt. The weakest position in the portfolio was Genco Shipping, a dry bulk shipping company. Genco suffered from the drop in shipping rates, the drop in commodities prices, and the fears of a severe global economic slowdown. Remember, we sold half of our position in Genco in May when it was trading over $84 per share. It now trades around $30 with a 13% dividend yield based on their $4.00 per share expected dividends. Genco's revenue is not closely tied to spot shipping rates since they enter into long term contracts with their customers. They are another instance of market valuations not making much sense. The small caps are suffering from a lack of liquidity as investors liquidate positions and move to safety. We expect to see a strong recovery in the portfolio when the markets stabilize.

Convertible Securities/High Yield Strategy: It was a terrible quarter for the high yield bond sector. Our high yield convertibles strategy fell 11.08% while the Merrill High Yield Index fell 9.48% and the Merrill Convertible Index fell 15.01%. Through the first three quarters of the year, our strategy is down 18.33% versus the high yield index being down 10.60% and the convertible index being down 17.71%. Our convertible preferred issues performed the weakest during the quarter, falling 33% on average. Ford is under severe pressure as car sales dwindle. They may receive a lifeline from the government as a $25 billion loan package for the auto manufacturers was approved recently. United Rentals is weak due to the slowdown in commercial construction. AES was down with the utility sector that fell 18%. We had three positions with strong gains. Trex bonds were up 32% when earnings came in better than projections. Continental Airlines bonds recovered 30% from their severely depressed levels from the prior quarter as fuel prices declined. And Encore Capital gained 11% as their earnings report was strong and this economic environment will provide many opportunities for their debt resolution business. With credit markets frozen and the economy weakening, leveraged companies are under selling pressure. Yield spreads versus Treasury bonds have widened out to historical highs; levels not seen since the tech sector meltdown in 2001-2002. Many high yield bonds now yield over 18%. If we are successful in owning companies that do not default, the future returns should be extremely attractive.

Intermediate Bond Portfolios: The Intermediate Bond Portfolio fell 2.89% in the third quarter compared to the 1.25% decline in the Citigroup 1-10 Year Government/Corporate Index. For the year-to-date period, our intermediate bonds are down 2.12% versus a gain of 0.30% for the index. Our Intermediate Tax Exempt Bonds declined 1.55% for the quarter while the Merrill 3-7 Year Insured Bond Index gained 0.52%. In the first three quarters, our tax exempt bond portfolio is down 1.53% versus a gain of 1.57% in the index. The flight to quality hurt our bond portfolios because the only fixed income securities that performed well were U.S. Treasuries. Even federal agency securities underperformed, but most of them are now explicitly backed by the same creditor as Treasuries. The Merrill municipal bond index outperformed our portfolio because it consists of more bonds that have been pre-refunded and are escrowed with Treasury securities. Yields on high quality corporate bonds increased dramatically versus Treasuries as investors fled any kind of credit risk. When some money market funds announced that they could not maintain their $1.00 share price because they owned Lehman bonds, credit fears became contagious and 90-day maturity Treasury bills traded at 0.05% interest. In other words, investors did not care about earning any interest; they only cared about getting their money back at maturity. We have seen high quality municipal bonds selling at yields that are 130% of long term Treasury bonds. An investor has to pay federal income tax on the interest from Treasury bonds. For conservative investors, we think the opportunity to own tax exempt bonds at current market yields is very attractive.

We were wrong last quarter when we suggested that the worst of the credit crisis was behind us. It now appears that we are in the midst of the climax to this story. We understand that the financial market volatility makes you anxious and unsettled. We are anxious and unsettled too. We did not expect the perfect storm to hit, but it has. This kind of market event has only happened one other time in the last century. Fortunately, policymakers have a much better understanding of what is happening and have many more tools to deal with the problems. We must stick to our convictions that the country's economic system is sound. We agree with Warren Buffet that this country has incredible assets: natural resources, a skilled workforce, and intellectual ingenuity. Many of our publicly traded companies are world leaders in their fields. They are on sale. Many cost 50% less than they did a year ago. They will survive this economic crisis and patient investors will reap the benefit.