

Commentary - 4th Quarter 2007

We extend our best wishes for a Happy New Year. As we enter 2008, the financial markets face many of the difficult issues that were the cause of volatility and weakness in the second half of 2007. Many economists now project a 40% chance that the domestic economy will experience a recession this year. By our view, the housing sector has been in a recession for the last year. The question was whether it would spillover into the broad economy. After the subprime mortgage crisis and the credit crunch hit, the hope was that foreign economic strength and a resilient consumer could keep us out of recession. Now it appears that growth in foreign developed countries is slowing and after last Friday's employment report, the domestic consumer may pull back too. The Federal Reserve has been slow to react to the potential negative effects that the credit crunch is having on the domestic economy. Whereas nine months ago credit was freely available and stimulated economic activity, now banks are reluctant to lend against any kind of projects. Many of the money center banks are having to focus on increasing their capital base due to losses on subprime mortgage positions and exposure to leverage buyout loans they cannot sell. The last thing they want to do is make new loans that require more capital. This situation offers an opportunity for regional and community banks that did not take on subprime mortgage exposure or participate in silly housing and construction finance deals to take market share back from the big guys who stayed too late at the party.

Credit problems can take a while to work out. Our last recession was relatively mild after the 2001 terrorist attacks and the dot com meltdown. The previous recession in 1990 was due to the Savings and Loan mess and many banks failed because they were not adequately capitalized when their investments soured. Congress created the Resolution Trust Company to liquidate the real estate holdings of the S&Ls and banks that were taken over by the regulators and that process took many years. That is why the current administration is working hard to avoid a wave of foreclosures on individual homeowners. A surge in foreclosures will really clog the financial system because most mortgages are packaged into securities and sold to investors. Foreclosures will cause missed payments on these securities and more writedowns in the value of the securities for banks, hedge funds, and other investors. As banks are forced to take losses, they are less likely to make new loans until the losses stop.

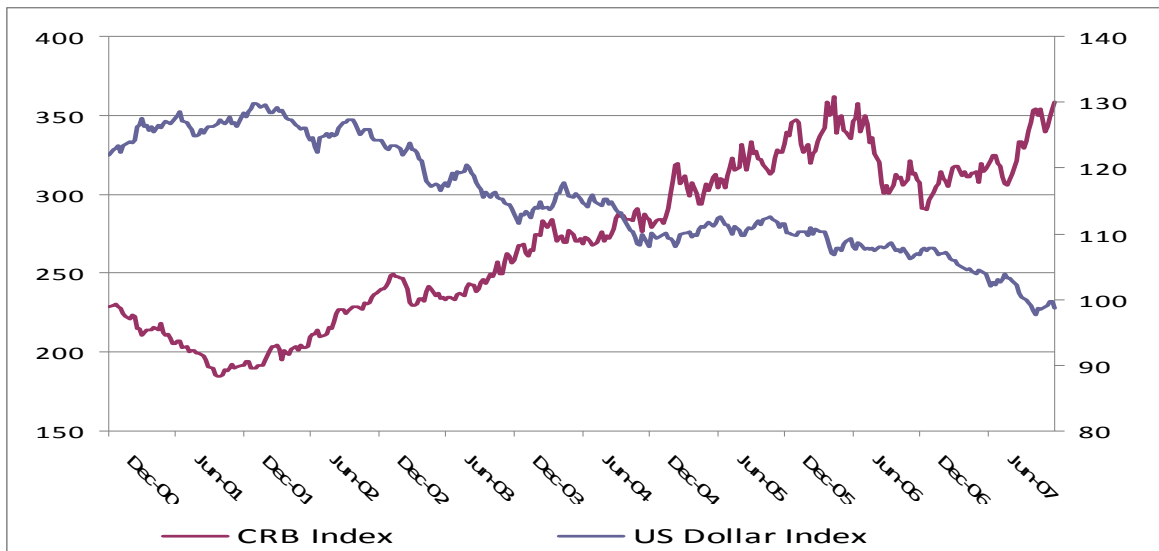
The Federal Reserve has been actively trying to help banks with their short term liquidity needs but they have been slow to lower the Federal Funds rate. They are concerned that if they are too aggressive in lowering the Fed Funds rate, they will be seen as bailing out the investors that made foolish decisions regarding subprime mortgage securities, collateralized debt obligations, and leveraged buyout loans. The Fed's objective of not protecting investors is a worthy one, however, the situation is bad enough that if they don't move more aggressively, the rest of the economy is going to suffer. Many investors in esoteric mortgage

securities have already taken their losses. More than a few CEOs of money center banks and global investment banks are going to lose their jobs. Many of the big investment banks have seen their share prices fall by half. The Treasury bond market is indicating that the Fed needs to move more aggressively since the yield on the two year maturity Treasury note is at 2.75% versus the Federal Funds rate at 4.25%. Usually those two yields are within plus or minus one half of one percent of each other. The Fed's gradual approach of raising or lowering the Fed Funds rate by one quarter of one percent at each meeting is not going to meet the needs of the financial system.

Which brings us to constraints on the Federal Reserve and their potential move to aggressively lower short term rates. The value of the dollar versus a basket of foreign currencies has fallen over 8% in the last year. It has fallen over 30% in the last five years. The Federal Reserve is concerned that weakness in the dollar will put more upward pressure on inflation. In their view, if they lower interest rates, the dollar may fall more and inflation will worsen. That might be the case, but our opinion is that if they lower interest rates and rescue the economy, the dollar will strengthen. Once the dollar strengthens, the Fed must recognize that commodity prices in dollar terms reflect whether they are providing too much financial stimulus or not enough. The graph below shows the value of the U.S. Dollar versus a basket of foreign currencies and the Commodity Research Bureau's commodity price index since 2000. Obviously, weakness in the dollar explains much of the surge in commodity prices. The Fed was providing too many dollars to the financial system. The Fed ignored market prices for commodities, and housing in particular, and now we are paying the price for their laxness. Once they lower interest rates enough to get the economy back on its feet, they must follow commodity prices as an indicator of whether they are being too easy or too tight on monetary conditions. The old gradual method of moving short term interest rates twenty-five basis points at a time leads to predictability that financial speculators will take advantage of. The Fed must be more disciplined in their approach to monetary system management and not ignore market price indicators. Otherwise, our currency will continue to decline and inflation will accelerate. That would be very detrimental to our securities portfolios.

On the positive side, corporate balance sheets are in decent shape. The stock market already has a recession priced into current values. The consumer has shown resilience to all the bad news and may not need much help to keep on spending. Sovereign wealth funds are providing a much needed source of capital for the financial system during this time of stress. And the Federal Reserve is lowering interest rates; they are cognizant of the risks to the economy. There may be more downside to the stock market, but a lot of bad news seems to be priced into the market already. We are seeing many cheap opportunities that we have not seen in a few years.

Graph 1. U.S. Dollar Index and CRB Index, December 31, 2000 to Present. Source: Bloomberg



Whereas in 2006 we think our portfolio performance graded as an “A”, 2007 looks to be more like a “B-”. Our Blue Chip Strategy beat its benchmark and the Small Cap Value Strategy beat its benchmark, but our strong mid-year performance dissipated in the second half of the year. Our bond strategies generated positive returns but they trailed their benchmarks and the Convertibles Securities Strategy barely stayed positive for the year. Here is a look at the individual strategies.

Blue Chip Strategy: Our large cap equity strategy gained 8.58% for the year, even though it declined 3.90% in the fourth quarter. Its benchmark, the S&P 500 Index, fell 3.36% in the fourth quarter and rose 5.48% for the year. The financial stocks in the Dow Jones Industrials hurt performance with Citigroup falling 44%, American Express down 13%, and AIG down 17%. Portfolio performance was helped by many of the industrial names that had exposure to global growth including United Technologies up 24%, Coca Cola up 30%, Honeywell up 38%, and Merck up 37%. The Blue Chips are reasonably valued at 15.4 times estimated earnings and a 2.34% dividend yield. They benefit from a weaker dollar as they have high exposure to foreign sales. If the financial sector stocks can stabilize by raising capital, stemming the write offs of bad investments, and better margins from lower interest rates, we could see a nice rally in 2008.

Small Cap Value Strategy: Our small cap equity strategy gained 5.82% for the year after falling 7.99% in the fourth quarter. The Russell 2000 Index dropped 1.57% for the year and 4.58% in the fourth quarter. We were very disappointed by the second half drop in small caps since at mid-year we were up over 20%, even though we did outperform our benchmark by over 7%. Large cap stocks may not have entered a bear market, but small cap stocks

have. The Russell 2000 Value Index is down over 20% from its mid summer high. We made a few changes to the portfolio in the fourth quarter. We sold Lannett Company, a generic drug company, that could never recover from an ill-fated purchase of an Indian generic drug company. We also booked a very nice gain on Markwest Hydrocarbon since they are merging with Markwest Energy Partners, an MLP, and many of our small cap portfolios cannot hold publicly traded master limited partnerships in tax sheltered accounts. We added two transportation related issues to the portfolio in December. Arkansas Best Freight Systems is a less-than-truckload trucking company based in Ft. Smith, Arkansas. We previously owned Arkansas Best in our Convertible Strategy through a convertible preferred issue. They are trading at their lowest valuation in over six years with virtually no debt and a nice dividend yield. We also added Freightcar America, a railroad car manufacturing company. Freightcar is trading at an enterprise value to trailing EBITDA of less than two. They have no debt and over \$14.00 per share in cash. Will there be no demand for new railroad cars? Research summaries for both companies are included for our Small Cap Value clients.

Convertible Securities/High Yield: Our convertible securities strategy fell 0.90% in the fourth quarter versus the Merrill Convertible Index decline of 3.09% and the Merrill High Yield Index dropping 1.14%. For the year, the convertible strategy gained 1.48% versus a gain for the Merrill Convertible Index of 4.12% and a gain for the Merrill High Yield Index of 2.17%. The high yield sector was negatively impacted by the widening of credit spreads in the second half of the year. Whereas prior to the credit crunch, high yield bonds offered additional yield of 2.7% over Treasuries, at year end they were trading 5.6% higher than Treasuries. As we said before, many issues are already pricing in a severe economic recession. We are now seeing yields that we have not seen since the last bear market. We recently added positions in convertible bonds of AirTran Holdings, the parent of AirTran Airlines, at a yield of 6.5%, Yellow Corp., a trucking company, at a yield of 6.23%, and Americredit, a subprime auto lender, at a yield of 12%. Our position in Gateway bonds was called at par as the company was acquired by Acer of Taiwan. We realized a nice gain since we owned the bonds at a substantial discount. We also sold our position in Fairfax Financial as the convertible bond was deep in the money, for approximately a 50% gain. Our portfolio now yields over 7% and we are receiving an attractive risk premium for taking on credit risk.

Intermediate Bonds: Our Intermediate Bond Portfolio gained 1.61% in the fourth quarter, bringing the return for the year to 4.33%. The Citigroup 1-10 Year Government Corporate Index rose 2.94% in the fourth quarter and 7.47% for the year. Our portfolio lagged the index during the dramatic drop in interest rates during the second half of the year. The Intermediate Tax Exempt Bond Portfolio rose 1.38% in the fourth quarter and 3.82% for the year versus the Merrill 3-7 Year Insured Muni Index gain of 1.99% in the fourth quarter and 5.35% for the year. We took advantage of bond market turmoil in less liquid municipal bonds to add very attractive yields in the fourth quarter. In some cases we were able to purchase AAA rated tax exempt issues with higher yields than similar Treasury maturities. Credit

quality will be very important over the next year until the subprime mess and credit crunch subside. We expect the Federal Reserve to aggressively lower interest rates in the first half of 2008 and higher yielding bonds to outperform high quality bonds when the economy shows signs of recovery.