



January 2009

INVESTMENT PERSPECTIVES

Our Approach to Bear Markets

Since we have not been in a serious downturn (Bear Market) in the stock market since 2000 we thought that there would be an interest in our approach to investing our clients' assets during this period. The current Bear Market officially began on October 9, 2007 when the S&P 500 reached a high of 1565. Since that time it declined to a low of 752 on November 20, 2008, a drop of almost 52%. At December 31, 2008, the index had recovered to 903, up 20.1% from its lows.

In our opinion, preparing for a Bear Market should begin in the last year or two of a Bull Market. There are three major stock selection processes that we concentrate on towards the end of a Bull Market:

- We continue to buy high quality stocks at what we believe are low prices. Typically, we find fewer stocks that meet our requirements as the stock market reaches new highs.
- We reduce what we consider to be overpriced holdings.
- We do not buy mediocre companies just because the stock market continues to rise.

By preparing for a Bear Market we do not mean that we know when the Bear Market will start or how bad it will become – we just follow the three stock selection processes listed above. Adhering to our value oriented discipline can be very lonely at times, but it is especially lonely at the end of a Bull Market.

Towards the end of a Bull Market, some value-oriented investment counselors are tempted to change their investment approach in order to attract new business. These Investment Counselors believe that they cannot bring in new clients unless they are aggressively buying stocks. They perhaps believe that prospective clients might feel that they are too conservative and will miss significant growth opportunities in the stock market. We never let this urge to grow our firm override our focus on Preservation of Capital and investing for the long term (which we define as at least the next 3 to 5 years, not just one year or less).

We are skeptical that the stock market rally that began on November 20, 2008, can be sustained given our lack of conviction about any evident stabilization or growth of corporate earnings. The following are our primary reasons for this perspective:

- Deleveraging – The U.S. consumer has not gone through a recession since the early 1990s and essentially was on a spending binge through the end of 2007. The 2001 economic slowdown was relatively mild by historical standards and did not significantly impact the U.S. consumer. While stock prices declined during this period, housing prices began a multi-year stint of dramatic increases resulting in an asset bubble. Now, with record debt levels, low savings, and declining asset prices (most notably housing) the U.S. consumer must go through the painful, albeit necessary, process of deleveraging. With about 70% of the U.S. economy and 20% of the global economy dependent on the U.S. consumer, and with the U.S. consumer going through a period of “retrenchment,” a meaningful domestic and global economic recovery will likely take longer than is widely expected, in our view.
- Credit Crunch – Access to credit is essential for conducting business in a well-functioning economy. Despite aggressive efforts by central bankers around the globe to lower interest rates and provide liquidity throughout the financial system, lending by banks has frozen up during the last several months. The banking system has been negatively impacted by bad debts, falling asset values and several government rescue efforts of various financial institutions (commercial banks, investment banks, insurance companies, and mortgage finance companies). Our assessment is that it will likely take time for banks to have confidence to begin lending again, credit to start flowing, and the banking system to return to some semblance of normal.
- Unemployment – The most recent U.S. unemployment rate was 7.2%, an increase from 4.7% at the end of 2007. For all of 2008, the economy lost a net total of 2.6 million jobs. We believe that the unemployment rate could rise to the 9.0% level before the current downturn is over. As a result, we expect companies will likely continue to cut costs by laying off workers well into 2009 or beyond.
- Corporate Earnings – A sustained, secular rally in the stock market is dependent on an improving earnings outlook, in our view. Companies will begin reporting fourth quarter earnings in the next few weeks and full-year 2008 earnings are expected to be down significantly from 2007 levels. We remain concerned about the ability of companies to grow earnings in the current economic environment and expect Wall Street analysts to continue to revise earnings estimates downward in the coming quarters.

As mentioned previously, consumer spending represents the largest portion of the U.S. economy. As consumers are forced to pull back by reducing debt and increasing savings, they will spend less on goods and services. Similarly, corporations are postponing and/or reducing capital spending. In a variety of different industries — autos, shipping, trucking, casinos and hotels, for example, there is excess capacity which will not disappear overnight and will likely contribute to a further fall-off in capital spending. Even for companies moving ahead with planned capital investments, more stringent lending standards and higher credit costs pose challenges for financing projects. We do expect consumers and businesses to spend again but it will take time to work off the

excesses from the past few years. Until this happens, we don't expect companies to post consistent earnings growth.

While we believe that calling market tops or bottoms is a futile exercise, we would point out that stock market history provides numerous examples of "false rallies" in the face of secular market downturns. For example, the 1973-1974 bear market was followed by six market rallies over the next eight years with average increases of 32.5%. All of these were false rallies, and the market did not return to its high of December 1972 until July 1980. Also, the Japanese experience in the 1980s shows that even in an overall market downturn there can be many short periods where stock prices rally significantly. As a result, we remain skeptical about simply extrapolating out the 20% gains we have seen in the past six weeks. Through our past investment experiences we have learned that patience is rewarded over the long-term.

Next Steps

Our focus has been and will continue to be to buy at low valuations what we consider to be the Best in Class companies. These companies are leaders in their respective industries – they have strong and consistent operating and financial ratios over long periods of time. Most importantly we diligently seek out the best metrics for the industry that we are researching – we call these "Monday Morning Metrics." These are the statistics that the CEO or CFO of a company first looks at when he or she walks into the office on Monday morning. They are the numbers he wants to see on his desk to know that the company is taking the appropriate steps to fix problems and to sustain growth. Some of these metrics may be industry specific, e.g., for a firm in the hospital industry, it may be something as simple as how many doctors the hospital is hiring in each town – this is an indication that the hospital is attracting talent and will be able to grow.

In a bear market, even the Best in Class companies sell at irrationally low prices. However, the better companies typically return to their underlying values while the lower quality companies do not, or go out of business. We believe Best in Class companies will survive through the current downturn and become more profitable in the next business cycle. Also, we believe that we have three to nine months to build a portfolio of these types of Best in Class companies. We will not rush in simply out of fear of missing the next Bull Market. As value investors, we must be patient and disciplined.

The long-term reason for our willingness to buy Best in Class stocks that meet our valuation standards is that we believe the following underlying conditions will eventually result in stabilizing both the U.S. and the world's economies. This will be one of the most exciting periods in the last 30 to 40 years to buy what we believe will be outstanding stocks at very attractive valuations:

- The Obama "Effect" – Some see his first year in office as being similar to Franklin D. Roosevelt's first year when the stock market rose 64% in 1933 (during the middle of the Depression). Also, Obama's proposed \$800 billion economic stimulus package may instill confidence that the government is tackling the economic malaise and unemployment.

- Government Bailout – It has been estimated that the total amount identified for all rescue programs from all branches of government is \$7.2 trillion. Approximately \$2.6 trillion of this amount has already been spent. The main purpose of all of these programs is to help consumers and companies access credit at very low rates in order to “encourage” them to start spending again.
- Oil prices – Having reached a high of \$147 per barrel in early July 2008, oil was at \$44.50 at the end of 2008, a decrease of approximately 70%.
- Interest Rates – The government is doing everything in its power to stabilize the housing market by reducing interest rates to all-time lows. Subsequently, mortgage rates have declined significantly and should provide relief both to those homeowners whose mortgages are resetting as well to those who are refinancing.

“This Too Shall Pass”

This phrase is attributed to one of King Solomon’s ministers who was given the task of finding a ring that would make a happy man sad, and a sad man happy. King Solomon thought that the minister would fail in the task, but the minister did find such a ring with the Hebrew inscription that says: *This Too Shall Pass*. Additionally, the phrase was used by Abraham Lincoln in a speech that he gave in 1859.

We cite this phrase here to provide some perspective on the current state of the stock market and our economy. We believe that there are better times ahead – but we don’t know when. The problems that we face are not insurmountable. The world and our country have faced more severe situations and have been able to come out stronger after the problems have been resolved. We believe that this will happen again.