



October 2008

## **INVESTMENT PERSPECTIVES**

### **Preservation of Capital – Our Primary Focus**

As you all know, we are going through some very tough and turbulent times. The current economic crisis was originally caused by the creation of cheap money with interest rates below 2% for many years. This policy was instituted by the Federal Reserve Bank and was strongly supported by the President and the Congress after the dot-com bubble burst and the 9/11 attacks. Cheap money led to an increasingly aggressive lending program from 2001 to 2007 which enticed many unsuspecting buyers to buy their first home with low variable-rate loans and become part of the American Dream.

This financial crisis was exacerbated with the emergence of two financial innovations. The first was the ‘Shadow Banking System’ which grew over the past 6+ years as banks moved more assets into an opaque web of entities, such as Structured Investment Vehicles (SIVs). These very large entities of thinly regulated, non-transparent and unusually illiquid investments had minimal restrictions on their use of leverage.

The second was the creation of Collateralized Debt Obligations (CDOs). CDOs allowed investment banks to take a pool of poor loans and bundle them together to make supposed ‘AAA’ loans that were then re-sold to institutional investors. The proceeds were used by the regulated banks to make new loans, creating a vicious cycle. Additionally, credit default swaps (CDSs) were developed to provide insurance on these CDOs. The CDS market enabled large banks, brokerage firms and hedge funds to make bets on the risk of defaults on various CDOs. It is estimated that the market for Credit Default Swaps alone has grown from approximately \$1 trillion in 2000 to over \$50 trillion currently.

Now that a large number of the mortgages are failing and insurance providers have to pay the resulting claims, we are discovering that some of these companies, such as AIG, are unable to meet their substantial obligations. In addition to the securitization of mortgage-related debt, there also was a substantial increase in the growth in other Asset Backed Securities (ABS) such as student loans, auto loans and credit cards.

This unprecedented flood of low-cost, easy-to-get money resulted in the following developments which we now trying to remedy:

- excess liquidity both here and abroad that enabled the creation of “unsafe” investing opportunities
- a generally complacent attitude toward risk
- a consensus that traditional, lower risk assets would generate unacceptably low returns
- an over-reliance on bond rating agencies
- easy access to credit as many banks lowered lending standards
- flawed incentive systems for mortgage brokers and investment banks
- a growing acceptance on “financial engineering” to manage risk

The Federal Government has taken a number of increasingly aggressive actions since August 2007 to help bring an end to the current financial crisis. The newly approved rescue package is the largest by far, about \$700 billion. While we won’t know for some time, we are hopeful that the rescue will help to alleviate the credit crisis that has gripped the country with banks fearful of making loans to individuals, businesses, or even other banks.

Also, the Federal Reserve Bank announced on October 7 that they planned to buy massive amounts of short-term debt (called commercial paper) in an effort to provide short-term financing to companies that need cash for their everyday operations, such as purchasing supplies and meeting payrolls. The commercial paper market had virtually dried up as investors such as money market mutual funds and pension funds were nervous about holding these loans. We believe that this action by the Federal Reserve is even more important than the \$700 billion rescue plan.

In addition to these rescue packages, we believe that regulation has to catch up with financial innovation. We must have a higher quality banking system with more oversight and regulation. Underwriting standards must improve and banks must hold loans to maturity. Additionally, financial “gurus” who created entities that allowed banks to skirt the rules on capital must be held accountable for their actions.

### Some Stock Market History

Each crisis that causes a bear market seems to be worse than any other before it – but when the crisis has passed we tend to forget the magnitude of that crisis and move on. Several recent crises (just in this country) include:

- the 1973-1974 oil crisis and stagflation
- the 1989 Savings and Loan bailout
- the 1998 Long Term Capital Management fiasco
- the 2000-2001 dot-com bubble

The United States has always recovered and moved forward.

Despite some shortcomings, the United States has some of the greatest and strongest institutions in the world. We have a viable free press, a fair and functioning income tax system, a strong legal system, and viable social security and Medicare systems. We tend

to forget that many countries in the world do not have these systems. Also, we have a \$14 trillion economy that is by far the largest in the world.

We have had 10 bear markets (including the current one) since World War II with an average downturn of 34.8%. The downturn in the current bear market is 29.9% with the high of 14,198 (on the Dow) on 10/4/07 and a low of 9,258 on 10/8/08. We have had 9 bull markets during that time with the average increase of about 177%. Each bull market lasted about 5.4 years.

The problem is that psychologically it seems appropriate to get out of stocks now and then get back in when the bear market is over. This works in floods and fires, but not in the stock market! The reason is that you know immediately when the fire or flood starts and you know when it ends, but you don't know when a bear market starts or ends until 6 to 12 months later.

The only reason to get out of stocks now is if you believe that the system is broken. We don't believe that this is the situation now - we believe that this country will survive and eventually flourish.

### Preservation of Capital

We cannot overemphasize the critical importance of investing your assets in order to preserve their purchasing power over long periods of time. Our firm's entire approach to investing is based on this concept. Accordingly, we have followed the same disciplined and consistent approach to managing our clients' assets since we began the firm in June of 1995 (and that Bill Hutchinson followed at Shuman Schneider & Hutchinson from 1980 to 1994). We will continue to follow this approach through all market conditions because we know that it produces the best results over longer periods of time!

Our policy is to purchase high quality stocks based on a value approach to investing. Each new research endeavor (we call this an "idea") involves identifying a stock that seems to fit our style and researching the "idea" through three increasingly detailed levels prior to deciding whether or not we will buy the stock. Each sell decision also involves these three levels of research.

As value investors we are skeptical of a company's ability to consistently achieve above average earnings growth. To ensure against potential earnings shortfalls, value investors seek a margin of safety in every new buy decision. Generally, a stock is attractive to value investors when the earnings outlook for that company is cloudy and the price has dropped significantly. Conversely, when the earnings outlook is very good and the price of the stock has risen significantly, value investors will often reduce their holdings. A basic belief of value investors is that the future is not very predictable. When growth investors are quite optimistic about the future and are driving up stock prices, value investors often begin selling.

Additionally, we strongly believe that a portion of your assets should be invested in bonds. Typically, the price of bonds move in the opposite direction from stocks - when

stocks are down, bonds tend to be up. This difference enables a portfolio's performance to be less volatile in both strong markets and weak markets, and tends to deliver more consistency over long periods of time.

We always focus on quality, on owning a diversified list of common stocks and bonds, and of striving to buy undervalued and financially strong companies. Additionally, we do not permit a particular stock holding to become significantly larger than any of the other stock holdings in a client's portfolio. We believe that this contrarian, value approach to investing is very helpful in delivering stable, safe, and consistent asset growth over long periods of time.

In our opinion, the current crisis (like all others) will pass and high-quality securities will provide sound returns over time. Accordingly, we believe that now is the time to begin accumulating additional high-quality, low-priced assets in your portfolio.