



INVESTMENT STRATEGY UPDATE

March 28, 2008

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Our title, the logo of the Williams Inference Service, is the Chinese word for crisis. Taken separately, its individual characters can be loosely translated as danger and opportunity.

This quarter's *Investment Strategy Update* marks the second time that we have used this crisis title. The first was in early October, 1990. At the time, the economy was three months into a mild recession, although we didn't yet know that. The capitalization-weighted stock market indices were down some 13% from their highs of the previous October, but the average stock had fallen by more than 25%. In the conclusion to that report, we stated that while we had yet to see sufficient pessimism to indicate a stock market bottom, it was time to line up the ducks (i.e., consider which stocks to buy and at what levels). In the following year, 1991, the Standard & Poor's 500 Stock Index rose 26.3%.

Every bear market is frightening and seemingly fraught with danger. The current bear phase is certainly no exception. What began with the revelation of trouble in the market for sub-prime loans has become much more broad, as the crisis of confidence has spread to several additional credit markets. And as if that weren't enough to worry about, oil prices have soared, the dollar has plunged, and the U.S. consumer is becoming increasingly reluctant to spend. Yet, there are also a number of positive forces at work. These include a very accommodative Federal Reserve Board that is firmly and clearly dedicated to restoring economic growth by aggressively lowering short-term interest rates and otherwise taking action to support the credit-extending apparatus of U.S. banks. A stable corporate sector (excluding financial companies) continues to benefit from strong economic growth in the developing markets. And, there is a huge pile of investable cash that will ultimately fuel the next stock market advance. Eventually, these elements will give a broad swath of investors the confidence to reinvest in stocks. As the cash pile gets put to work, prices will move higher and cause others to worry about being left behind. Add to that a relatively inexpensive stock market and there's the opportunity. We have no doubt that this crisis is moving toward a positive resolution. Our primary question is one of timing.

Recessions and the Stock Market

Recession Cycle	Stock Market Lead At Peak (months)	Stock Market Lead At Trough (months)	% Decline In Real GDP	% Decline In Stock Market	Duration Of Stock Market Decline (months)
1953-54	6	8	-2.6	-13.7	8
1957-58	12	6	-3.2	-21.6	6
1960-61	8	4	-1.6	-13.6	15
1969-70	13	6	-1.1	-36.1	18
1973-75	10	5	-3.1	-48.2	21
1980	-1	4	-2.2	-17.1	1
1981-82	8	3	-2.6	-27.1	20
1990-91	0	5	-1.3	-19.9	3
2000-01	12	-11	-0.4	-49.1	31
Median	8	5	-2.2	-21.6	15
Average	8	3	-2.0	-27.4	14

Source: BCA Research

One of the most important points to glean from history is that the stock market is a leading economic indicator. Since World War II there have been ten recessions, nine of which are represented in the chart above. Over this time period, the stock market has peaked a median eight months prior to the economy entering recession, and bottomed five months before its end. Thus, for investors, it has paid to use periods of economic weakness to put money to work in anticipation of the inevitable recovery. In the past, if you had waited until a recovery was underway, you would have missed a good portion of the positive returns that followed. In the case of our 1990 example, the stock market rose 27% off the bottom before the recession had even ended.

Another point to note is the amount by which the stock market tends to fall in conjunction with recession. While the range is broad, the median decline has been close to 22%, which is not that far off the decline to the recent intraday lows on March 17. If we count only the closing price on that day, the S&P 500 was down 18.7% from the market's peak on October 9, 2007. This implies that we have probably seen the bulk of the damage that we will experience this cycle. Even if the downdraft ultimately approaches the 27% average, the risk/reward tradeoff is becoming increasingly attractive, in our opinion.

Also worth noting from the chart is the median duration of the stock market declines that have been associated with recessions. Although the median of fifteen months is rather long, implying that we might not see a stock market bottom this summer, there is a great deal of variability in that number. Given the reasonableness of current stock market valuations and the fact that we expect this recession to be rather short and shallow, we believe the length of

the decline will be tempered. Also, if one looks at the four most recent bear markets (including those not associated with a recession) three of them lasted less than four months.

We Remain Upbeat

One of the reasons we are confident that the economy (and the stock market before it) will soon get back on its feet is the longstanding history of U.S. institutions facing up to reality. Unlike in Japan in the aftermath of their bursting stock market and real estate bubbles in the late 1980s, there is no ingrained commitment on the part of U.S. financial company managements to keep weak assets on the balance sheet. Nor is there any support from the government which would allow these companies to ignore or hide their problems for any length of time.

We have a strong conviction that the aggressive fiscal and monetary measures being undertaken by our government and the Federal Reserve Board will be sufficient to bring the credit crunch to an end and the economy to a recovery. In other words, they will do what they have to. The fiscal stimulus package passed in February will boost consumer spending. Additionally, the provision to materially increase the size of what constitutes a conforming mortgage loan that can be bought by Fannie Mae or Freddie Mac will increase mortgage availability and, therefore, lower costs to home owners in qualifying markets. At the same time, the Fed is attempting to instill confidence in the financial system through lower short-term interest rates, direct injections of liquidity, broadening access to its borrowing window, encouraging the extension of credit, and, when necessary, by inserting itself as the lender of last resort. Lower short-term interest rates should enable banks and other lending institutions to offer more attractive mortgage rates and terms to new borrowers or refinancers, while also fostering a restoration of banking profitability by allowing those institutions to pay less for deposits or borrowings from the Fed and other sources.

We are also encouraged by the fact that outside of the financial services industry, corporate debt levels are historically low, with current interest coverage ratios at least twice what they were during the 1990 and 2001 recessions. For many companies, there is little need to borrow and little need for us to worry about their ability to repay debt. Also, at least as it concerns the larger U.S. companies, an ever-increasing portion of their earnings have been coming from abroad. The story of 2007's fourth quarter earnings reports was repeated over and over. While U.S. multinationals reported weakness domestically, they saw strength nearly everywhere outside the U.S. Although we expect growth in Europe and Japan to weaken, the developing world doesn't seem to slow much at all, as evidenced by the continued high prices for key commodities such as oil, iron ore, and copper. Corporations are also bullish on their own stocks, judging by the strong level of share repurchase announcements, which have actually increased in the time since the sub-prime crisis began last August.

Thanks to the aggressive actions of the Fed, the pile of cash reserves that has nowhere to go is getting bigger every day. Every dollar of that liquidity needs to be invested somewhere,

and there seem to be few attractive choices other than equities. Cash and cash equivalents are increasingly unattractive, as the returns on those holdings are becoming smaller with every change in the Fed's targeted short-term interest rate. Residential real estate is unlikely to draw in a lot of funds, since there is little reason to expect that the burst housing bubble would be followed by anything but a moderate recovery in pricing. And typically, weakness in residential real estate prices precedes softness in the commercial real estate markets. Finally, high quality bonds were a great investment last June, but now the 10-year Treasury note pays a very low 3.5% while inflation remains a long-term threat, so the expected future returns from quality fixed-income investments are also less than attractive. That leaves equities, which have the advantages of being inexpensive, liquid, and varied.

In Search of a Bottom

So where are we now? The credit markets are in disarray. In recent years, the interest rate spreads on riskier loans have been far too low, as have been the lending standards under which those loans were made. Furthermore, hedge funds and other investors in those loans, both long and short, were allowed to invest with far too-much leverage and far too-little disclosure. Now, we are paying the price.

While BTR is generally opposed to increased regulation, we think there needs to be a set of reasonable controls over both investment leverage and disclosure. We don't mind when speculators lose their own money because of foolish risk taking, but we get very concerned when the degree of leverage in place affects the well being of the economy, the financial markets, and our clients. We hope and anticipate that a more reasoned regulatory structure will be forthcoming to block such absurd and abusive behavior in the future.

We know from experience that bear market bottoms take place in the midst of extreme and sometimes climactic pessimism. In a selling climax, the last of the bulls capitulate, lamenting that hope is gone, the future is bleak, and there is no reason ever to own stocks again. We don't know whether this bear market will end in such a climactic final sell-off, but it may be headed that way. Nonetheless, as the current credit crisis evolves, investors will inevitably come to grips with the downside risk. Once that occurs, they will be free to focus on the ultimate recovery. And, as we have suggested, there is plenty of liquidity available to fuel the next advance.

There are two effective methods of determining when, during bear market declines, to add to equity holdings. The best method is to call the bottom, but that is a talent which few can legitimately claim. Fortunately, long-term investors do not need to identify tops or bottoms in order to reallocate assets successfully. Rather, they need only to correctly recognize periods of relative risk and opportunity. The best way of doing that, in our opinion, is to focus on the valuations of individual stock issues. Bear market declines are not perfectly synchronous. Investor capitulation can also occur on a stock-by-stock or group-by-group basis. As the stock market declines, some of the individual securities that we are considering for purchase will begin to reach valuation levels at which we can be confident that their future returns will be quite positive. Perhaps these stocks will decline still further,

but we are long-term investors and, at a certain price, given their fit into our distinct portfolio makeup, we are willing to own them. This strategy, while not always comfortable, has been highly effective for us, long term.

Conclusion

There are no two ways about it. The U.S. financial markets are in crisis mode. The combination of a credit crunch, economic recession, and a bear market in stocks is no doubt dangerous for investors and, therefore, cause for concern. Yet inevitably, these dangers will lead to opportunity. One key to investment success is having the discipline to act on long-term opportunity in the face of short-term danger. Our belief is that the current recession will turn out to be mild and short-lived. However, we cannot be certain. And, for that reason, we continue in a defensive stance for now, maintaining our buying power, selling non-core holdings on strength, and being very careful with any purchases we make.

Nonetheless, we expect that we are only a few months from the final bottom. Once again, it is time to line up the ducks. We know what stocks we want to buy. Now we must decide at what levels to buy them.

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