



INVESTMENT STRATEGY UPDATE

March 27, 2009

Glory be, a rally. Over the three weeks following the March 6 low, stocks rose some 20%. Will that date turn out to have marked the final bottom of what has been the worst stock market decline since the Great Depression? It's too soon to say. While there are early signs of fundamental improvement, a whole host of negatives still remain. Yet typically, the stock market bottoms ahead of the fundamentals and, if March 6 was the bottom, the signs were classic. There was substantial cash on the sidelines, pessimism was rampant, and nary a positive word was being uttered by anyone, including our newly inaugurated president and his key lieutenants. In the days immediately preceding and following the low, the volume of panicked client calls to brokers and investment managers skyrocketed. "I can't stand it any longer. Sell all my stocks!" It was a full blown capitulation.

CONFIDENCE

"The only thing we have to fear is fear itself." So said Franklin D. Roosevelt in his first inaugural address. FDR's words seem quite relevant to today's economy and stock market, but we would slightly temper his words by removing the "only." It is our belief that consumer and investor confidence is the most significant determinant of how, when, and by how much the economy and stock market will recover.

There is little doubt that the severe setbacks in the economy and stock market resulted from the enormously over-leveraged, over-speculative housing, consumer, and banking sectors. Nonetheless, serious government policy mistakes have accentuated the downturn. In hindsight, the decision to let Lehman Brothers fail was a huge blunder. And, unfortunately, prior to March, the new Administration had done little to improve the situation. The lack of detail and poor presentation of Treasury Secretary Geithner's bank rescue plan in early February sent the stock market on yet another leg down, as investors feared that he had few real ideas about how to improve bank balance sheets. The release of President Obama's 2010 budget proposal, shortly thereafter, sent the market tumbling further. Although it was packed with programs intended to fulfill his promise of change, the budget proposal had relatively few incentives for American companies to hire new employees or increase spending on capital improvements. Instead, the president proposed to increase taxes on businesses and the wealthiest Americans. While the social engineering aspects of his proposals may or may not yield the long-term benefits he expects, the worst recession in generations does not seem to be the appropriate time to increase the burden on this country's economic growth engine.

American consumers and businesses have essentially been on strike. To a significant degree, discretionary spending has stopped, even by those who still have the money to spend. And, it seems likely the lack of spending will continue until there is increased confidence that the financial system is safe, that the economic deterioration is coming to an end, and that the troubles we as a country face are not insurmountable.

Continuing Negatives

To be sure, there is still much to worry about. The global economy is very weak. World trade continues to spiral lower, resulting in increasing protectionist rhetoric. The U.S. budget deficit is about to soar. Corporate earnings estimates (the “E” in P/E) continue to be ratcheted lower. And, while U.S. residential real estate may be just a few months from finally realizing a bottom, the commercial real estate downturn seems to be worsening. Also, while operating profits have begun to improve at a few financial institutions, leverage remains excessive. The number of non-performing loans is growing and a lot of “toxic” securities remain on their books. Additional capital infusions could be necessary.

So far, we believe that the government programs intended to heal the economy are mostly just adding to the confusion. We have a budget proposal that appears long on social goals and short on stimulus. Then, there is the alphabet soup of legislative programs that few seem to understand: TARP, TALF, HASP, ARRA, and now PPIP. Perhaps they should all be combined into one all-inclusive program, which we would title the Asset Relief Facility (ARF).

A Growing Number of Positives

So, is there anything we can point to that could give investors hope? Yes, in fact there are a number of positive developments, most importantly those that address the primary fundamental issue, the overall health of the financial system. Despite the confusing acronyms, the new administration has cobbled together a set of programs which should help to kick-start economic activity. Many have argued that the only way to fix lenders’ balance sheets is to remove from them the asset-backed securities that contain so many troubled loans. They could be right, for that’s what Resolution Trust Corporation accomplished in the early 1990s, so perhaps it would work again. With the newly-introduced Public-Private Investment Program (“PPIP”), procedures will be put in place to use a combination of government money, private investors’ money, and low-cost government loans to buy “toxic” loans and securities from financial institutions. Lenders would then be free to make more mortgage, automobile, credit card, and small business loans. If the lenders lend, then the money the Federal Reserve has been pumping into the system will more effectively be put to work.

Whether or not the PPIP works is almost beside the point, given the changes being proposed to the accounting treatment of securities that have lost value. The now-infamous “mark-to-market” accounting rules that went into effect in 2008 were intended to improve

the quality and transparency of financial reporting. In our opinion, they accomplished the opposite. As concerns about the mortgages, credit card receivables, and other loans underlying asset-backed securities increased, the market for those securities dried up. As a result, “mark-to-market” pricing reflected not just the admittedly bad economic reality, but a further, and in some cases significant, illiquidity discount. The Financial Accounting Standards Board is currently attempting to provide revised guidance to financial firms on how to determine “fair values” for their asset-backed securities. While discussions are ongoing, there is a strong expectation that changes will soon be forthcoming and will be reflected in this year’s first quarter earnings results. Therefore, going forward, those particular unintended consequences should abate, which would lead to fewer write-down-associated losses and perhaps even some gains from write-up adjustments.

From a confidence standpoint, almost as important as the stabilization of the financial system is the fact that some government officials are finally starting to talk up the economy, as Fed Chairman Bernanke recently did on *60 Minutes*. And that may not be just wishful thinking or government cheerleading. Looking at recent economic data, both new and existing home sales increased unexpectedly in February. February retail sales were also better than expected, while January’s strong retail numbers were actually revised upwards. Mortgage applications have risen during each of the past three weeks, providing evidence that the Fed’s attempts to lower interest rates for individual borrowers is working. Also businesses have retrenched, such that inventories (except for automobiles) may now be sufficiently low that even a little bit of restocking will lead to increasing production. The unexpectedly strong durable goods orders in March may be evidence of just that. Furthermore, there are signs of improving domestic economies in China, Brazil, and Chile. While those economies are still too small to drive world trade on their own, growing signs of emerging-nation stabilization is a meaningful start.

From a stock market point of view, there are several additional positives, as well. By most metrics, stocks are not expensive. The level of investor fear is very high, and ironically, in the stock market, lack of confidence is actually a good thing. There are very substantial cash reserves on the sidelines, earning negligible rates of interest. And our expectation is that a significant portion of those sidelined funds will be reinvested in stocks as confidence returns. Pension funds are another source of future buying power as, for the most part, they are currently allocated well below their target equity levels.

Conclusion

And so, we come back to our original question. Was the March 6 low the stock market bottom? We don’t know. Nobody knows. Yet our belief is that the recent lows are likely to be looked back upon as a part of a broad bottoming process, albeit with a significant degree of continuing volatility. In other words, we think that we are now past the point where we need to consider seriously the possibility of a complete breakdown of the financial system. The combination of the current federal safety net, Federal Reserve Board reflationary efforts, and government programs now underway will prevent another “great depression.” The healing process is underway.

Still, the U.S. economic and financial system remains substantially overleveraged. While a meaningful pullback has already occurred, we expect the deleveraging process will continue for many months to come – perhaps even years. During the remainder of the process, U.S. economic progress is likely to be well below the long-term growth trend, but that doesn't mean that it will be negative.

From an investment standpoint, we have little conviction about how the next several months will evolve, but good companies with real futures and solid balance sheets presently sell at very reasonable levels of valuation. We believe that fundamental portfolio management and stock selection diligence, combined with a larger-than-normal degree of patience, will be amply rewarded over the coming months and years.

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