



# INVESTMENT STRATEGY UPDATE

August 16, 2007

## A Crisis of Confidence

The long-awaited correction is well underway, and the question now is: is this what we had been expecting, or have events unfolded in such a way that they are likely to cause further problems? In short, while we think there is still more to go on the downside, we view the current pullback as a buying opportunity. We do not believe “the sky is falling,” and yet unfolding events have obviously resulted in some new uncertainties that bear close watching.

The repricing of high-risk debt was certainly overdue. Cycles of speculative greed are recurring, and somehow each time the parties involved come to believe that they are doing the right thing, (more about this in a future *Investment Strategy Update*). This time, the buyers of high-risk debt were able to convince themselves that what they were buying was not so risky after all. And as always, the bankers and brokers were happy to accommodate them. The primary areas of excess encompassed sub-prime mortgages and leveraged buyouts, all funded with ridiculously low interest rates and generally inadequate loan covenants.

Now we are faced with what has been a rather sudden re-pricing of that debt, resulting in a great deal of uncertainty. Yield spreads (the interest rate difference between risky & risk free assets) have ballooned across all classes of non-Treasury debt. In the sub-prime sector the excess number of sellers over buyers has led to a highly illiquid market which, in turn, has resulted in difficulties pricing some of those issues at all, and therefore in valuing the portfolios that contain them. Faced with these unknowns, the high-risk credit market has all but shut down. Highly-leveraged hedge funds, leveraged buyout funds, and other holders of high-risk debt have faced rising liquidity pressures and have had to sell whatever they could in order to fund those needs. We believe that a lot of quality stocks are being sold as a consequence.

Unlike at the start of most bear markets, stock market valuations are currently quite reasonable. So as long-term investors, our questions are: Will the current credit squeeze develop into a more general credit crunch? What will be the effect of evolving events on the underlying economy? And, what is the likely trend of corporate profits, since in the long run it is corporate profits that determine stock prices?

Our belief is that the result of the present turmoil on the US economy will be deceleration, but not recession. Consumer spending is likely to slow, but corporate America is highly liquid and has little need to borrow. Thus far, quality borrowers have had little trouble funding their liquidity requirements, albeit somewhat more expensively than before. Our

assumption is that the world's central banks, including the Federal Reserve, will do what they have to do in order to avoid a general credit crunch. Furthermore, corporate profits are increasingly dependent on the global economy, and we see little reason to change our favorable global-growth outlook. In fact, a somewhat slower economic growth outlook will likely relieve the Fed's inflation rhetoric and may actually allow for a longer period of low interest rates, and therefore a more sustained economic advance.

In our opinion, what the stock market has suffered to date is a crisis of confidence. Thus far, loan defaults, even among sub-prime borrowers, have not been substantial. Can the current difficulties spread to higher quality financial institutions? Perhaps, but BTR's portfolio exposure is limited. We do not know when the current decline will end, but we suspect that we are more than halfway there. The important thing for us is to make sure that the securities we own are the ones we will still want to own coming out the other side. For now, we are concentrating on quality and keeping our buying power intact, but we are also carefully watching the stocks that we want to purchase for favorable entry levels.

In summary, periodic stock market corrections are normal recurring events – even healthy to the extent that they serve to restore value. Downtrends typically end at the point of maximum pessimism. So, keep calm. Thus far, year-to-date portfolio returns are still mostly positive. The discipline of investing for the long term remains of utmost importance.

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