INVESTMENT
STRATEGY UPDATE

November 21, 2008

From the Depths of Pessimism

The study of human psychology, particularly crowd psychology provides much insight into the behavior of markets. The level of a market, such as equities, gold, real estate, antiques, etc. is largely a function of the collective hopes, fears, and expectations of current and potential investors. There have been several studies over the years indicating that the patterns of crowd behavior are repetitive and even somewhat consistent. Two of the better known treatises on this subject are The Crowd by Gustave Le Bon and Extraordinary Popular Delusions and the Madness of Crowds by Charles Mackay.

Periodic speculation has occurred in real estate, gold, antiques, precious stones, technology companies, and even tulip bulbs. Excesses occur, bidding prices up far beyond realistic value. Under the greater fool theory, market participants realize they are paying too high a price, but they assume prices will keep going up and that surely some greater fool will buy it from them at an even higher price. Eventually the bubble bursts.

Excesses and group think also occur on the sell side, and that is what we are currently experiencing. Some believe that the stock market will never go up again. But eventually the pessimism will peak, the selling pressure will abate, and new up trends will ensue.

This bear market has been particularly difficult, as the depth and complication of the previous excesses were far beyond that which most investors or investment professionals understood. We had thought that the unwinding of leverage would occur over time, by means of a prolonged period of slower-than-trend economic growth. Unfortunately, following some huge government policy mistakes in the handling of the Lehman bankruptcy and the Fannie Mae and Freddie Mac takeovers, the leverage seems to be unwinding all at once, in a self-feeding and highly-destructive cycle the likes of which most of us have never before seen.

While it is obvious that the current economic environment is bad and worsening, the stock market's destruction, to date, seems to have gone far beyond fundamental reason. The forced liquidation of leveraged investment vehicles continues and we don't know exactly when the carnage will subside, but it will. And, it is the huge and growing cash reserves held by investors that will inevitably fuel the next advance.

At current levels the stock market is very good value relative to alternative opportunities. In fact, there are a number of very-attractive high-quality companies that are now selling at price levels we never expected to see. As stated above, no one can be sure at what level the stock market will bottom, but we believe that the equity sectors within our portfolios will prove to be the most rewarding over coming years. In addition, we believe that, from currently depressed valuation levels, solid returns will also be provided by the high-quality end of the corporate and municipal debt markets.

As always, we welcome your comments and questions.

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