INVESTMENT STRATEGY UPDATE

October 1, 2008

Rescue?

What a month! We were witnesses to history, with a widespread investor flight to safety, a substantial freeze-up of the U.S. credit markets, and a heretofore unimaginable dismantling of the investment banking industry. In our September 17 interim memorandum to clients, we did our best to make sense of the carnage and the still-developing financial crisis. We realized that more significant government intervention was likely to be forthcoming, and we hoped it would happen soon. Our opinion was that it was too late to sell equities, and we took comfort from the fact that our client accounts were significantly under-exposed to the financial services industry, were broadly diversified in high-quality companies with reasonable valuations, and had at least some cash cushion. We also took the prudent, and probably unnecessary, step of moving most client cash reserves out of money market funds that invested across the spectrum of short-term investments, and into money market funds that invested exclusively in Treasury and other government securities.

After a very poor sales job to the American public and some excessive wrangling in the halls of Congress, legislators have agreed that government intervention needs to be taken to the next level, with a financial rescue package of unprecedented size. As we go to press, the Senate has passed an intervention bill, and the House seems likely to follow. The core of the plan is that the government, through the Treasury Department, will purchase distressed assets from a variety of banks and other financial institutions, presumably at a meaningful discount. The Treasury will hire independent investment managers to execute the purchases, then hold or dispose of those assets over time, to the benefit of the government. The banks, for their part, would effectively replace illiquid (though by no means worthless) assets on their balance sheets with cash. They will certainly take a financial hit, but this program should increase confidence in both the short-term and long-term viability of the banks, which should then increase the confidence of their trading partners, and thereby serve to oil the economy's lending apparatus.

Assuming this all goes more or less according to plan, what does it mean for investors? Are we completely out of the woods and on the path to economic and stock market revival? The short answer is "no". The global financial system has suffered significant damage, and it will take time to repair. As everyone now knows, the financial leverage inherent in the U.S. economy was far too high. A period of de-leveraging was inevitable, and although that process is now underway, it still has a long way to go. This paying down of debt will apply to nearly every economic entity, from the hedge funds with 30:1 debt-to-equity ratios, to the former investment banks (Goldman Sachs and Morgan Stanley) that have been granted approval to convert to bank holding companies with half the balance sheet leverage, to the homeowner with negative equity or a crushing level of credit card debt.   Barring a huge increase in income, de-leveraging can only be accomplished through lending less (for banks) or spending less (for individuals), which obviously implies weaker economic growth.

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We also noted in our last communication that, despite all that had happened up to that time, our economy had not yet technically fallen into recession. To that date, the weakness on the consumer side of the economy had largely been offset by the rising growth of U.S. exports – a result of high productivity and a weak U.S. dollar. Even before September's events, we were concerned that a slowing global economy, particularly in Europe, would not allow our exports to remain sufficiently strong to continue offsetting the weak consumer. Now we are certain that they won't. The financial crisis has resulted in a huge blow to both consumer and business confidence. A further contraction in retail spending and corporate investment will soon be reflected in economic statistics. We are clearly now in a recession, and while we do not know how deep it will be, due to the likelihood of some ongoing positive influence in the export sector, we do think it could persist for a while.

The impact on financial markets of all that has happened will be mixed. On the bright side, it has become abundantly clear that inflation is no longer a major risk. Energy prices have dropped precipitously as expectations of a global slowdown have increased. In fact, de-leveraging itself is a deflationary process. Where once there was too much money chasing too few assets, the opposite situation is likely to prevail for some time. All of this gives the Federal Reserve the flexibility to lower short-term interest rates to complement the probable effects of the rescue package. Hopefully, the heads of central banks around the world will also recognize the opportunity to step back from their still restrictive stances, particularly in Europe and the U.K. On the other side, however, a commitment of $700 billion is enormous by any standard. Even if the plan is able to generate a profit for the government, which is a very real possibility, that will likely take some time to develop, and in the meantime, the budget deficit will grow significantly.

Regarding equities, we believe a mild recession is already priced in to the market, but that doesn't mean the stock market is now ready to start the next bull move. There are far too many unknowns about how the global economy will work through the de-leveraging period. A stock market bottom may not be far off, but equities will remain volatile and there will certainly be periodic setbacks. We see this as a time of good value – one that will reward us in the long term for owning high-quality companies that are neither overly leveraged nor too exposed to the U.S. consumer. So this is not a time to abandon our positive long-term expectations, but neither is it yet a time to add aggressively to equities. Our plan is to monitor developments and use the ebbs and flows, if they can be called that, to adjust our investment positions.

We did not expect the level of destruction that befell the U.S. financial infrastructure, nor the resulting hit to investor confidence, but we continue to believe in the viability of our system and look forward to better times ahead.

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