A Limited Liability Company

First Quarter 2008 Review & Commentary

Overview

The volatility of the late 2007 markets continued and intensified in the first quarter of 2008. Virtually all equity asset classes were negative for the period including lower quality fixed income securities.

Equities (Stocks)

Domestically stocks of all market caps did poorly, albeit within a narrow range with the average Large Cap fund losing just over 10% for the quarter and the average Mid Cap fund losing 9.6% and Small Caps also losing 10%. Growth components of Large, Mid and Small Cap performed even worse, highlighted by the average Small Cap growth fund losing just under 15% for the quarter.

International funds provided no refuge with an average loss of 9.2% for the quarter. Emerging Market funds ended their winning streak with a quarterly loss of 11.7%.

Aside from the funds, many individual foreign country equity returns made the US look quite good by comparison. Just a few examples include Turkey -28.5% Cyprus -40%, Japan -18%, France -16%, Russia -13%, Italy and Germany -18% and Australia -16%. The Chinese market just achieved the dubious distinction of *losing 50%* from last year’s peak. These numbers are in local terms, and in most cases returns were even worse for US investors of currency conversions.

Even Natural Resources funds were no place to hide as the average fund lost 4.5% for the quarter. Real Estate funds, arguably at the root of the problem did ironically well, losing just 1.2% for the quarter.

Fixed Income (Bonds)

High quality bonds provided some refuge. The average Intermediate Government bond fund gained 4% for the quarter. High Yield bond funds continued to suffer from a flight to quality and averaged a loss of 3.6% for the quarter.

Indices cited above are as reported in The Wall Street Journal*, both print and online, April 3, 2008. Fund averages cited are the respective Lipper Mutual Fund Indices.*

First Quarter 2008 Commentary

"There is the dangerous cliché in the financial world that everything depends on confidence. One could better argue the importance of unremitting suspicion."

J. K. Galbraith

In last quarter's commentary I tried to provide some historical backdrop for the current credit crisis (or panic, if you prefer). This quarter, I'll follow up and look a little more closely at the current debt crisis, review how we got here, the current dominant themes and mind sets as well as some of the possible outcomes. Let me just start by reiterating the point of last quarter's commentary, which was we've had numerous credit crises over the last 200 years and they all came to an end and confidence was ultimately restored.

Risk, It's Baaaack……

What led to the current crisis was an enormous amount of risk added to the system in the, what is now clear to all, false belief that we could remove risk from the system through innovative financial products. This perceived reduction of risk led to excess credit being issued and bubbles in the prices of the underlying collateral (houses and private equity for example). I've discussed bubbles and the psychology that fuels them extensively in past commentaries, so I will only briefly review a couple aspects of them here. In a bubble, speculators abandon any sense of intrinsic value and buy assets at any price on the belief that someone else will pay even more for them later. Think of a crisis as the mirror image of this. No one will buy an asset because they think it will only go down in price, despite its intrinsic value. Bubbles are about returns, crises are about risk.

The pendulum has swung completely the other way and debt investors from not seeing risk anywhere to now seeing it everywhere. Furthermore, not only do they fear the risk they see, they particularly fear the risk they don't see. The result has been a virtual shut down of the credit markets as banks hoard their cash and cut lending dramatically.

Talking The Talk

Every bubble and crisis has its dominant concepts and lingo. The current credit crisis has brought to the forefront the concepts of the "Self-Reinforcing Cycle" and "The Black Swan." The self-reinforcing cycle is essentially a downward spiral where one bad event triggers another, then another, ad infinitum. Applied to the current situation it basically plays out that if no one can get a mortgage because of lack of lending (see above) then the price of houses goes down. Declining housing leads to jobs losses, which means fewer people can afford homes and more people default on their mortgages. This in turn causes banks to lend even less, which brings us full circle on our downward spiral. The potential for events to unfold in this way is currently the Federal Reserve's greatest fear and why they have thrown everything, including the policy equivalent of the kitchen sink, at the problem to try to avoid and/or break the cycle.

The other current dominant concept is The Black Swan. This concept comes from the title of a book written by Nassim Nicholas Taleb and is based on the discovery of black swans a species previously thought to be non-existent. The premise here is that we underestimate the occurance of infrequent and very unpleasant events. Said another way we tend not to differentiate between "not very likely" and "never." For instance the likelihood that you'll get into a car accident on any particular day isn't very high, but it does happen and it can hurt an awful lot. In other words believing that what will *most likely happen* is what *will happen.* This is precisely what is causing the blow up of many of the new "innovative" financial products. These products were created using models that failed to accurately account for unlikely events, black swans. This is essentially what happened to Long Term Capital Management in 1998 and led to crisis in world markets. One would think the smart folks on Wall Street who dream up these innovative products would have learned from that experience. Apparently not.

Walking The Walk

To synthesize the themes of the self-reinforcing cycle and black swan, the apparent range of outcomes from the current situation is somewhat broader than normal. At one end is the possibility that despite the Fed's best efforts, a self-reinforcing cycle takes hold, the economy deteriorates significantly, more (perhaps many more) banks fail, there is rioting for food in parts of the world (more than there already is) and government efforts to restore order results in a huge run-up in inflation. We'll call this scenario Great Depression, The Sequel. It's probably not going to happen, but there weren't supposed to be black swans either.

On the happy end of the possibility spectrum, the credit crisis ends abruptly when a credible investor (like Berkshire Hathaway) declares that they can't buy bank stocks fast enough, liquidity returns to banking, loans are made again, oil and commodity prices drop dramatically eliminating any worry of inflation and all is right with the world. We'll refer to this scenario as Goldilocks. Call me an optimist, but I think this scenario is more likely than most think.

I like the Goldilocks scenario for a number of reasons, possibly the least of which is because, economics and probabilities aside, it's just more pleasant. Think of this as a variation on Occum's Razor, if two or more equally likely scenarios present themselves, choose the most pleasant. More seriously, however, there are plenty of other, more defensible reasons to like it as well. As noted above, at the depth of a panic intrinsic values are ignored in the rush to sell assets before prices go lower. Eventually, however, smart market participants will recognize these intrinsic values and purchase these assets effectively putting a bottom under and halting the falling markets. There are a number of indications in our current situation that an enormous amount of cash is sitting on the sidelines waiting to do just this. Included on these sidelines are distressed debt hedge funds which are finally starting to nibble at what they perceive to be a market bottom. As an aside, the analogy of bottom feeders to hedge funds isn't completely inappropriate.

On the equity side, valuations were very reasonable going into this crisis and have only gotten more reasonable, even in the face of potentially softening profits. When talking with equity managers on various conference calls two main themes emerge. The first is "Hey why are we getting punished, we didn't do any thing wrong. It was the bond guys who acted badly." The second theme is near glee at some of the bargains being found in the market place. That's not to say that today's bargain isn't tomorrows bigger bargain, but historically if you buy reasonably priced assets and wait, good things happen.

As recently noted by both Ben Bernanke and Alan Greenspan, corporations are going into a recession with unusually strong balance sheets. Industrial (non-financial) corporations in the Standard & Poor's 500 have amassed $615.5 billion in cash and cash equivalents. That compares with $352.4 billion in 2001 and $95.5 billion at the time of the 1990-91 recession. In short most corporations will likely use any softening in business as an opportunity to retool, buy weaker competitors, hire better talent, and ultimately emerge much stronger and more efficient.

The last and perhaps most difficult part of the Goldilocks scenario is falling oil and commodity prices. In the interest of full disclosure, let me start this by saying I've been pretty wrong about this topic for a while. In fact, see my third quarter 2005 commentary to find out just how long a while it's been. It reminds me of an economist I worked with years ago who was once introduced as having "predicted five out of the last two recessions." That said, much of what I outlined in that commentary on the price of oil still holds true and I've also said a number of times that bubbles are characterized by speculative excess driving prices higher and longer than anyone ever thinks possible. That would certainly seem to be the case here and current commodities prices would seem to exhibit all of the classic signs of a bubble. I would also add that every bubble is accompanied by claims that demand far outstrips supply and nothing on the horizon will change that. The current claim is that demand from China and India are growing so rapidly that supply will never catch up. I would respond by saying that increasing commodity demand is simply inconsistent with recession and an economic slow down. At some point the commodity bubble will burst, obviously exactly when that might happen is best left to someone else to predict.

A look at the current level of stocks (as measured rightly or wrongly by the S&P 500) and commodities (as measured by the prices of gold and oil) can provide a great deal of insight. The S&P 500 is currently trading around where it did in July of 1999. That means, barring any great run up in the next year, the index is facing a lost decade of potentially zero return. That would be at least a little ironic for a decade that will probably be referred to as the "0s." Factor in inflation and the picture is much worse. If we look back at July of 1999, the very common wisdom of the day was to index by putting all of your money into an S&P 500 index fund. Pretty painful advice in retrospect, as the common advice of the day often turns out to be. Oil and gas on the other hand are trading at all time highs. Call me contrarian, but I'd much rather own the asset class that's languished for ten years rather than the hot investment of the day.

Play Ball

So where are we in the cycle of the current credit crunch? Since its spring time, I'll employ a baseball analogy, and say that we're probably at the end of the seventh inning.

Given how the game has gone up to this point, it could still be plenty exciting. As Yogi Berra said, “it ain’t over ‘til its over.” So to continue our baseball analogy from a Pete Rose perspective, if I had to put odds on each of the scenarios I’d probably go with 25% Goldilocks, 5% Great Depression The Sequel and 70% somewhere in between.

We pay for returns with uncertainty. It is the reason why assets fluctuate in value and why these assets ultimately produce a higher return than say, savings accounts. We can manage this uncertainty, and we can even learn to expect the unexpected but we can never eliminate it. In fact, it is often the pursuit of risk avoidance that ultimately results in increased, unintended risk.

This isn’t the first credit crisis, it’s probably not even close to the worst and it certainly won’t be the last. The greatest strength of the US economy and markets is our ability to get back up, dust ourselves off, fix the problems and get moving again. Over the longer term efficiencies will continue to be realized from rapid new communication technologies, the internet, nanotech, and a number of other new and yet to be discovered innovations and breakthroughs. Your portfolio will be positioned to take advantage of long term opportunities presented by short term difficulties.

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