



Fourth Quarter 2008 Review & Commentary

Overview

The fourth quarter of 2008 was historically extraordinary, both in terms of events and performance of markets across the globe. This period included the worst week for the Dow Jones Industrial Average since the index was started in 1884 and also saw the index swing more than 1,000 points in a single day for the first time.

Equities (Stocks)

The indiscriminate across-the-board selling of all risk (non-treasury) asset classes that began in the third quarter intensified. Domestically, Large Cap US stocks lost 22% for the three months ending December 31st making for a one-year loss of 37%. Other domestic equity asset classes were even worse for the quarter with the average Mid Cap fund losing 25% and the average Small Cap fund losing 26%. Small Cap funds, oddly enough, held their own for the year with a loss of 36% while Mid Cap funds lost 39%.

International diversification did nothing to help overall equity performance for the quarter or the year. International funds had an average loss of 21% for the quarter and 44% for the year. Emerging Market funds lost an average of 30% for the quarter, bringing their average one-year loss to 56%.

Gold funds performed relatively well for the quarter losing only 5%, but had a substantially negative year with a loss of 28%.

Fixed Income (Bonds)

Some classes of bond funds provided something of a haven for the quarter and the year. As to be expected in periods such as this, long-term Government Bond funds had very good nominal and relative returns at 8% for the quarter and 9% for the year. High Yield Bond funds continued to experience difficulty, losing 18% for the quarter and 26% for the year.

Fourth Quarter 2008 Commentary

“Madness is something rare in individuals -- but in groups, parties, peoples it is the rule.”

Friedrich Nietzsche

Chicken Little Rules the Roost

Reports of the end of the world are premature. Don't get me wrong, there is plenty of unpleasant news to go around, but comparisons to the Great Depression are, to put it quite bluntly, an insult to those who lived through the real thing. We currently have an unemployment rate of around 8%. Various economists are forecasting 9-10% unemployment by year end. The Great Depression saw unemployment rates surpass 20% and the default of nearly 50% of all first mortgages. Currently mortgage default rates are just over 7%. As an aside to these mortgage statistics, about one third of houses in the US today have no mortgage at all (a very underreported fact), so the default rate as a function of all homes is closer to 5%. Clearly, we have a very long way to go before we get to anything approaching a depression.

As another comparison to provide perspective, a recent study looked at the percentage of our income that we spend on various items, including housing, clothing and food. In 1955 the average family had to spend about 29% of their income on food and beverage versus 16% today, nearly half as much. We now spend about 4% of income for clothing versus about 10% in 1955. The point is, we have a great deal more discretionary income than we did in the 1950s and certainly in the 1930s, which should be very effective at muting the blow of a downturn.

It's important to remember that the markets are not the economy. That may sound a bit strange or surprising depending on your view, but a bad economy does not necessarily mean bad equity markets and can often mean good bond markets. As I've said before, stock markets are generally believed to anticipate events six to nine months out. That is why holding or increasing an equity allocation when things look the worst is so important.

Extreme Makeover, Economic Edition

Perhaps a useful model for today's economy is to relate it to a house. As we all know, houses become out of date and, more seriously, can deteriorate over time. We live in a few hundred year old economic house and haven't done any serious structural work or additions since the 1930s when the core of our current banking and securities laws were written. We did more modest renovations in '73-'74, '81-'82 and '01-'02. These were for the most part new countertops, cabinets, wallpaper, that kind of thing. In the meantime, over the last few decades, some real structural problems have developed and we need some new space. We've dealt with these structural problems and additions before, back in 1819, 1837, 1857, 1873, 1903, 1907 (we didn't really understand a lot about structural engineering back then) and in the 1930s, of course, we did the big overhaul and additions we're all familiar with.

So now looking around the house, we find we have some bad beams, need to replace windows and update the electric and plumbing. Pretty soon we find ourselves using the renovators

favorite phrase “while we’re at it we might as well...” Usually in these sorts of extensive renovations, we just end up tearing off parts of the house and rebuilding them, which is exactly what we are in the middle of doing with the economy.

As anyone who has gone through this process in real life can attest, it can be a very unpleasant process to live through and almost always costs more and takes longer than planned, which seems to be just the case with the economy currently. Then of course in our case here, we’ve run across some dishonest contractors, most notably Bernie Madoff, who we’ll discuss a little later. When the work is all done, the memories of the dust, inconvenience and angst fades and the final product is declared to be worth it.

Moving back to the real world, we are solving real structural economic and market issues here, some of which we have been warned about for a while including the explosive and unchecked use of derivatives, the lack of oversight for vast parts of the financial system, growing trade imbalances, a growing income and wealth gap, imperial CEOs, an excess supply in the banking industry and the low savings rate, among other issues. So perhaps counter-intuitively, these events will ultimately produce positive solutions to these outstanding issues. Over time we will begin to forget the pain of this period and be able to observe only beautiful new surroundings and a much more solid structure that will support growth for years to come.

Surprise!

Perhaps the most interesting component of this economic and market downturn is the surprise by which it was met by most market participants, including some of the world’s greatest and most experienced investors and observers. The surprise for most wasn’t that we had a downturn that was preceded by a credit-fueled real estate bubble, but the speed, severity and depth of it. This is somewhat understandable if your job and experience is valuing assets rationally. What the participants and observers underweighted was the speed and extent to which fear and irrationality could consume normally rational markets. This irrationality in turn triggered selling to meet redemptions, touched off greater fear, triggering greater redemptions, etc. It’s hard to not be reminded of a stampeding herd where no individual member knows why the herd started moving or where it’s going.

The famous (or infamous depending on your ideological bent) economist John Maynard Keynes coined the term “animal spirits” to account for this dynamic of mass psychology in markets. Perhaps the concept is more easily explained as a sort of a greed-and-fear-o-meter with fear at one end and greed at the other. It’s pretty fair to say that the meter these days is pegged at the fear end. The meter moves a lot over the years, though. Remember that just ten years ago it was pegged quite firmly at the greed end as everyone *knew* that holding internet and Large Cap US Growth stocks would surely lead to riches. A recent study seems to indicate the Keynes’ intuition was right on track. A recent study in the Netherlands using neuroimaging showed that “deviation from the group opinion is regard by the brain as punishment.”

Rational market participants tend to look like fools when the meter is pegged to either end. Those buying now can be perceived as fools, just as those who were selling in 1999 were. Fortunes are made by those who have the fortitude to shun the animal spirits.

The Price of Everything and Value of Nothing

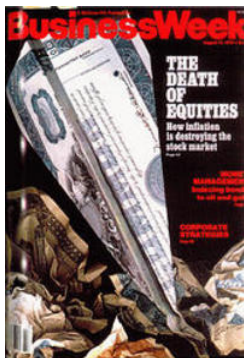
The reason for the disparity between animal spirits and reality lies in the varying gap between price and value. Price is the nominal level at which an asset would be expected to change hands or has most recently done so. More simplistically, what something sells for. Value is the intrinsic, underlying worth or utility of an asset. This may seem like splitting hairs of an arcane, ethereal concept, but it is very useful, especially in times like this when price and value diverge significantly.

Speculators are concerned with price, investors are concerned with value. Speculators fear the animal spirits, investors understand them and that they can present excellent opportunities. Animal spirits come and go, value endures.

To explain this concept let's look at housing prices. Let's say you bought your house five years ago for \$300,000 and today it would sell for \$250,000. The value of your house can come from a lot of things like the fact it keeps the weather out, looks nice, impresses your neighbors, etc. Other than slowly deteriorating (which is why the IRS has a multi-decade depreciation schedule for it) the actual *value* of your home stays pretty constant. The value is its usefulness to you. Ultimately it's a long-term asset and the *price* isn't as important as its utility.

As an aside to housing value and pricing, I will point out that I think the current situation is being exacerbated by pricing provided by current transactions. The classic definition of price is the level at which an asset changes hands between a willing buyer and a willing seller. I would argue that most sellers in this environment are hardly willing, but are forced by circumstances including foreclosure. Furthermore, the sales that are taking place are often not representative properties. This is a result of real estate not being fungible (identical and interchangeable). In other words, my share of XYZ stock is the same as your share of XYZ stock, so they're fungible. My house is different from your house.

With assets, over the long run (the period which is the domain of investing rather than speculating) value is more important than price. Values are currently extraordinarily compelling and are being widely ignored, just as the extraordinary overvaluations of the late 1990s were widely ignored.



August, 1979

The media (who I picked on a great deal last quarter) is the voice of the animal spirits, and magazine covers may be the ultimate expression of this. The prime recent example is the July 12, 2007 Fortune cover story entitled "The Greatest Economic Boom Ever." Uh, yeah..... There is a saying that they don't ring bells at market tops and bottoms, but headlines such as this certainly ring loud and clear with "look out below." While I haven't quite seen anything lately quite as blatant as Business Week's now famous headline from August 13, 1979 declaring "The Death of Equities," (when the Dow was at 875) it isn't too hard to find very dire and negative headlines.



July, 2007

We tend to talk about long-term returns at the tops of bubbles, usually in an attempt to justify ever increasing prices (stocks have returned 10% on average, residential real estate has never had a negative year, etc.). However, we most need to keep these long term returns in mind during times like this.

Burned By Bernie

Adding to the market and economic difficulties of the fourth quarter of 2008 was the news that a fellow named Bernie Madoff had admitted (to family and employees, at least) that he had for many years engaged in a massive scheme which had defrauded investors of \$50 billion. We'll skip a discussion of the irony of someone named Madoff making off with the money (even Tom Wolfe can't make this up). As with any Ponzi scheme he simply took money from later investors and gave it to earlier investors which made his returns look great and, in turn, attracted more new money with which he was then able to fund returns to other prior investors. This all went along just fine (for Madoff, at least) until the markets turned and there were no new investors.

Before I get into the particulars of this, let me take a moment to clarify one often overlooked fact. The true losses to the overall group of Madoff investors were nowhere near \$50 billion. At the end he was thought to have about \$15 billion under "management." Of this there seemed to only be a couple of hundred million of actual money left at the end, which, in his delusion, Madoff actually tried to pay out to his staff as bonuses. So did the rest of the money go to money heaven? Not quite. Essentially the money was distributed between investors over the years, less what Madoff skimmed, which was likely a couple of hundred million. So, not to take this too lightly, but he basically was a version of Robin Hood, robbing from the rich and giving to the (other) rich.

This is a serious topic and the above is really intended as a primer to lead into the much more serious topic of regulation and more specifically, how could our regulatory system have let this happen? The charitable answer is the Securities and Exchange Commission was completely asleep at the switch. The less charitable explanation is that lobbyists have completely reduced the oversight system to be worse than having no oversight. I say this because with no oversight, investors would then have engaged in some due diligence rather than being under the illusion that the government is looking out for their welfare at all.

Let's look at how Madoff conducted business. His original and primary business was as a broker/dealer and market maker in stocks, which dealt with institutions. He was at the forefront of this business for many years, helped to form the NASDAQ stock exchange and worked with the SEC on regulations. There appears to have been nothing nefarious in this part of his business. As far back as the 1970s, however, Madoff started acting as an investment advisor for others rather than acting as broker. He continued to do this in an unregistered capacity, presumably by using the rules for hedge funds, which limit the number and size of investors. Over the years Madoff's companies were investigated 16 times with no fraud detected. In 1992 a feeder fund that sent all of its assets to Madoff was investigated by the SEC and the report noted the "curiously steady" returns of 13.5%-20%. In 2005 an investigation discovered that he

was (surprise) acting as an investment advisor without being properly registered. Yet they were unable to detect any fraud.

Madoff's lure was his seeming ability to attract investors with amazingly high and, more curiously, consistent returns. He apparently never reported a losing *month* in a business where long periods without a losing year are extraordinary. Clearly a red flag. Madoff also retained custody of client assets, which is very unusual for an investment advisor. Clearly another red flag. Harry Markopolous, a Boston money manager, looked at Madoff's returns in 2000 and in four hours declared that it would be impossible for them to be legitimately obtained. He spent the next nine years trying to warn the SEC in numerous letters and meetings, all to no avail. Flags don't get much redder than that. In summing up this case in two paragraphs, I've left a lot out, but suffice it to say that the more one understands the details, the more egregious the SEC's failure in this matter looks.

Why This Won't Happen to You

At some point you may have wondered about your accounts (at least at some dark corner of your mind at 3 a.m.) thinking something along the lines of, "Why can't I be like Bernie and run off with investor's money?" There are, happily, multiple parts to that answer. Primary among them is the idea of the separation of custody and discretion. Custody is the holding of another's assets. The custodian (TD Ameritrade, Schwab or Fidelity, for example) holds the assets. Discretion is, of course, the ability to make trades within an account. In this case I retain discretion subject to the constraints in your investment advisory agreement, but not custody. In other words, I can't take what I don't have. The custodians are completely independent entities from me. I am not their employee, they don't compensate me and I don't compensate them. They provide no advice with respect to your holdings. They are simply a service provider to you by executing the trades I give them and keeping records. I can also tell you, as a practical matter, advisors and custodians keep each other on a very short and cautious leash, always vigilant that the other may do something to harm the client. That's why you get quarterly statements from me and monthly statements and online account access from them and they always match precisely. Overall, this provides a very strong system of checks and balances and verification.

Another contributor to security is that your account holds only publicly traded securities and funds (except in the rare case a client transfers in some sort of more opaque holding). At any time you can easily independently verify the price and performance of any holding in your account. An important part of any scam is that returns are too good to be true. It's hard to imagine anyone reading this currently believes that to be the case.

Finally there is the fiduciary obligation which is part of being a registered investment advisor (RIA). This requires advisors to act in their client's best interest. This may sound strange and obvious, but as we'll see in a moment, it's actually somewhat unique.

There are three main ways to deliver financial services; the previously mentioned registered investment advisor (RIA), a broker (broker/dealer or B/D) and a hedge fund. Hedge funds are unregulated, private partnerships that are limited to 100 members who must meet income and net worth requirements. These often do not use an independent custodian, generally do not

disclose holdings to clients and can be subject to having money stolen outright from them. While many hedge funds are highly successful, the format doesn't really lend itself to the average person's needs.

That leaves us to look at Broker/Dealers. This is what most people recognize from advertising. B/Ds have custody, but not discretion. They hold the money, but are legally not allowed to provide advice except "as is incidental to the sale of securities." So despite all of the advertising to get you to believe that Merrill Lynch, SmithBarney, Edward Jones, Wachovia, etc. are your "trusted advisor," the reality is that they are legally not allowed to advise you and have no fiduciary duty. They have managed to get around this by sometimes also registering as an RIA, taking advantage of what in my view is lax enforcement and spending an enormous amount on lobbying.

The structure is designed to the maximum amount of transparency and minimum amount of conflict of interest. To conclude our unpleasant, but necessary, discussion of bad deeds I would say you would be hard pressed to find a story of a properly registered RIA who uses an independent custodian and holds publicly traded securities who has been involved in any sort of fraudulent activity with investor's money. To paraphrase Churchill regarding democracy, it may not be the perfect structure, but it is certainly better than all of the rest.

While the last few quarters have obviously been unpleasant, I hope you retain the confidence that your assets are being managed with the best possible approach in the best possible operational structure.

So to tie everything together, valuations (which are ultimately the only important metric) are extraordinary and expectations couldn't be lower. In other words, the perfect environment for real investors. To this second point, Nassim Nicholas Taleb in his book *The Black Swan* observes "Consider that the feeling of safety reached its maximum when risk was the highest!" We can argue that conversely, the current *feeling* of safety has reached its lowest, along with actual risk.

I've made a little game over the years of making the most improbable sounding predictions in conversations and when I get the look that implies I must be insane, I know I'm on the right track. It happened in 1999 when saying the dot-coms would implode and again last year when I said the price of oil would crash. It happened most recently when I say that in the next year or two we'll see a 12 month period with a 50% rise in the major stocks average. Try it yourself and see what kind of reaction you get. John Paulson, the very successful hedge fund manager who was one of the few who correctly called the extent of the credit meltdown and it's effects (complete with a 38% return last year) summed it well recently when he said, "We're bearish on the economy, but very bullish on opportunities in front of us."

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