

Looking Beyond the Darkness

Dear Client:

The global economy is facing its greatest challenge since the Great Depression of 1929-33. The credit markets are frozen, housing prices are crashing down to earth, the consumer is hurting and investors are losing confidence in the future. The global stock market has plummeted by about 40% so far in 2008 which will likely make this the worst year for stocks since 1930. Over the first ten days of October alone, stocks sank by 23% as a result of panic selling and forced sales from margin calls and hedge fund liquidations. Investors seemed eager to dump stocks at any price in exchange for the short-term safety of US Treasuries, FDIC insured bank accounts or even stuffing the proceeds under the mattress. This predicament, of course, can be largely attributed to the sub-prime mortgage meltdown and uncertainty about the government's ability to turn the tide on the worsening credit crisis. While the recent \$700 billion bailout plan will eventually help, more immediate intervention has been required to infuse liquidity directly into the banking system. Of course, this crisis extends well beyond our borders as many foreign banks are also in dire need of government intervention to keep them afloat. This past weekend, the finance ministers of the G-7 nations (France, Germany, Italy, Japan, Canada, the United Kingdom and the US) met in Washington to hammer out a coordinated strategy for addressing the crisis. With the combined efforts of the G-7 nations, the Federal Reserve Board and the Treasury Department, perhaps the tide can be turned on the credit crisis and the severity of the economic downturn can be limited.

Having reviewed the background of the credit crisis in prior reports, I will skip the chronology of events and focus instead on the current state of affairs which has impacted all aspects of our financial lives. According to the FDIC, more than fifteen banks in the US have failed this year, including the largest failure in history, Washington Mutual. Investment banks have also failed, including Lehman Brothers and Bear Stearns. Other financial institutions have been forced to merge with stronger entities, including Wachovia with Wells Fargo and Countrywide and Merrill Lynch with Bank of America. The two biggest mortgage lenders, Fannie Mae and Freddie Mac have been taken over by the US government. All of these failures and consolidations have led the surviving financial institutions to hoard their available cash in order to save their own operations rather than lend it out to consumers, businesses and other banks. As a result, the flow of funds available for commerce has become severely constrained. Businesses are having trouble securing cash for normal operations and capital expenditures, consumers are finding it harder to secure mortgages and auto loans, and municipal and state governments are finding it more difficult to secure funding for routine cash flow needs and infrastructure expenditures. With a shortage of cash for all of these purposes, the engine of economic progress is slowing to a crawl with potentially disastrous results for the weakest enterprises. Of course, the main source of fuel for the economy is consumer spending which is slowing as well. Faced with falling home values, slumping retirement account values and rising unemployment, consumers are cutting back on spending by cancelling travel plans, postponing home improvements and delaying major purchases. The most vulnerable are being forced to choose between feeding their families, paying for healthcare or paying their mortgages. Faced with weakening consumer spending and the prospect of lower earnings, businesses will be forced to consider additional layoffs as well as other cost cutting measures. Thus, the age-old vicious cycle of economic expansion and recession, of boom and bust. Unfortunately, this recession will likely run deeper and longer than those of the most recent past.

Beginning of the End?

No, this is not a doomsday prediction, but rather a report on some encouraging developments. As I was writing this letter on Monday, October 13th, the Reuters news service released the following story from London which may mark the beginning of the end of the financial crisis.

Governments across the world launched multibillion dollar bailouts on Monday to shore up tottering global banks and Britain called for a new Bretton Woods agreement to reshape the world financial system. The slew of bank bailouts worth hundreds of billions of dollars were designed to stave off the world's worst financial crisis in nearly 80 years, accompanied by declining global economic growth and the threat of widespread recession.

"Only by global action can we fully restore the confidence that is needed and build the international financial order," said British Prime Minister Gordon Brown.

He called on world leaders to create a new "financial architecture" to reflect the global reach of economics and banking, in much the same way that the current international economic system was set up at a conference in Bretton Woods, New Hampshire, in 1944.

"Market sentiment is a bit more positive, the government has grasped the nettle and committed to a rescue plan," said Keith Bowman, equity strategist at the English investment firm of Hargreaves Lansdown. "There's still a huge amount of nervousness and volatility around but we do seem to have taken a step in the right direction with some coordination from governments and some definite action."

Philip Finch, a global bank analyst at the Swiss bank UBS, added, "Despite prospects of a worsening economic crisis, we believe that the nationalization of parts of the banking system could be viewed as the defining moment that marked the start of the end of the financial crisis,"

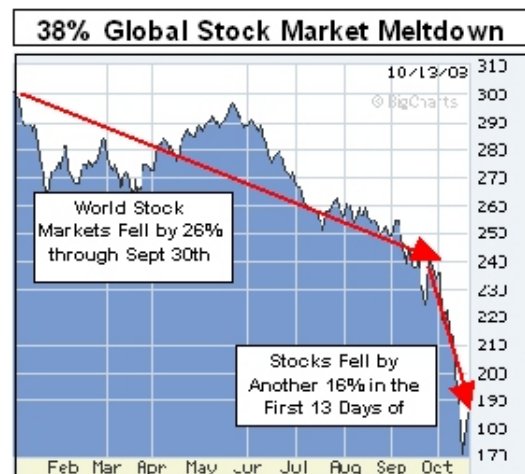
Finally, Ciaran O'Hagan, an interest rate strategist at Societe Generale in Paris, offered perhaps the most fitting summary of Monday's intervention by the world's governments, "Is all of this enough to stop the rot, and even set us on the road toward a build-up in confidence? The glass can be seen as half-full or half-empty."

My bet is that the glass is half-full and that this globally coordinated action by the central banks will stave off a Great Depression-like economic meltdown. I would not have made this bet had the G-7 countries not agreed to emergency initiatives this past weekend. Nonetheless, while the banking system may be in the process of being saved, we're still facing one of the most serious recessions of the last eighty years and we should expect the investment markets to remain volatile for the foreseeable future.

Asset Class Performance Observations

Normally, I review the performance of the various asset classes in order to point out distinctions and, perhaps, suggest which ones might outperform in the future. This time, however, with the stock market having declined by 16% since the end of September, my normal quarter-end review will be shelved. (We've enclosed the standard quarter-end performance review along with this mailing, however.) Instead, I'd like to review what's happened to the global stock market through Monday, the 13th of October.

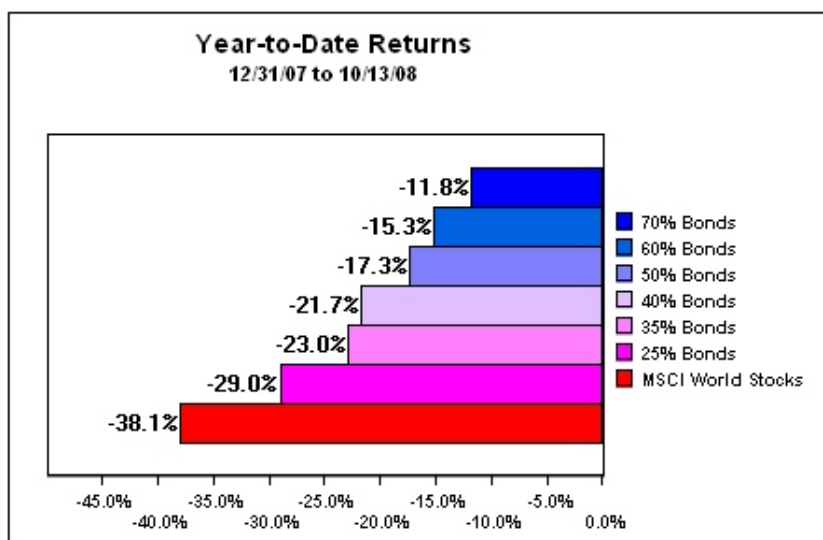
The performance graph is not pretty. Stocks have declined across the board by between 16% and 50% for the year-to-date period ending October 13th. From bad to worse, the performance of the major asset classes was as follows: US Real Estate down 16%, US



Small Company stocks down 27%, US Large Companies down 30%, International Large Co.'s down 36%, International Small Co.'s down 40%, Emerging Markets and Natural Resources losing about 50% each. Even US Bonds did not go completely unscathed, although their 0.50% loss (one-half of 1%) provided a welcome sanctuary from the carnage in the stock market. The best performing asset class was US Treasuries which gained slightly less than 2% for the year-to-date. That's the worst set of returns from top to bottom that I've ever reported in my thirty-three years of being in the business. With steep losses across the board, it's clear that panic selling took hold of the markets. Over the past few weeks, we've entered a period of irrational fear, I suspect, where some stock prices are approaching historic bargain territory.

How Have Client Portfolios Held-Up?

I wish I could report better news, but the results have been downright miserable. October's relentless wave of panic selling saw stocks plummet by 16% in just a few days. While global stocks are down 38% for the year, stocks have dropped by a total of 42% since last October's peak which matches the two-year decline during the 1973-74 recession. During this severe decline, the only asset class which dampened risk was bonds. In the chart below, note how the varying allocation of bonds in the asset mix helped to dampen the downside. Instead of a



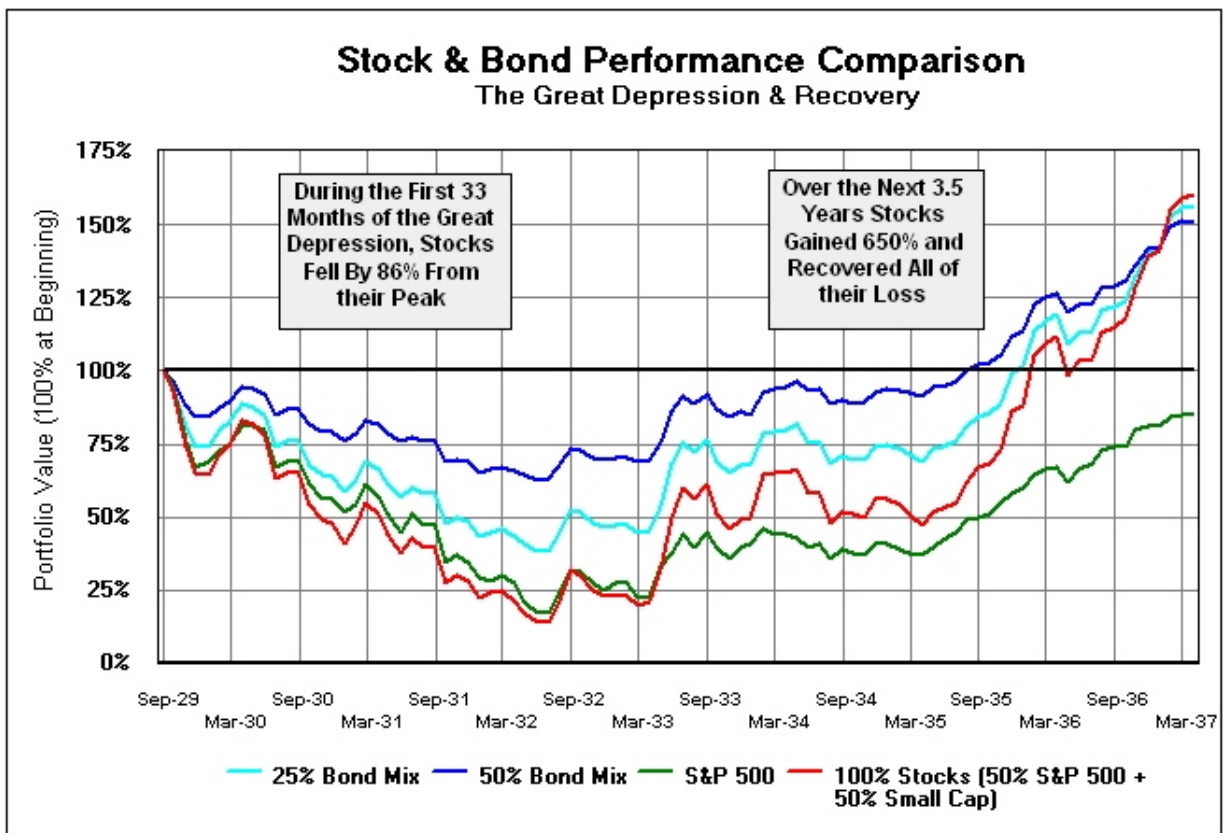
38% loss had one invested 100% in stocks, the loss for a 25% bond investor was reduced to 29%. For a conservative portfolio allocation of 70% in bonds, the loss was limited to about 12%. The losses were pretty much in line with what would have been expected between these two extremes. Nonetheless, the results are hard to stomach.

A Look at the Aftermath and Recovery Following the Great Depression

Early in my investment career, I studied the Great Depression in order to learn how stocks and bonds fared during an extreme period of economic contraction. The logic for doing so was to test various portfolio structures to see how they would hold up under such a scenario. In fact, the essential ingredients which we utilized to formulate our current asset allocation strategies were based upon risk and return data which includes the period of the Great Depression. We have learned some very important lessons from that time which guide our thinking today. In the chart below, note that stocks crashed by 86% over a three-year period from their September 1929 peak (i.e., a \$100,000 portfolio of stocks fell to a market value of just \$14,000!). No wonder some investors who had borrowed money to invest in the stock market (never a good idea) decided to take a leap out of a tall building rather than face financial ruin. Had they not borrowed money to invest in stocks to begin with, or had they just been able to hang on for a few years, they might have lived long and prosperous lives. The losses are only half

of the story, as radio commentator Paul Harvey used to say, "the rest of the story" is that stocks demonstrated remarkable resiliency as the economy turned for the better. For the three and one-half year period following the depth of the Depression in 1932, stocks gained 650% and climbed back to break-even and then on toward positive territory. Note also the path of the green line representing stocks of US Large Companies (the S&P 500). Larger company stocks didn't rebound as quickly as stocks of smaller companies. It would take the S&P 500 another nine years until 1945 to fully recover! Note also the two blue lines indicating the effect of mixing varying degrees of bonds to the stocks and how the losses were much less severe.

So what were the primary lessons we learned from the Great Depression and which we still apply today in our



recommended portfolio structures? First and foremost, allocate a sufficient portion of the portfolio to bonds so that it should not be necessary to sell stocks when prices are depressed (like now). We do this by examining each client's spending requirements and allocating sufficient dollars to bonds to cover withdrawals for a period of *at least* five years. In fact, for retirees we recommend a bond reserve equal to at least ten year's worth of spending. During the Great Depression, the full cycle from peak to trough back to recovery covered a span of about six years, so the five to ten-year guideline is thought to be sufficient. Of course, if a client is able to cut back on spending and reduce portfolio withdrawals during the downturn, all the better (i.e., a penny saved is a penny earned). The second important lesson was that diversifying the portfolio across both Large and Small Company stocks was critical to a speedier recovery during the Depression (the same has been true during other recoveries). Over the past eighty years, US Small Company stocks have appreciated at a rate 20% higher than US Large Company stocks, albeit with higher short-term volatility (average annual historic returns of 10% and 12% respectively). As an analogy, picture a 1,000 foot cruise ship carrying 2,000 passengers trying to navigate through a tricky channel versus a smaller 200-foot expeditionary cruise ship carrying only 150 passengers. The larger cruise ship may have a smoother voyage in a choppy sea, but it takes longer to change course and the captain's orders need to pass through a more time-consuming chain of command. The expeditionary cruise ship,

on the other hand, is more nimble and able to adapt more quickly to changing conditions; and though the smaller ship's ride might be a bit more choppy, the captain's orders don't have to pass through a time-consuming chain of command. In the Great Depression, Small Company stocks were the main driver leading to a speedier portfolio recovery. Perhaps they will serve that same purpose in the next recovery, or perhaps another primary driver might be Emerging Markets stocks which enable investors to participate in the economies of faster growing regions of the world. The third lesson learned from the Great Depression was that once the five to ten-year spending reserve guideline was satisfied (Rule #1), any excess should be rebalanced periodically back into stocks. During the depth of the Depression, stocks were selling literally for pennies on the dollar. Those who had liquid reserves in cash or bonds were able to take advantage of those low prices by being buyers instead of sellers. The ability to buy stocks at lower prices through portfolio rebalancing is one of the investor's most important leverage tools. (The other side of the coin is also true, i.e., when stocks are climbing it's important to rebalance some of the profits into bonds which is what we were advising clients to do between 2003 and 2007.) Ironically, the lower stock prices fall, the lower the purchase price per share and the higher the potential rate of gain in the future. To summarize, the three important lessons we learned from studying the Great Depression were: (1) establish sufficient reserves in cash and high quality bonds to cover five to ten-year's worth of expenses; (2) allocate a significant portion of the portfolio to stocks of Small Companies (today, we would add stocks of Emerging Markets to the list); and (3) rebalance the portfolio on a periodic basis as long as Rule #1 is reassessed and recalculated.

Where Do We Go from Here?

Despite last Monday's stock market surge, we're still apprehensive about recommending across the board portfolio rebalancing until we see more concrete signs that the liquidity crisis is abating. For clients who are more risk tolerant, we would be comfortable recommending a modest shift from bonds to stocks. For risk averse clients, we may not recommend rebalancing until we're completely convinced that their future spending needs are securely invested in bonds (at least ten year's worth). We will approach this on a case by case basis. In the meantime, we are reassessing all of our actively managed mutual funds to make sure the managers are positioned to participate in the recovery when it does occur. We are also continuing to examine each of our bond fund managers to better safeguard that portion of the portfolio should the economic downturn worsen further. Overall, we believe that "value" stock managers will perform better in the future recovery and that some of the most beaten-down asset classes may offer the best potential returns going forward (value managers would include an advisor like Warren Buffett who is buying stocks of depressed financial companies at bargain prices). According to the Compustat research service, ten percent of all stocks today are trading for less than the value of their cash holdings and about 40% are trading at P/E multiples of less than eight times earnings (the historic average P/E ratio is about 16 times earnings). Such valuations have not been seen in well over twenty years and we believe that value funds are in the best position to take advantage of what might be a great buying opportunity. In addition to looking at possible opportunities in the current market, we're also looking beyond today's dark times toward the needs of our economy in the future. The next administration in Washington will undoubtedly need to stimulate the economy and we believe that significant financial resources will be directed toward alternative energy and infrastructure (i.e., bridge repair, flood management systems, etc.). Perhaps these two areas will also be important drivers in the eventual recovery.

Some Words of Wisdom

As we were witnessing one of the worst five day stock sell-offs in history last week, I found that my emotions were beginning to challenge my rational thought process. After all, this was the worst period for the stock market in more than thirty years and perhaps since the Great Depression. The financial press was highlighting the negative news and capitalizing on our fears and emotions. Amidst the turmoil, I decided to give a call to my 93-year-old uncle who introduced me to investments when I was fourteen. After a career in the iron ore business,

he started a second career as an investment advisor at age 55 having been a serious investor his entire life. He helped me construct a modest investment portfolio with \$10,000 that I inherited from my grandmother. In the late 60's after the crash of the "nifty-fifty" stocks, my \$10,000 portfolio shrank to about \$5,000, but instead of throwing in the towel, he convinced me to stay the course and to sell some of my losers and buy some beaten down Natural Resource stocks which was his field of expertise. By the time I graduated from college, the portfolio had grown to \$50,000 and I had quite a little nest egg to help start my career. Unfortunately, the 1973-74 recession wreaked havoc on my portfolio and its value shrank to about \$30,000. With some more encouragement, I rode out that recession and the portfolio recovered and grew to become the seed money for my business career. Had I sold my stocks at either of those two low points, I would never have had the funds to start a business that would eventually become Aequitas Investment Advisors.

While speaking with my uncle, I asked about his experience during the Great Depression which began in 1929 when he was fourteen. He recalled that his father (my grandfather) was involved in the steel business in Youngstown, Ohio, when the Depression began and that his business ran into trouble in 1932. With the family facing some financial hardship, my uncle had to work his way through college which was common at the time. One thing he clearly remembered was that his family had no debt and that those with high debt levels were hit the hardest. Surprisingly, he recalled that his life during the Depression was filled with more happy memories than sad ones. He said everyone felt poor (i.e., in the same boat) and that there was greater enjoyment of the simple things in life; he remembered that dancing with his friends helped to lift the spirits. When I asked what investing lesson he learned during the Depression, he mentioned that his grandfather's largest stock holding was a steel company named Youngstown Sheet and Tube which fell from \$90 a share in 1929 down to \$2 by 1932 (a 98% drop!). While that could have spelled devastation had he been forced to sell, my grandfather was able to hold on for another six years while the price climbed back to \$90 and eventually became one of his most successful investments. Like then, he said, the losses we're seeing in today's stock market are on paper and as long we're not forced to sell, we will likely see their prices recover over time. After all, for every seller of stock, there has to be a buyer, so it makes sense that "smart" investors are probably the ones buying up all of the shares that the panicking sellers are eager to unload for less than they're worth. The last comment my uncle made was that we all might have to tighten our belts during the downturn, but that based upon his extensive experience, stock investors will do very well over the long-run. I asked him what his current asset mix was at age 93. He said he had 70% invested in stocks and 30% in bonds and he didn't plan on making any changes.

Enclosures

Finally, enclosed are two items: (1) an exact replica of the investment chart hanging in my office and (2) a recent Op-Ed article from the NY Times written by Paul Krugman, the recent winner of the Nobel Prize in Economics. The chart examines various aspects of our nation's financial life over the past 80+ years, including how stocks and bonds performed during recessions and wars, how they fared under both Democrat and Republican administrations, the history of inflation, unemployment rates, etc. The chart is rich with information and it provides solace during times when we might be questioning why we own stocks to begin with. In the NY Times article, Krugman praises the recent actions of British Prime Minister Gordon Brown who may have set the example as to how governments should lead the financial markets out of these desperate times (Brown's actions are likely responsible for the short-lived surge in stock prices earlier this week). He also provides a brief summary of the credit crisis. I hope that you find these enclosures useful.

Here's to a greater appreciation of what we have and faith that the world will become a brighter place.

Sincerely,

Warner A. Henderson