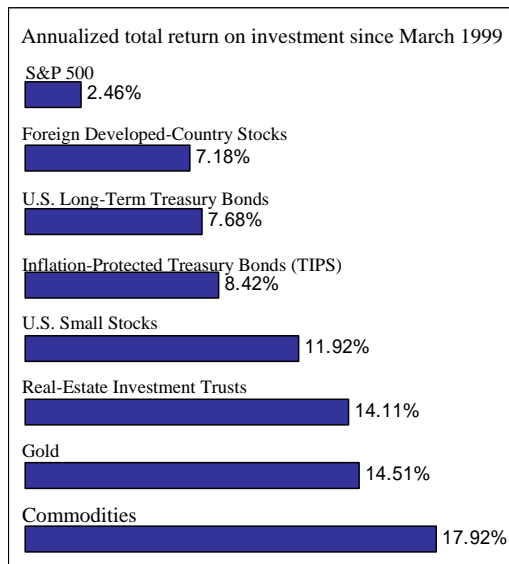


Quarterly Commentary

1st Quarter 2008

How many day traders glued to their quote machines in March of 1999 would have predicted that nine years later the S&P 500 Stock Index would be at lower levels, excluding dividends? So far, in the first decade of the 21st Century, stock returns for the S&P 500 Stock Index have been miniscule by historical standards as well as compared to other asset classes (see chart below). Predictably, this is what happens following years of extraordinarily high returns, such as those that stock investors experienced from 1982 to 1999. The superior returns in the boom years actually borrow gains from the future years. Like night follows day, sub-par returns follow the boom, and it can happen in any asset class. This concept of reversion to the mean happens consistently over long periods in the investment field and is a cornerstone principle of value investing.



Source: Wall Street Journal

While our equity clients did not experience the mass hysteria of the late 1990's, they thankfully have not experienced the hangover of the 21st Century. This "Lost Decade" of stock returns has previously occurred twice in the U.S., both during the Great Depression and as recently as the decade of the 1970's when high levels of inflation hindered stock returns. The term "Lost Decade" has also been used to describe the 1990's in Japan following its euphoric stock market, which peaked in 1989.

We anticipated the current bust in the residential real estate market back in 2004. That downturn is currently in high gear. The peak of the U.S. housing market is generally thought to have been in 2005, so it would not surprise us if annualized returns for residential real estate from 2005-2015 would be unsatisfactory. As we have experienced in stocks, however, that does not mean that attractive returns cannot be made investing in real estate sometime during that ten year period because the bust will likely be followed by a recovery. **When** you invest during a "Lost Decade" can be as important as **how** you

invest. As always, valuation at the time of investment is the greatest determinant of future long-term returns.

While the stock market was experiencing extraordinarily high returns from 1982-1999, commodities had exactly the opposite experience. The commodity bubble of the 1970's was bursting during this period, lasting almost twenty years. There was tremendous under-investment and actual divestment in whole industries like oil and gas, mining, and agriculture. At the same time, worldwide demand for commodities began to accelerate as developing economies demanded evermore raw materials to meet their rising living standards. Increasing demand began to outstrip restrained supply.

Take oil and gas for example. Between 1986 and 2000, the American petroleum industry reduced its work force by 60%, according to a report by the Interstate Oil & Gas Compact Commission. Now the industry is faced with another challenge that some call "the great crew change"- as much of the labor force approaches retirement. Discouraged by the risk of job loss that the previous generation had experienced, an entire generation of potential future workers has opted out of working in the oil and gas industry. Managements of oil and gas companies realized ten years ago that they would be experiencing a potential labor force crisis as college petroleum engineering programs deflated across the country. Nationwide enrollment for petroleum engineers plummeted to 1,387 students in 1990 down from a peak of 11,014 students in 1983. For the next fourteen years, enrollment remained under 2,000. Often, college enrollment patterns can be pretty good contra-indicators of the future. Should that be the case, you might want to steer Junior into another field other than hedge fund manager or private equity manager.

Even though commodity stocks have been excellent performers over the last several years, we continue to favor many of the securities in those industries for the very reasons described above. We believe their businesses are still in the relatively early phase of long-term prosperity. Most importantly, compared to their fundamentals, their stocks continue to be reasonably priced. In many cases, their stock prices have not kept pace with their rapidly improving fundamental values.

An ounce of prevention is worth a pound of cure?

The reason for our criticism of recent Fed policy is that we are confident that the Fed's current actions are sowing the seeds for the next bubble in some, yet-to-be-determined asset class. By lowering overnight interest rates substantially below the inflation rate (Fed Funds rate of 2.25% versus CPI of 4.3%), the Fed is virtually guaranteeing that another speculative bubble will inflate. We are no longer surprised by speculators' willingness to leverage their investments if money is offered readily and cheaply. It is this leverage that helps create the excesses that flow into various asset classes. The longer that this cheap money condition is allowed to exist, the bigger the future bubble.

We were critical of Greenspan as Fed chairman when he failed to combat the "irrational exuberance" in the stock market that he so accurately identified beginning to brew in late-1996. There was little preventive action such as increasing the margin requirements, which would have restricted the practice of buying stocks on margin. The stock market

bubble of the late 1990's and early 2000 grew to over-valuations the likes of which we are unlikely to ever see again.

Following that, Greenspan missed an opportunity to rein in a housing bubble by encouraging homebuyers in February of 2004 to refinance with adjustable rate mortgages (ARM's) near the peak of the housing market (see our criticism in our 1st Quarter, 2004 Commentary). We felt so strongly about this issue that we wrote a special article in July of 2004, probably a full year before the peak of the residential real estate market, suggesting potential solutions to the issues at hand. The core of our recommendation was to break up Fannie Mae and Freddie Mac, the quasi-governmental (they act like for-profit companies during the good times and government agencies during the hard times) housing lenders, and to privately re-capitalize them to insure their solvency. Interestingly, we prompted a lively rebuttal from a member of the mortgage industry. It is fairly typical that industry participants that are the most entrenched can be the most defensive when a contradictory opinion threatens their prosperity.

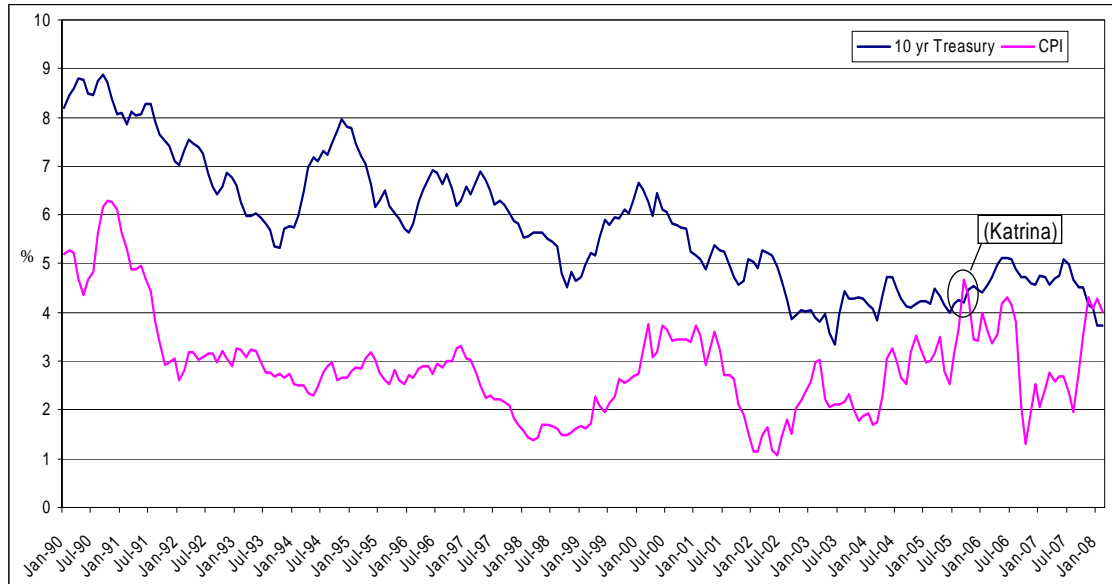
Today, demands for government assistance are being made, although it is now estimated that the costs of the mortgage market's imprudent ways could exceed \$500 billion. This amount is probably many multiples of the original estimated cost had government intervention been enacted expeditiously. We as taxpayers have and will pay generously for the bursting of the sub-prime and housing bubbles that were allowed to grow unchecked by the Fed. For the first time, the Fed is now bailing out Bear Stearns, a brokerage firm that was heavily exposed to the sub-prime fiasco. Interestingly, this is an industry that the Fed does not even regulate, yet. We believe that if proper controls had been established in a timely manner, we would not be debating the expensive bailout of the mortgage market.

Future Bubble Watch?

Where is the next inevitable bubble that is being created by current Fed behavior? Our best guess is probably the bond market. We have told our clients that we currently find investing in bonds very unappealing given the risk/reward tradeoff. As can be seen from our opening chart, bonds over the last nine years have vastly outperformed equities. This is a rare event given that over very long periods stocks have generated double the annualized returns of bonds (approximately 10% versus 5%).

Since inflation is the arch-enemy of bond investors, our attitudes about inflation dictate our opinions about future bond returns. For the first time in over 25 years, the 10-year U.S. government bond yield (3.5%) is less than the inflation rate (4.3%). This means that the average bond investor is going backwards even before taxes are considered. As you can see from the chart on the following page, the last time our nation experienced inflation rates at current levels, with the exception of the brief and unusual period immediately following Katrina in 2005, was in 1991. Then the 10-year government bond yielded over 8%, more than double the current rate. Keep in mind that this relationship is actually muted, because the Boskin Commission, which was established by the government in 1995 to re-calculate future CPI inflation rates, lowered the CPI Index after 1996 by roughly 1.3% annually. Had this adjustment not been made, the current CPI

inflation rate would be running at a 5.6% annual rate. The last time we witnessed inflation running at that pace, 10-year government bonds were yielding almost 9%.



Source: St. Louis Federal Reserve

A service called “Shadow Government Statistics” run by John Williams has the expertise to calculate CPI increases according to two previously employed methodologies. The first adjusts CPI to 1990 methods. Using this approach, the January 2008 year-over-year calculation rose 7.6%. Their second method, which “reverses gimmicked changes in official CPI reporting methodologies back to 1980 was roughly 11.8% in January (year-over-year).”¹ As the federal government is the greatest beneficiary of under-stated inflation rates due to minimized cost-of-living increases on transfer payments, we wonder if this is the greatest financial conspiracy never told. To us, the seemingly muted government inflation statistics do not pass the smell test for data integrity. We believe that current government inflation statistics are under-stated.

As we assess current bond market conditions, two recent trends bear mentioning. Credit spreads for lower grade corporate bonds have widened from all-time lows last summer when compared to Treasuries, but, generally speaking, this is because Treasury yields have dropped, not because corporate yields have risen significantly. Corporate bonds may appear somewhat more attractive today with yield spreads slightly above historic averages, but more so relatively than absolutely. Also during the quarter, select municipal bonds became mis-priced. This was due to the illiquidity in this market created by the trauma with municipal bond insurers and auction-rate securities. However, municipal bond yields offered more relative value than absolute value. Most municipal yields are still below the inflation rate. We think that bonds are unlikely to provide attractive long-term future returns especially if high and rising inflation is on the horizon.

To summarize, whenever we have witnessed ultra-low interest rates like we have today, there is a cost, and it usually falls on the backs of savers. Clearly, the Fed’s action of aggressively lowering interest rates is favoring borrowers over savers. Investors (savers) who are dependent on investment income are being sacrificed over the interests of

¹ www.shadowstats.com

borrowers, and we are concerned that this could lead to financial mistakes on the part of savers reaching for yield out of desperation at an inopportune time. We are typically champions for savers, so we believe that our job today is to guard our savers (fixed income clients) from making permanent mistakes in the bond market.