



January 14, 2009

Quarterly Commentary

4th Quarter 2008

One of our favorite uncles gave us this advice many years ago, “As you go through life, if you will buy only those things that you can afford, and pay cash for what you buy, financially you will be way ahead of your peers by the time you reach forty.”

Apparently, many speculative investors were never the beneficiaries of similar sage advice. As we mentioned in the addendum to our third quarter comments, the greatest credit contraction of our time has resulted in the unwinding of highly levered positions in stocks, bonds and commodities. While hedge funds were the most highly levered, there is evidence that many individual investors were buying stocks with borrowed money as well. The transfer of securities from speculatively financed owners to financially strong owners, which began late in the third quarter, continued at an increasing pace in the fourth quarter. In addition to wreaking havoc on practically all investors’ portfolios, including those we manage, the rush to redeem assets was the trigger for exposing the greatest financial fraud in history. On the following pages, we will discuss where we think we are in the forced and panicked liquidation of securities in this bear market, and we will provide some data for supporting the suddenly bullish expectations for stocks that we began to express to you on October 10th. We will also explain how your arrangement with FRM differs from those investors burned by the Madoff fraud. Finally, we will describe the many bond and stock additions we made during the fourth quarter, as valuations were driven to extremely low historical levels, bringing expectations of very attractive future returns.

The Great Unwinding

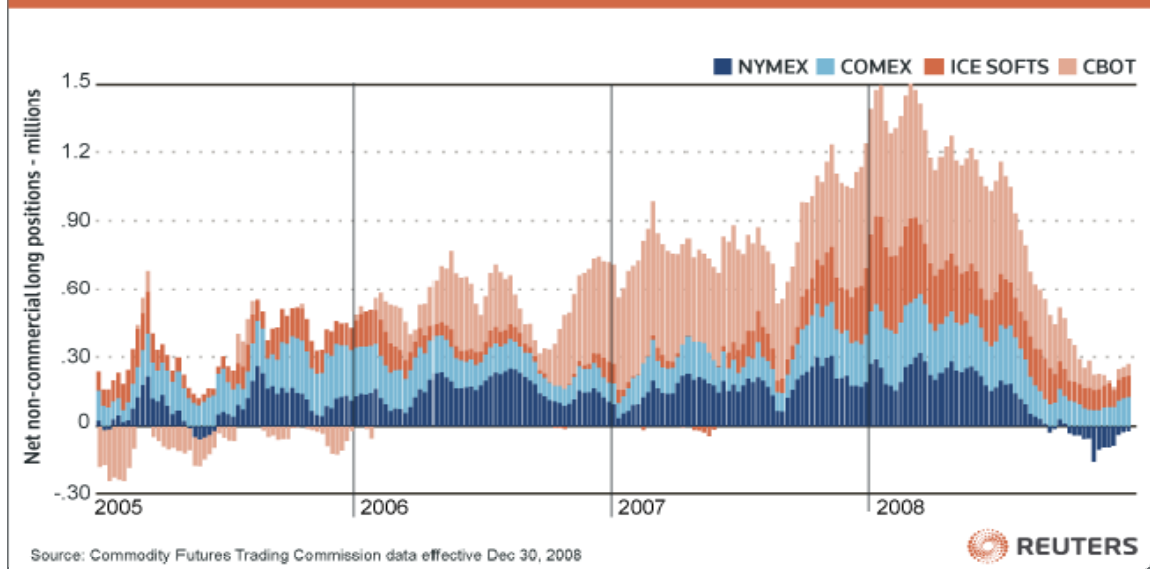
This will come as no news to you, but still it is fascinating to look back for just a moment and think about the fact that it took less than six months for Wall Street, as we knew it, to no longer exist. Lehman Brothers went into bankruptcy liquidation, Bear Stearns was acquired by J.P. Morgan (a bank) in a forced sale, Merrill Lynch was purchased by Bank of America in a forced sale, and Goldman Sachs and Morgan Stanley had to seek bank status in order to receive credit from the Federal Reserve and bailout capital from the U.S. Treasury. Citigroup/Smith Barney was already a bank and brokerage combination, and as we mentioned last quarter, did irreparable damage to themselves in recent years.

The credit that Wall Street previously extended to hedge funds and individual investors was in turn supplied by purchasers of short and intermediate term commercial paper and notes. When this source of funds dried up, the big Wall Street institutions could no longer finance the hedge funds and individuals to the same extent.

So where are we today in this Great Unwinding? While the true answer is that nobody knows, we have looked at two areas that could give us an idea. We believe that one indicates that the forced liquidation of asset positions could be nearing an end. The other remains a large question.

We believe that in the current environment, the positions of non-commercial players in commodities are a good proxy for speculative activities in commodities and securities in general. We believe this because the credit extended for commodity speculation generally reflects the availability of credit for all speculation. As shown on the following chart, the ownership positions of speculators in commodities, which took three years to build, has contracted dramatically since mid-year '08.

Commodities net length

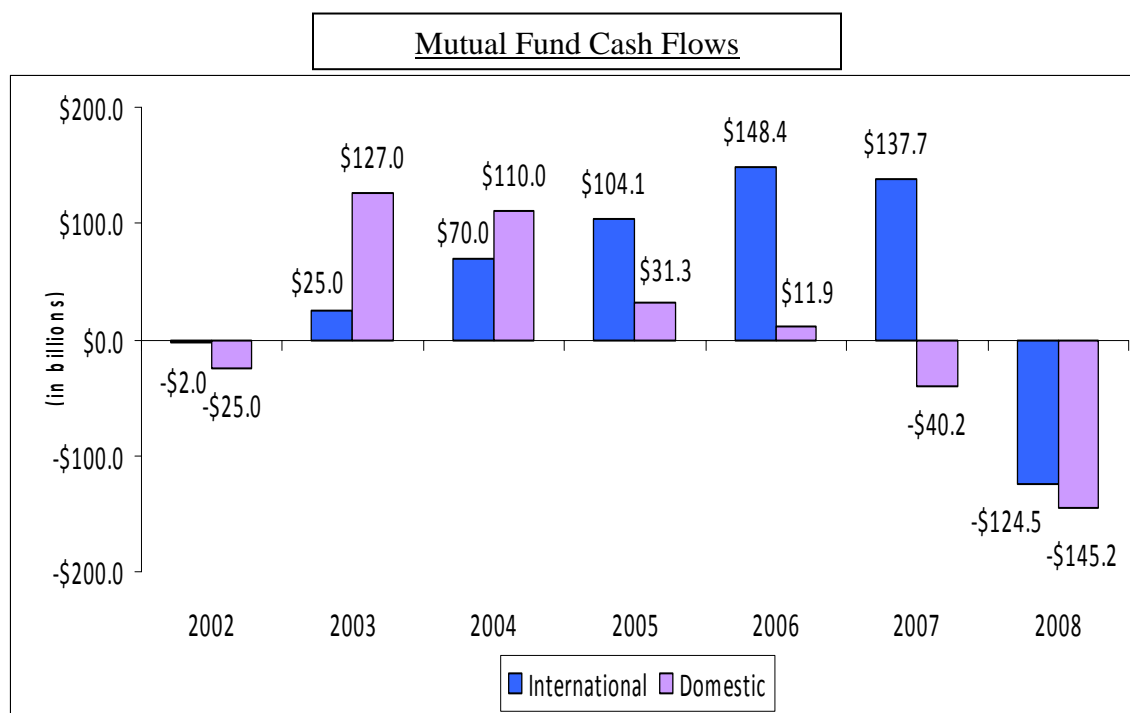


At this stage of the credit cycle, credit for speculation has dried up. Net positions of speculators, as reflected above, are very low compared to mid-year. You might ask what might keep speculators from continuing to sell, thus undertaking a net short position. As you can see from the above chart, this has actually happened to a small degree on the NYMEX (New York Mercantile Exchange). However, we do not expect net short positions to build to any great degree, because this requires the extension of margin credit, just as a long position does. Thus, for the time being, we expect speculation in commodities to have less of an impact on those markets. The leveraging of stocks and bonds through margin debt will probably be much less of a factor in those markets as well.

We are less certain about the continuation of hedge fund and mutual fund liquidation. Ending hedge fund asset numbers for 2008 are not available, but it is known that large liquidations took place in the fourth quarter. The industry started the year with about \$2 trillion in assets (that is \$2,000 billion for those of us that have to stop and think about that sort of thing). Most estimates we have seen say they ended the year somewhere around \$1.4-\$1.5 trillion. We have also seen estimates that say that the hedge fund industry averages about three to one leverage, meaning that for every dollar that investors wish to withdraw from the fund, three dollars of assets have to be sold to meet the redemption. This doesn't take into account that many funds

are much more levered than the average, and it is not unreasonable to assume that the most highly levered funds are the ones meeting the greatest amount of redemption requests and margin calls.

Mutual funds experienced large redemptions in 2008. As shown in the chart below, domestic mutual funds have not enjoyed significant cash inflows since 2004. This was offset by the growth through 2007 in domestic investor purchases of international mutual funds. In 2008, all mutual funds have been in liquidation, especially in the second half of the year.



Source: Investment Company Institute, Trim Tabs

We recently ran across a counter-point to the trend in hedge fund and mutual fund redemptions. According to Bloomberg, the ratio of cash, bank deposits and money market fund balances to U.S. stock market value now stands at 74%, the highest this ratio has been since 1990. Of course, a tremendous bull market began in 1991, fueled by that large amount of investor liquidity.

To summarize where we think we are in this bear market, we believe that the Great Unwinding of credit for speculative purposes has mostly run its course for this credit cycle. It is really unknowable whether hedge fund and mutual

fund liquidation has bottomed or reached a capitulation point similar to those that marked the end of other great bear markets.

A Value Investor's Dream

As we opined to you at the end of the third quarter, we believe that security valuations currently reflect bargains that we have rarely seen before. Low valuations are the key ingredient to attractive future returns. We look at many fundamental characteristics in determining value. We acknowledge that in the current environment, company earnings are very uncertain and unpredictable. In our work, we spend almost no time trying to predict earnings in the near-term, so let us look at asset values relative to the current market.

The S&P 500 currently trades at an average of about 1.6 times book value. This is lower than it has traded in many, many years. Of course, numerous companies in the index trade lower than this figure. Because book value is based on historical cost net of depreciation, this means that many companies are trading near or even below **replacement** cost, since the cost of replacing almost all tangible assets is higher than historical cost due to inflation.

Another indication of value in the broad market is the dividend yield on the S&P 500. Again, we acknowledge the uncertainty of future dividends in today's environment, but at 3.02% at the end of the year, the index yields almost double what it did just two years ago. We mentioned in our third quarter commentary that average dividend yields had moved above the yield on the five-year Treasury note. Now the average yield on the S&P 500 has risen significantly above the yield on the **ten**-year Treasury note, which stands at 2.4%. As usual, our portfolios yield significantly higher than the index average.

The Madoff Fraud

Since an \$80 million Arkansas Ponzi scheme that defrauded many sophisticated business people was uncovered in the late fall of 2002, we have tried to make it a point to discuss with prospective clients, particularly our high net worth individual prospective clients, how the three-party

structure our clients have protects them from someone absconding with their funds.

We never thought we would live to see the day when someone like Madoff would make the Arkansas fraudster look like a piker, but it happened, apparently to the tune of \$50 billion. His hedge fund was using the old Ponzi formula of paying earlier investors attractive returns with money garnered from more recent victims. It is interesting that in both cases the fraud took in many “sophisticates.”

In each of our client relationships, our clients’ assets are held in custody by a third party custodian of their choosing. This third party provides a monthly accounting of each client’s assets, and no client assets are pooled with anyone else’s. We review the transactions that we record in your accounts with those of the custodian on a daily basis. Every account is reconciled between our records and the custodian’s on a monthly basis. We only have our clients’ limited power of attorney to execute security transactions on their behalf, not to transfer assets. Thus, our clients are protected because they are the only ones that can authorize withdrawals. We believe that the structure we have implemented best protects our clients from fraud.