

July 5, 2007

## 2007 Second Quarter Review

Crowds gathered, the sky lit up and the sound of thunder rolled across the country. I'm not referring to the 4<sup>th</sup> of July fireworks, but to the breathless coverage of the launch of the i-Phone last Friday. The i-Phone is supposed to do everything but your laundry, and they're working on that. There are rumors that this new product may bring about world peace. One of our most difficult tasks as investors is to separate hype, hyperbole and hand-wringing from relevant fact. We are not often helped by members of the financial press, who have become much like the local TV newscaster who that tells you there is an imminent threat to your life, home and family.....details at 11:00. That threat turns out to have been contrived, exaggerated and all but manufactured in order to keep you watching. Many business and investment reporters have become cheerleaders or scaremongers, depending on what the market is doing. Lately, they've been doing a good job of cheerleading. Their job is to get your attention, not give you analysis, much less perspective. We will try to cover some of that ground.

The stock market gyrated, but fell slightly in the first quarter, then staged a rollicking rally off the March 6<sup>th</sup> lows into April and May. June saw the indexes decline somewhat to end the second quarter up 6% for the year in the S&P 500, and up just over 7 ½ % for the Dow Jones 30 Industrials. Bonds declined as interest rates rose, with the US 10 Year Bond Index falling 3 ½% so far this year. The yield on the US 10 Year bond has increased from 4 ½ % to over 5% since the first week of March. This is important partly because so many mortgage rates are set at a premium to this bond's yield. In general, rates have gone up with negative implications for housing, inflation, and the consumer.

The story of financial markets is nearly always the same. There is a pendulum that swings between fear and greed, with infinite variations in between. Our task is to have enough perspective to know when we might be near the extremes. At present we are far enough along in the "greed" swing to want to be careful. We should be prepared for the inevitable swing into the "fear" zone because "forewarned is forearmed".

Blackstone Group and Bear Stearns offer cases in point. Blackstone issued stock in an "IPO," raising more money to buy more companies with "private equity." "Private Equity" is the new name for the "Leveraged Buy-Out" or LBO of the 1980's. Year-to-date, there have been \$300 billion in "private equity" deals where public stock gets taken private, three times the level of last year. That frenzied deal activity has given some investors confidence that there is a "liquidity put" beneath most stocks; that is, a level below which the stock won't fall because it will then be taken private. While true in some cases, the over-confidence it implies smacks of late bull-market rationalization and could be dangerous should credit conditions tighten. An interesting note is that the "hot"

(and much hyped) Blackstone Group IPO suddenly cooled off and the stock soon fell below the initial offering price.

The stories about Bear Stearns focus on the major problems they're having with two of their hedge funds that invested in "sub-prime" mortgages and derivatives. "Sub-prime" is the new name for what used to be called "junk," or speculative grade, bonds. These are the types of "dislocations" that we have expected with the deterioration in the housing and debt markets and the increased leverage and complexity brought about by the "financial engineers" at brokerage firms that produce and invest in derivative investments. The credit markets are slowly awakening to the idea that sub-prime investments (like Bear Stearns') and overleveraged deals (like Blackstone Group's) may not have a happy ending.

Many of the saner minds on Wall Street agree that we have been in a "credit bubble." Assets have increased in value at least partly because it has been so easy to borrow money to buy them. Complexity and leverage in the financial system has increased. Warren Buffet has called financial derivatives, of which there are some \$400 *trillion* worldwide, "financial weapons of mass destruction." Blackstone and Bear Stearns are really smart guys who have been making lots of money. But so were the guys at Long-Term Capital, the hedge-fund run by literal geniuses, that collapsed in 1998. As Jim Grant put it, "If the Nobel Laureates at Long-Term could miscalculate, so can we all."

Mr. Grant put it best. "The philosophical premise of value investing is that the future is unpredictable. Not knowing, and knowing that one can't know, the careful investor insists on a margin of safety in the form of a low price. Of course, in a credit bubble, one can insist until one is blue in the face. Prices won't oblige until the bubble bursts."

We are trying to be careful investors, knowing that there are warning signs, and also knowing that there are still good investment values to be found. Markets can "go parabolic" (up) even while those warning signs are flashing. Value investors are often unhappiest when speculative markets run up and away from "fair value." Less careful investors are happiest then, but unhappy later when the bull markets that they "believe in" turn against them. Both investors experience frustration and discomfort. However, the careful investor usually keeps more of his money.

Enclosed you will find your quarterly reports and statements. Please review them at your leisure and call with any questions, comments, or suggestions.

I hope you have a good summer while we do our best to make it a profitable one.

Sincerely,

Claude R. Carmichael CFA