January 11, 2007

2007 Year End Review

If you have a sense that the 4th quarter was a tough one in the investment world, you're right. In fact, it was the worst 4th quarter in 20 years for the Dow Jones Industrials. (Remember the crash of '87? I do.) This wasn't quite as bad as 1987, but it was bad enough that I started getting flashbacks. Most of our concerns from the beginning of last year proved to be well-founded. Our main trepidation (that the mortgage and "derivatives" problems would surface and then spill over into the general economy) proved prescient and kept us from being overly aggressive in our investing. That turned out to be a good thing since the market headed south in July, splatted in August, rose to a new "record" in October, then sold off again into the end of the old year and the beginning of the new. By December 31st, the S&P 500 Index was up only 3½%, as was the Lehman Treasury Bond Index. The "average stock," as represented by the Value Line Arithmetic Index was up only 1%. The "small capitalization" stocks were pummeled as shown by the Russell 2000 Index, down almost 3% for the year. However, the indexes only tell a fraction of the story. There were many different bull and bear markets. Consumer/housing/finance stocks took investors to the house of pain while infrastructure/commodity/energy stocks took them to the party. Large company stocks worked much better than small ones, and value investing in general returned almost zero for the year. The crosscurrents have been very powerful, indeed.

I grew up in and around boats at the mouth of the Chesapeake Bay. I had never been seasick in my life until I went fishing with a friend in his boat just off the tip of Montauk a few years ago. We were anchored in swirling waters caused by the crosscurrents coming off the north and south shores at the tip of the island, and swells were clashing from two different directions as well. The boat was pitching hard in a completely random fashion. To my embarrassment, it finally got to me. Recently, I have had a very similar sensation with this market. The volatility has been described as "ludicrous" by more than one market veteran whose writings I follow. Recently, a year's worth of performance in many stocks (10-15%) has been routinely made or lost depending on whether you bought or sold one day or the next. Obviously, the real value of a company doesn't often change that fast, but the stock prices recently have. Starting last July, we have seen the end of a period of high liquidity with low volatility and have now begun a period of low liquidity with high volatility. The pendulum has swung. It reminds me of one of Warren Buffet's best sayings about the stock market. "On the short term," he says, "the stock market is a voting machine. On the long term it is a weighing machine." As anyone following the presidential primaries can attest, voters can be fickle and highly emotional.

It's been tough for us, but consider the plight of shareholders of Countrywide Credit. Just this past February, if you had told shareholders of Countrywide that the company would be taken over by Bank of America in less than a year, they would probably have mortgaged their houses *again* to buy more stock. The idea that the takeover would give them a *loss* of 84% ($45 a share down to $7) would have occurred to few. So, Bank of

America has ridden to the rescue of Countrywide Credit and may save the economy the headache and heartache of sorting out that can of worms. The Federal Reserve Board appears ready to continue to lower rates and take other actions to help. Some people think this will be enough to save the market and turn the crisis around. Fortunately or unfortunately, I am now old enough to have been through several economic crises in my time on Wall Street. We have always come through them and profited nicely on the recovery. My experience tells me that system-wide problems of this kind often get resolved with a high-profile bankruptcy that causes a climactic sell-off. If events follow this course, we should be prepared.

"Circle the wagons, but be ready to ride!"

As I've mentioned before, the goal in times like these is to protect capital well enough so that you still have plenty to invest when most others have been beaten and are too discouraged and/or financially impaired to continue. We have circled the wagons in order to defend ourselves by trimming positions, jettisoning under-achievers, and maintaining healthy amounts of cash in reserve. The good news is that the "Value Restoration Project" (so named by Jim Grant) is well underway. A lot of stocks are getting cheap; some very cheap. We are now seeing quite a few stocks trading at 9 or 10 times this year's earnings; something we haven't seen in a while. Investors are still afraid to buy, meaning that the pendulum has now made the inevitable swing back to the "fear" zone.

Although declines like these are uncomfortable, they can set up wonderful money-making opportunities. We may be more than half way through this crisis. Remember that a year ago there were no headlines about the mortgage and "derivative" problems that now occupy everyone's attention. The market usually "looks ahead" and rises before the economy recovers. Consequently, we will want to venture out of the wagon circle sometime before the "all clear" has been signaled. The counter-intuitive nature of successful investing continues to be a difficult but potentially very remunerative exercise. "Remember," a wise Wall Street veteran once said, "when the time comes to buy, you won't want to."

Enclosed you will find your statements and reports for 2007, as well as a capital gains report for taxable accounts. If you would like to discuss your portfolio or any investment ideas, just give me a call. I look forward to a prosperous 2008 for us all.

Sincerely,

Claude R. Carmichael CFA