October 6, 2008

2008 Third Quarter Review

Obviously, everyone is nervous if not alarmed about recent market action. Even Warren Buffett called recent economic developments an "economic Pearl Harbor." Because we considered this "liquidity crunch" scenario as a possibility, we have kept large reserves of cash in our portfolios, the only exceptions being those who withdrew their cash reserves for large purchases or for emergency health expenses. Our cash reserves have provided somewhat of a cushion against the stock market decline and have meant the difference between a downdraft and devastation. The safety of those cash reserves is of utmost importance to us. In these extraordinary times, I think we should first address the issue of that safety.

Recent moves by the U.S. Treasury Department have made our cash reserves about as safe an investment as there is at the moment. Government officials became alarmed recently that there might be a "run" on money market funds, particularly when the Reserve Primary Fund, the nation's oldest money market fund, "broke the buck" in mid September. Shares declined to 97 cents from the normal dollar level after the fund took losses on some short-term "commercial paper" issued by Lehman (who had just filed bankruptcy). Fearing a run on money market funds in general, the government agreed to insure the assets in each account of every "participating" money market fund for at least three months, extendable to one year at the Treasury Secretary's discretion. Banks howled "foul play" because their accounts were limited to coverage of only $100,000 insurance by the FDIC. As a concession, the government countered that it would insure the balance of the money market fund in each brokerage account up to the level each account held on September 19th. For the time being, it appears that money market balances, at least to the level held on September 19th, are very secure.

Regarding the strength of the financial institution that holds most of our assets, Schwab has been a major beneficiary of the recent turmoil as investors have looked for strong companies that have avoided becoming encumbered by mortgage-related problems. A good indication of the perception of Schwab's strength is that its common stock has been one of the best performing of any major financial institution in the country, remaining near it's 52 week high while many others have plummeted. The combination of the Treasury's guarantee on money market funds and Schwab's financial strength (plus SIPC coverage) gives me reasonable assurance that our assets are not at risk to default by the carrying firm. I have included a copy of a letter from Charles Schwab providing more information about the financial strength of Schwab & Co.

There is simply too much that has happened recently in the market and the economy to cover adequately in a few pages of text. Almost every item on the laundry list of potential problems that we have highlighted in these reports over the last two years has crowded onto center stage and now commands our attention. Just last quarter we mentioned that these kinds of crises usually do not end without a high profile bankruptcy (or two, or three). Those have now come to pass. Massive intervention by the Federal Reserve is now taking place. Thankfully, we have remained defensive over the past year or more and have avoided becoming aggressive as each recent crisis has been called "the bottom" during each subsequent bounce.

The major stock market indexes are now down 25% so far this year, and down over 30% from the highs of last October. Hedge funds that used high amounts of leverage to boost their returns are now faced with redemptions by unhappy investors who have seen the value of their accounts cut in half or worse. Leverage is a double-edged sword. Stock price declines are now reaching a crescendo with frightened investors competing with forced selling from hedge managers, as well as investors hit with margin calls on their leveraged investments. Oil and commodities, which had done so well until July, have declined precipitously partly due to this forced liquidation by speculating hedge funds, as well as by investors fearing "demand destruction" in an economic recession. Consequently, stocks and other investments prices can be pushed well below normal values into true bargain territory. That presents an opportunity if you have the cash.

There is also a tug of war between inflation and deflation. Money is being destroyed by the "debt repudiation" that follows bankruptcies and asset write-offs (deflation). Money is being created by the Federal Reserve to keep credit flowing (inflation). Currently, fears of deflation are running highest and commodity prices are dropping. Eventually, money creation will likely overshoot the target and create a new round of inflation on the other end of this crisis. More on that later.

We have remained defensive and have built up our cash reserves in order to provide some protection from this economic storm. As any sailor knows, weathering the storm is the first priority, and we have taken the steps to get through this one by paring down our holdings and ejecting investments that haven't performed well enough. Having the cash reserves gives us the flexibility to take advantage of this adversity. I am reminded by Vince Farrell that the average bear market involves a decline of 31 to 34%, which is near where we are now. Then:

> "..when a bear market turns, a gain well in excess of 30% is normal. Bear markets end when the news is at its worse, and long before the statistics and the numbers turn to the positive. We need to keep that in mind."

When the pendulum swings between fear and greed, the trick is to be fearful when others are greedy (up to June-July of 2007), and greedy (or at least opportunistic) when others are fearful (now). We've gotten much of the first part right. That is not to say that we should be heroes and go charging into aggressive investments. We should be willing, however, to nibble at values that once were and soon may again be considered compellingly attractive. Until then, we would all be happy just to see a ray or two of sunshine on the storm-washed deck.

Enclosed you will find your quarterly statements and reports. Please review them at your convenience and give me a call with any questions, comments, or suggestions you might have.

Sincerely,

Claude Carmichael CFA