

QUARTERLY COMMENTARY

First Quarter 2008

Beginning in the late-1990's, we warned repeatedly about the unprecedented and potentially disastrous growth of debt and derivatives. We simultaneously highlighted the public's disdain for saving, which progressed dramatically to the point at which the U.S. population has been spending more than it has been earning (negative savings). We never pretended to know how this unhealthy mix of conditions would play out, but we knew that it was unsustainable and rife with potential for severe economic distress.

Sure enough! That which is unsustainable has once again not been sustained. Led by troubled subprime mortgages, any number of derivative securities, levered up three, five, ten or more times with debt, have collapsed in price. Homeowners, in over their heads, are losing their homes at record levels. "The best and the brightest" financial firms in the known universe have already written off over \$200 billion, and at least that much again will likely be written off before the current crisis ends.

The Federal Reserve, along with central banks around the world, has reacted aggressively by dropping short-term interest rates by 3% and opening lending facilities to virtually any financial institution that needs liquidity. It is an open question whether the Fed will succeed in rescuing legions of homeowners and homebuilders, the banking system, the economy and ultimately the asset markets.

In the late-1990's and in most years since then we have also cautioned clients that stock market valuations were at or near historic highs. Readily admitting that valuations were poor short-term market timing tools, we warned that such valuations had always ultimately forecast market price direction correctly, although occasionally with a multi-year lag. That proved to be true in this cycle as well. Far above average valuations led to well below average equity returns.

Common stocks, as measured by the Standard & Poors 500, earned an annualized total return of 3.5% over the ten years ending with this year's first quarter. Investors in risk-free 91-day U.S. Treasury Bills did slightly better while foregoing all the excitement attendant to common stocks. That ten-year period included the euphoric run-up to the dot.com bubble, Y2K, the biggest stock market decline since the Great Depression, a five-year stock market recovery and the current financial crisis. Because the stock market did extremely well leading up to the dot.com top in March 2000, decade-long comparisons are going to be even more difficult over the next two years. We are pleased that every portfolio we have managed over that full ten-year period -- whether stock, bond, cash or balanced -- while assuming far less risk, has done significantly better than had we simply bought and held the S&P 500.

On a much shorter-term basis, we are also pleased that client portfolios were up this quarter with the S&P 500 down 9.45%. Over the most recent twelve months, the S&P was down more than 5%, while our portfolios were up from 6% to 7%. We owned relatively few common stocks through that dangerous period, but our selectivity paid off with those stocks outperforming the S&P 500 by more than twenty percentage points.

Notwithstanding the steady stream of unsavory financial headlines, stock prices are making valiant attempts to remain above their mid-March lows. Barring an even bigger negative surprise, it is reasonable to expect stocks to attempt to rally off those lows. We have no conviction about how far or how long such a rally might last, but we added stock during the market's decline to benefit from potentially rising stock prices. We do not believe that the long-term weak cycle has ended, but the significant decline from last August begs at least for a relief rally. In an election year that rally could prove stronger than underlying fundamentals might warrant. At the same time, however, we recognize the danger that the best efforts of the Fed and the Congress may fail and that markets could again be punished. We remain ready to further reduce risk exposure should conditions require that.