

Market Commentary

Before we turn to a discussion of the current chaos on Wall Street, we want to address the question that is no doubt uppermost in your mind: What about the money you have entrusted us to manage for you?

First, we believe your money is safe at Charles Schwab and in its money market funds. Schwab's business is very unlike that of Bear Stearns, Lehman Brothers, etc.

Second, despite our best efforts accounts we manage have gone down in value this year consistent with what has happened in the overall stock market. Unless one was all in short maturity government bonds and cash, you would have lost money this year. Our approach has been to generally buy dividend paying stocks and we have tried to focus mainly on very large companies. Unfortunately companies which meet those criteria in the financial sector have been among those hardest hit by the current crisis. Investing has been and always will be a judgment business. Between us we have well over 60 years of experience and have seen good markets and bad markets. We invest our own money the same way we do our clients' funds. It's no solace to you or us that many very large and well-respected mutual funds own some of the same stocks we do, which have been hit so severely by these problems. The point is not that this is okay, but rather that if you stand near a hurricane, everyone gets wet.

Third, we continue to believe in the underlying strength and resilience of the American economy. We believe in the type of companies we buy for our clients and ourselves. We think the U.S. economy and the U.S. stock market will rebound.

Now, how did we get here and where do we go?

It's hard to know where to start in discussing the state of the stock market and the economy. So far this year 4 of the 15 largest financial institutions in the U.S. have been sold for a token amount or liquidated. Washington Mutual, the largest savings and loan in the U.S., is gone and absorbed by JP Morgan. Wachovia, the fourth largest bank, is about to become part of Wells Fargo, Citigroup, or some other bank. Fannie Mae and Freddie Mac, the largest mortgage finance companies in the world, are effectively gone as private stockholder institutions. American International Group, probably the largest insurance company in the country if not the world, struggles to continue to exist. Bear Stearns is gone. Lehman Brothers is gone. Merrill Lynch is soon to become part of Bank of America, which previously purchased Countrywide Financial.

These are but the biggest names that have disappeared in the financial tsunami we have

experienced this year. Banks won't lend to each other. The government is guaranteeing most money market funds. Massive layoffs are in store. On September 29, the stock market experienced the largest decline in 20 years in percentage terms, wiping out more than \$1 trillion in market value in one day. Treasury bill interest is close to zero as investors flee to the safest possible investments. It is not hyperbole to say that today the U.S. faces the greatest financial crisis since the Great Depression.

Before discussing how we got into this situation, we want to emphasize the following:

Conservative, value stock investors have suffered greatly this year because of the implosion of the financial sector. For those of us who invest in this way, probably the only way to avoid the problems would have been to completely change investment philosophy in anticipation of something which hasn't happened in more than 75 years.

We are not making excuses, saying losses are okay, or anything like that, but the reality is that we have lots of good company in this boat.

This wasn't a long slow process of deterioration. Much of it actually happened over a period of two months and in some cases a few days.

Diversification is important. Even though we had a lot of exposure to financial sector stocks, we also have substantial exposure to other sectors and have always maintained cash and in many instances bonds in accounts. Without such diversification the problems we have experienced would have been even worse.

We have always advocated a relatively simple approach to investing and eschewed some of the fancier new financial inventions. Little did we or most people (including regulators charged with overseeing financial institutions) know how infected the whole system was with those instruments (i.e. derivatives).

In a modern economy all of the parts are in some way interrelated. That's how an overvalued real estate problem becomes a systemic problem.

Most important of all, the worst time to change strategies is when chaos exists and many others are acting impulsively and out of fear. It's tough to stay the course and there are certainly no guarantees of anything, but in our considered judgment, that is by far the best choice right now.

How did we get into this situation? Many books will be written on this subject, but here in short form is a summary of what we think happened and why.

The basic problem was an overinflated real estate bubble which finally imploded. The overvaluation of real estate was facilitated by lax lending standards, low interest rates, greed on the part of people who thought real estate would go up forever, and excessive securitization of real estate related securities which increased the flow of capital to this sector of the economy.

The bursting of the bubble worsened due to lack of adequate regulation of financial markets in general and derivatives specifically. While the judicious use of derivatives can be helpful in facilitating capital expansion, they can enable excessive risk taking and leveraging of the underlying assets. The derivatives market, which has a value in the tens of trillions of dollars, has been characterized by a lack of transparency and thus accountability. It's not an overstatement to say that no one really knows who owes what to whom or where the real risks end. Warren Buffet once called derivatives "weapons of mass destruction", and he has certainly been proven prescient in that regard.

There have been other factors which have exacerbated these already major problems. Although there is disagreement about the impact of short selling, it does seem to have further eroded confidence in some already shaky financial institutions, increasing the downside pressure on their stocks and engendering more fears by depositors, bond holders, and credit rating agencies.

Hedge funds can also be a positive force in the markets by providing additional liquidity and a means of reducing risk. However, lack of regulation and transparency has enabled them to undertake highly leveraged investment activities, which can have a deleterious impact on the economy and help to spawn fears about some already weakened companies.

The somewhat arcane concept of "mark to market accounting" also bears some responsibility. Mark to market accounting requires companies to adjust the value of investments on their balance sheets to the current market value. However in markets which are frozen by fear about the quality of underlying assets, market values plummet as few investors want to venture forth. This causes the companies owning those investments to take large write-downs which in turn endanger their credit ratings. Credit rating downgrades spawn further write-downs and collateral demands which again weaken the companies holding the investments. If this sounds like a downward spiral, you've captured one of the basic problems.

What started as a real estate bubble has evolved into a major crisis of confidence in our financial system and thus our economy. The financial system is the lifeblood of any economy. The ability to raise capital (both equity and debt) and invest funds is at the heart of a properly functioning economy. The financial system and free markets are in the end based on faith, trust and confidence that parties to an investment contract or transaction will fulfill their end of the contract. When such faith is absent (either because of concern about the other party going out of business or that the collateral they post isn't good) the system cannot function.

That is where we are today. Businesses, investors, and everyone else is scared. They are worried that the financial institutions which underpin our economic system won't survive. The decline in the stock market has substantially eroded retirement savings. Investors (including professional investors) are frozen by fear of what domino will fall next.

Who is to blame? Some will blame lack of regulation. Others will blame government for not acting sooner or more decisively, or taking impulsive steps which have wiped out investors (Fannie and Freddie). Some will blame short sellers and hedge funds or greedy Wall Street banks. In our opinion, it would be a mistake not to include the many, many people who used their homes like ATM's, bought more house than they could afford or purchased additional houses on the assumption they could "flip" them and make a profit. Real estate wasn't and isn't a "sure thing" investment and like every other free lunch scheme this one is ending very badly. Affixing blame is interesting, but it doesn't solve the current crisis. There is justifiable anger at those who helped cause or exacerbate these problems, but it is necessary to put that aside to solve them.

We believe it is a false dichotomy to say that we need to choose between saving Wall Street and Main Street. Wall Street and Main Street are inextricably tied together, and if what is being called Wall Street is not saved, the consequences will be as severe for ordinary Americans as they are for Wall Street. This is a matter of the ability to borrow money to finance businesses large and small, and the future of retirement plans, and personal savings.

As we write this the so-called "bailout bill" has just been signed by the President. Most reasonable people have concluded that whatever its flaws it is essential to start to free up capital and restore confidence in the system. Even if it works, this will not be a short and easy process, but it has to start.

Finally, we know how painful all of this is. The unrelenting negative news is very depressing. We can't offer blanket reassurances that everything will be okay tomorrow. What we can do is provide our perspective, experience and judgment. We urge you to contact us to discuss your concerns.

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