CAPITAL STRATEGIES
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Financial Market Commentary 4th Quarter 2008

Summary

January 16, 2009

All of the negative factors the economy has faced for the last several quarters came to a head during the 4th Quarter of 2008. The US stock market posted its fifth consecutive losing quarter. In fact, it lost almost as much last quarter (21.94%) as it did in the previous four quarters combined (21.98%). Foreign markets were almost as bad. The (MSCI) Europe & Asia Far East (EAFE) Indices 20.33% last quarter. There was no refuge in any part of the stock market. The S&P 400 Midcap Index fell 25.55% and the Russell 2000 (small cap) Index declined 26.12%. Gold was the top sector last quarter with a 5.4% loss, but gold stocks fell 28.2% for the full year. The health/biotech lost just 15.3% on the quarter and 23.0% on the year – that was great performance by 2008 standards. On the other hand, natural resources, technology, financial services, and real estate each lost more than 25% in the fourth quarter and 40% since the beginning of the year.

Bonds were more complicated. As the economy weakened government bonds became more attractive. Corporate, municipal, and foreign bonds were hit by fears of default and a sudden massive de-leveraging on the part of financial firms and speculators. Basically, bonds with very little economic risk were sold almost indiscriminately in order to raise cash for margin calls. Bid/Ask spreads got so wide in October and November that for all intents and purposes there was no market. Investors flocked to treasury securities because only treasuries and cash were liquid. The government bond benchmark averaged 7.3% in 2008, but very few bond funds returned anywhere near that. High grade corporate bonds lost 5.6%, municipal bonds fell 9.1%, and high yield corporate bonds plunged 25.9%. Even TIPs lost 2.4% as inflation expectations fell.

The important thing to realize is that almost nobody expected a collapse like this. There were those who warned that the losses from mortgages were going to take a significant toll on the financial sector, and there were others who said that consumer spending was going to slow considerably. We wouldn't have disagreed with either idea. After all, we had raised extra cash back in 2007, months before the first wave of the mortgage crisis hit. But the total collapse of confidence we saw from September 2nd to November 20th …where world stock and credit markets went into an almost un-interrupted free fall … had no precedent. Stocks lost 42% here and 44% overseas, and long term corporate and municipal bonds lost 15-20% (when they could get bids).

Economic downturns can be forecast to some degree, but panics cannot. Certain institutions had to sell what they could to raise capital, and the market was unwilling or unable to support them. Prices began to plunge. Investors got the opportunity to buy stocks at prices last seen in 2003, and they turned and fled the market. This is understandable in retrospect, but not predictable ahead of time.

During the past twenty years in the securities markets, we have seen dozens of times when the market seemed especially vulnerable. Other than one day in 1987 and two weeks in 2002, stocks declined in an orderly fashion, providing sellers an opportunity to get out at reasonable prices. Those who sold into panic in 1987 or 2002 saw a fairly rapid recovery in stock prices, such that they were quickly regretting their lack of courage. Lessons like these are drilled into the heads of money managers. We know that if we sell during a free fall we are highly likely to experience regret (and probably soon). This time, it hasn't played out that way.

Activity

We took steps in the second week of October to make portfolios more conservative. Normally you don't want to sell into weakness, but these are not normal circumstances. We raised cash levels to between 20% and 40% (depending on risk tolerance) and we started using individual stocks for the first time. Berkshire Hathaway and Leucadia are holding companies that are similar to mutual funds in that they hold stakes in a number of other companies. They just happen to have better track records than 99% of the funds that are out there. The other two stocks we added provide very high yields which are well-covered by operations. We are becoming much more interested in income these days because we cannot count on appreciation either from higher earnings or from expanding price/earnings multiples.

Performance

Our flagship Balanced Model Portfolio declined a little more than 14% in the fourth quarter of 2008, and was off 24.58% for the full year. Obviously, we are not pleased with losses like this but relative to any and all of the stock indices your portfolio held up rather well.

Outlook

Right now we are seeing the worst economic conditions since the 1930s. We are likely to see that Gross Domestic Product (GDP) declined in 2008, which would be the first time that happened on an annual basis since 1949. Housing starts, retail sales, consumer confidence, and other economic measures are at or near the lowest levels recorded. We just received a chart from a leading mutual fund company that shows that 10 year rolling stock returns are at their worst levels in

200 years at -1.38% annualized[1]. All of this is not to depress you but to give you a historical context of how bad things are and have been.

In the short run it is very difficult to be bullish. The economy is contracting in almost every sector and there is very little question that earnings this year are going to be lower. Certainly there are some that are going to abandon stocks. We tend to read the information we have just provided you differently. Intermediate to long term potential returns are the highest in 25 years. The market was very rewarding to those who invested at the previous 10 year low return points. If you invested in 1941 (the only other time where 10 year returns were negative), you experienced twenty years where average annual returns were over 10% (by 1960 the market's trailing 10 year annualized returns were just under 20%.) The next cyclical low was in 1976, where 10 year annualized returns sank to less than 2%. If you invested at that point you were not immediately rewarded, but when the bull market began in 1982 returns improved dramatically (ultimately peaking in 1999).

We can't tell you when the turnaround will begin. We are only suggesting that now is the flip side of 1999, when long-term returns had been very high and expectations were even higher. In those days we were actively warning our investors that future returns would not be nearly as strong. We didn't know then what the catalysts would be that would lower returns just as we don't know now what will cause future returns to be so much better.

Commentary – A Tower of Blocks

Most of us at one time or another have built a tower out of wooden blocks. At some point, the height of the tower relative to the width of the base becomes a problem and the tower crashes. More often than not, the tower doesn't completely crash; you are often left with a foot or so on which you can start rebuilding. Usually you will start over anyway, because the crash has created structural problems such that the tower would fall over even sooner. Economies are kind of like block towers except you don't have the luxury of starting over once you hit a recession. Governments and central banks will try to stabilize the "base" whenever the economy starts to teeter.

A solid base consists of low interest rates, low asset prices, and plentiful materials and labor at reasonable prices. As the economy grows, asset materials, and labor prices rise, which puts upward pressure on interest rates. The economy eventually has what financial people like to call a "correction", where economy activity falls, inventories are worked through, prices fall, and interest rates can be lowered enough to start the cycle again.

Usually, corrections don't allow you to build from scratch. Frequently, asset or labor and/or materials prices do not decline all the way back. Therefore, the next cycle produces highs over and above the previous cycle's highs. After a few

[1] Global Financial Data via the American Funds Group. The only other time in the last 200 years that ten year returns were negative was late 1939 to 1941.

cycles the base may develop serious structural problems. Raising and lowering interest rates may work very well to control materials prices, but asset and labor prices may be somewhat immune. The private sector has become so proficient at creating credit that housing prices rose even when the Federal Reserve raised rates in 2000. Certain sectors of the economy have long made themselves invulnerable to normal business cycle effects on wages (CEOs, professional athletes, tenured professors, etc.). Speculators have learned how to profit from rising asset prices through leverage. The sheer weight of these economic anomalies was such that when they began to collapse neither the government nor the Federal Reserve could save the "tower". Asset prices (real estate, stock, and bond) have tumbled. Labor prices also will before this is over.

Economically speaking this means a longer and deeper downturn than we have experienced in a very long time. Americans have over-consumed and under-saved for decades. Ideally, we would resolve this by exporting more than we import and increasing our savings, both individually and as a nation. Unfortunately, we don't produce all that much that can be exported (our biggest exports are entertainment and aerospace/defense goods, and those are produced only in a few places). Again, many of the weakest sectors of the economy are those that are least sensitive to government action, so getting out of this mess isn't going to be quick or easy.

Ultimately, we are going to rebuild the economy. There is going to be pain; businesses are going to fail and more people are going to be laid off. All of this is ultimately going to set the stage for a better expansion as surviving companies have fewer competitors and therefore better profit margins. Speculative activities are going to be regulated again. Compensation is going to be more competitive, whether you are running a printing company or a printing press. Using what we've learned from the failures of the past two decades, we are going to construct a base that we can build on for a long time. We are very optimistic about where we are going to be ten years from now in terms of our economy and our financial markets, so be patient and hang on tight during the rest of this bumpy ride because it will get better!

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