ADDING VALUE

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Fourth Quarter Investment Review and Outlook

Investment Commentary – *Patience is Genius*

2007 is destined to be one of those landmark years in investment history. It rivals the "Nifty-Fifty" of the 1970's, the October market crash of 1987, the banking and S&L crisis of the early 1990's, the Asian crises and Russian default of 1998, and the dot.com bubble of 1999-2000 (and those are just the crises that occurred during our professional years).

All of the above were some ugly times. This also is one ugly market. During 2007, along with the Dow Jones Industrial Average ("DJIA") hitting a record high 34 times, the US stock market has also seen 14 daily swings bigger than 2%. In contrast, there was only one day from 2004 – 2006 when the DJIA moved up or down by more than 2%. The culprit for this unsettling year, the major volatility of which started in August, is the lax lending standards of the past five years for mortgage lending. These easy years of loan originations have created tens of billions of dollars in losses to banks, insurance companies, hedge funds, and other institutional investors. We wrote extensively in our last newsletter of how it happened and why it happened (greed and stupidity). Where the losses are hidden is unfolding daily.

The world is far too complex to be run and influenced by any one group of companies. However, when US financial institutions get into trouble, the rebound seems to be necessarily slower. One aspect of this financial crisis was that brokers and mortgage agents were incentivized to sell mortgages without considering the consequences of their actions. It was very easy to "rationalize" their activities, i.e., home ownership for all. Another aspect of the current financial crisis is that lenders of all sorts have lent too much money and did not demand enough interest to compensate them for the risks they took. There has been a colossal under-charging for credit across the board. The bottom line is that financial markets and Wall Street have participated in one big ugly ongoing experiment in the psychology of human *mis*judgment.

As a result of their mistakes, as quoted by Colin Symons of Symons Capital Management, "Capital is impaired and capital is the basis of how banks make money. When a bank takes Structured Investment Vehicles onto their balance sheet, or slows securitization, or takes a write-down, they are shrinking their base from which to do business." Further, the prospect of American financial companies being partially sold to foreign corporations, in order to receive cash infusion because of this misjudgment is, to be sure, disconcerting. If we want to consume far beyond our means, and then make stupid mistakes with poorly analyzed securities, one way or the other we are going to end up selling our assets to pay for it.

TODAY'S STOCK MARKET REPORT:

- Helium was up, feathers were down.
- Paper was stationery.
- Florescent tubing was dimmed in light trading.
- Knives were up sharply.
- Cows steered into a bull market.
- Pencils lost a few points.
- Hiking equipment was trailing.
- Elevators rose while escalators continued a slow decline.
- Weights were up in heavy trading.
- Light switches were off.
- Mining equipment hit rock bottom.
- Diapers remain unchanged.
- Marine shipping lines remained at an even keel.
- Raisin market dried up.
- Coca Cola fizzled.
- Caterpillar stocks inched up a bit.
- Sun peaked at midday.
- Balloon prices were inflated.
- Scott Tissues touched a new bottom.

ADDING VALUE is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

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What follows are quotes from some mutual fund managers derived from the *Wall Street Journal*, shareholder letters, and personal conversations (all managers may not be in all portfolios depending on individual circumstances):

Chris Browne – Managing Director, Tweedy, Browne Co. LLC

"While we also become anxious when confronted with an unpredictable future, we simply choose to accept it for what it is. We can't do much about it. We take comfort, like (Ben) Graham did, in having what we believe to be a margin of safety afforded by a cheap entry price and collateral value. We have never used leverage to "goose" our results…We have refused steadfastly to view risk as volatility. Rather, we have embraced and attempted to exploit the near-term variability of our equity markets." *Shareholder's Letter, 9/30/07.*

Dan Fuss – Co-Portfolio Manager, Loomis, Sayles & Co.

"The lesson you have to carry forward is that about the worst thing you can do is get into frequent asset re-allocations. There's a financial cost going from fund A to fund B. The most important cost is that it messes up your thinking about what you want to accomplish with these funds." *Wall Street Journal, 12/3/07.*

John Bogle – Founder, The Vanguard Group

"I think a very important lesson is: Don't let your emotions drive your investment program, because you will be thinking of getting in and out. For investors, the best rule by and large is to ignore the daily moves of the stock market. The stock market is a great distraction for the business of investing." *Wall Street Journal, 12/3/07.*

Jean-Marie Eveillard – Portfolio Manager, First Eagle Overseas Fund

"Individual investors should remember one thing: Sometimes what matters is not how low the odds are that something totally negative might happen. Sometimes what matters more is what the consequences would be if something truly negative happens." *Wall Street Journal, 12/3/07.*

Robert L. Rodriquez – President and Chief Investment Officer, FPA Funds

"A good example of how we like to invest is to establish positions and then wait patiently for the underlying investment fundamentals to work out. It requires patience and a willingness to go against the crowd…We view holding cash as the residual of investment opportunity. When we find securities that meet our investment standards, we will deploy capital." *Semi-Annual Report, 9/30/07.*

Warren Buffett – Chairman and CEO, Berkshire Hathaway Inc.

"It's not risky to buy securities at a fraction of what they are worth." *2007 Annual Meeting.*

Bill Nygren – Portfolio Manager, Oakmark Select

Our largest holding, Washington Mutual, has been our most costly error. It has become clear that a higher percentage of WaMu's mortgages are impaired than we had initially believed, and with an unprecedented decline in home values, this company has become much riskier than we had anticipated. Given what we know today, we should have sold WaMu stock some time ago when its price was higher. It would be cathartic to just sell WaMu now. However, I continue to believe the stock has a very attractive risk-return profile. WaMu's deposit franchise remains strong, and I find it highly unlikely that potential loan losses will overwhelm the company's franchise value. Whenever we own a stock that declines sharply we ask ourselves the question: If we didn't already own this would we buy it now? I'm confident that the answer for WaMu is a resounding "yes." *Special Shareholder Letter, 12/18/07.*

John Kenneth Galbraith – Author, <u>A Short History of Financial Euphoria</u>

"The investing public is fascinated and captured by the great financial mind. That fascination derives, in turn, from the feeling that with so much money involved, the mental resources behind them cannot be less. Only after the speculative collapse does the truth emerge." *A quote from the book.*

Chris Davis – President & Portfolio Manager, Clipper Fund and Selected American Shares

"The basic question facing us is whether it is possible for a superior investment manager to underperform the market for three years in a row. The assumption widely held is no. And yet, if you look at the records, it's not only possible, it's inevitable…Looking closely at the records of the best large-cap managers of the last ten years (whether in

value, growth or blend), more than 90% of them lagged their benchmark by at least two percentage points per year for three years in the midst of their ten–year stretch of out-performance. Furthermore, more than 60% of all of these top-performing managers under performed their benchmark by at least five percentage points per year for three years." *Semi-Annual Report, 6/30/07.*

We are not prognosticators; we'll leave that to the "talking heads". We do, however, use some simple yardsticks and common sense to review current market conditions. Here are some of our thoughts for 2008.

1. The most reliable guide to home value is rent. In most markets and under ordinary conditions, people won't lay out much more in monthly costs to own a house than they would to rent a similar property unless they expect a huge profit when they sell. Speculators sometimes fuel the illusion of the profit potential. Once the excitement and speculative fervor subsides, however, prices will revert to their normal, long-term relationships with rents. The price correction required to restore the price-rent equilibrium is staggering in those areas that experienced the largest increases, i.e., over 40% in Miami. We believe that the affordability crisis, the condo glut, and the seller's unwillingness to agree to these declines, will prolong this situation for many years.

2. We should not underestimate the difficulties and pitfalls in pricing highly complex securities. The *Wall Street Journal's* front page story on October 12, 2007 detailed the three different methodologies used to price securities: marking to market, marking to matrix, and marking to model. As Warren Buffett said: "They call it marking to market, but it's really marking to myth. I refer to marking to model as Imaginary Accounting. You imagine a price and then you account for it at that price. Many of these security values are predicated on valuation models that were created by management. This is like having the fox guard the hen house." You can expect a lot more discussion and downward pressure on the price of these securities. To understand more about these complex pricing systems, we recommend a fascinating new book by Richard Bookstaber, <u>A Demon of Our Own Design</u>.

3. We have invested any short-term cash needs for 2008 in *FPA New Income*, a fund managed by Bob Rodrequez. This fund is at its highest average credit quality ever with AAA or higher rated securities representing nearly 91% of the fund, and an additional 8% invested in AA securities. A record low is invested in high-yield securities. The fund does not own any subprime related securities, collateralized debt obligations, or any of the other alphabet soup names of securities that have been created with complex derivative securities. After much research, we believe that this fund may be even safer than some of the money market funds in the market place. Bob Rodriquez has been very outspoken about some of the issues in the short-term bond market place and has been focused on preserving and protecting your capital. You can read his comments on www.fpafunds.com.

4. The American consumer has been the dominant engine on the demand side of the global economy for the past 11 years. Consumer demand is typically funded by two forces – income and wealth. Since the mid 1990's, income has only increased 17% in inflation-adjusted terms. Lacking support from earned income, US consumers turned to wealth effects from rapidly appreciating assets to fuel consumption. By Federal Reserve estimates, equity extraction from houses surged from 3% in 2001 of disposable personal income to 9% in 2005. Both income and wealth are now under pressure; consumers have no choice but to stop spending. A capitulation of the American consumer spells considerable difficulty for the global economy. Recent numbers indicate that 21% of Chinese exports go to America. A needed re-trenching of the American consumer does not have favorable implication for a global economy. It will be interesting to see how the Fed works its way out of the quandary. Recently, we have had a central banker who was politically compliant (Greenspan); we started our careers with a central banker who was truly politically independent (Volker). This Fed's decision coupled with the 2008 Presidential elections should be intriguing!

5. The loss of easy credit may have an effect on another area in the capital markets – private equity funds. While there is a small minority of private equity firms that operate differently,

most use a great deal of debt to buy public companies, or their underperforming divisions, and then "flip" the companies in three to five years after extracting enormous fees. The stunning growth of these funds, which have now raised hundreds of billions of dollars, coupled with the drying up of credit should give investors pause. Chris Davis (who was quoted earlier) says this: "Sadly, the losers in the game are likely to be the pension and endowment funds that are now rushing into this area…Consider this: to raise the money they want to put into private equity funds, many pension and endowment funds are selling their public companies (or in the vernacular reducing their allocation to U.S. stocks). They are in essence buying back some of the very same companies that they used to own but at a premium to where they sold them. At the same time, they are adding significant leverage and paying much higher fees." It seems this story too will end with the "unforgivingness of forgetfulness", or for further illustration of this strategy, we refer to the old book, Barbarians at the Gate by Bryan Burrough.

We are not overly optimistic about the prospects for 2008. Because of the re-pricing in the housing market, the potential low returns from private equity, and the complexity of the financial engineering in the derivatives market, it is very tempting for investors to want to get out of the market until the future is less foggy and more knowable. Although such an approach seems reasonable, it does not work for the simple reason that it confuses risk with the perception of risk. The time to look for opportunity is when there is fear and uncertainty. So aligned with intelligent, process-driven managers and having sufficient cash flow requirements covered for the next two to three years for those in withdrawal mode, we continue to look for the opportunities created by enervating crises of judgment rather than for the exit. We remain focused on attractive long-term opportunities which will always exist in every market.

Happy New Year to All!!

Sincerely,

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