

ADDING VALUE

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→
WORDS OF WISDOM:

"Individuals who cannot master their emotions are ill-suited to profit from the investment process."

Benjamin Graham

"History provides a crucial insight regarding market crises. They are inevitable, painful, and ultimately surmountable."

Shelby Davis

"Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in the corrections themselves."

Peter Lynch

"I will tell you how to become rich. Be fearful when others are greedy. Be greedy when others are fearful."

Warren Buffett

"The function of economic forecasting is to make astrology look respectable."

J.K. Galbraith

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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AT THE CURRENT RATE OF DECLINE, THE U.S. STOCK MARKET WILL CEASE TO EXIST IN 16 DAYS

Given the extreme market moves during the Third Quarter 2008 and continuing through October, we are using this newsletter as a format to answer some of the most repeated questions, to allay some of the panic and fear that exists among our clients, and to explain the status of your portfolio composition and diversification.

MY PORTFOLIO IS IN A FREE FALL AND YOU ARE DOING NOTHING ABOUT IT.

The stock markets around the world have been challenged since the fourth quarter of 2007. Instead of the turmoil settling down, in recent days the news has become even more dire. As a reaction to the calamitous news of the financial company bankruptcies and reorganizations that are capturing the headlines, the prices of almost all investments have declined meaningfully. The world is in a full-pledged panic attack, otherwise known as a bear market, and it is beyond the risk tolerance of most participants.

WHAT SHOULD YOU DO WHEN YOU ARE IN A WAR ZONE?

Make no mistake about it; we are in the midst of a full scale, globally spreading financial *confidence* crisis. Central bank and government authorities are struggling around the clock to contain and dispel it with limited tangible effects so far. In many respects, this market movement is very similar to a war zone. The news media and other information sources have set up a constant barrage of inflammatory information, much of which is meaningless, misleading, frenzied, and irresponsible. In times of maximum stress, as all Marines are taught, you must rely on your training. Investment professionalism and experience must take over instinctually to help you avoid making uninformed decisions and crucial mistakes. The answers are not contained in the panic headlines, but in thoughtful analysis.

IS THIS AN ARTICLE OF FAITH ON YOUR PART?

Yes. In the aggregate, Greg and I have over 70 years of experience in the investment industry. The mutual fund managers that we use in client portfolios are also not "spring" chickens. They too have 40 years or more of experience in the trenches. A current witticism that is circulating around the industry is that "there are no atheists in the trenches." However, today's predicament is so serious-indeed the very future of the modern financial system appears to hang in the balance - that failure is simply not an option. What ever is necessary will be done. The world's "collective we" will simply not disintegrate again as it did in the 1930's. Coordination, reflation, recapitalization, creative thinking, leadership, concerted action and, most importantly, **time** will ultimately prevail. We must be patient! **We are not at the mercy of reacting to the panic, because we have already been proactive in anticipating our strategic positioning of our client portfolios.**

GIVE ME A BREAK. DO YOU REALIZE HOW MUCH MONEY I HAVE LOST?

We do **not** trade pieces of paper. We are **not** gamblers. Instead, using the fundamental processes of some of history's greatest investment minds, we select investment managers that own businesses that are financially sound. Some of the extremely important characteristics of the companies (selected by these investment managers) in your portfolio include:

1. They are the highest quality businesses.
2. The companies generate substantial free cash flow.
3. The cash earnings yield is substantially (in some cases over 3 times) above the yield on the 10-year Treasury- an unprecedented spread.
4. The businesses are competitively entrenched with enormous barriers to entry.
5. Most of the holdings are extremely well-capitalized, with no need to access the capital markets, much less bank loans.
6. The manager/owners of the businesses should actually gain competitive advantage over their weaker adversaries in the tough days ahead.

We did not have to make changes to the portfolios during these tumultuous times, but like any good strategic general, we had already positioned ourselves to win this battle. To the best of our knowledge, not one single client portfolio has experienced a PERMANENT LOSS OF CAPITAL. We simply did not have exposure to the excessively leveraged companies which no longer exist; companies such as Bear Sterns, Lehman Brothers, Fannie Mae, Freddie Mac, or Merrill Lynch.

In addition, we correctly anticipated the demise of certain money market funds and in November, 2007 moved all clients to a U.S. Government money market fund. Again, as the worst case scenarios unfolded in the ensuing months, we did not have to panic. Using only government securities for our client's portfolios, we eliminated any exposure to Freddie Mac and Fannie Mae or questionable commercial paper and negotiated CDs.

IF YOU ARE SO SMART AND ANTICIPATORY, YOU WOULD HAVE TAKEN MY PORTFOLIO TO CASH AND AVOIDED THIS DEVASTATION.

We are not market timers. Despite celebrity appearances of those that "called" this downturn, we do not believe, nor are there any academic studies to support, the success of any market timing strategies. We do engage in healthy investor behavior and support maintaining a long-term investor strategy. In the near term, this is far easier said than done, especially in the face of extremely disappointing short-term results. The impact of engaging in unhealthy investor behavior is quite striking. A 2007 study produced by Dalber and Lipper entitled "Quantitative Analysis of Investor Behavior" computed "average stock fund investor" returns by using industry cash flow reports from the Investment Company Institute. The results of this study showed that the average stock investor had a return of just 4.3% over the period 1987-2006 compared to the average stock return computed using the S&P 500 Index over the same period of 11.3%. On a \$10,000 investment, this equates to a dollar difference of over \$62,000, assuming the reinvestment of dividends and capital gain distributions. This is an enormous penalty for long-term performance results.

In addition, it must be noted and heavily emphasized, that it didn't take a genius to conclude that there were potential problems in the mortgage and credit markets. What is always an uncertainty is when the potential problems will manifest themselves and to what degree of severity. This is true in all recessionary periods including the Internet and tech bubble, the crash of 1987, the S&L crisis of 1990, etc.

I DON'T BELIEVE IT. THIS TIME IS DIFFERENT. THIS TIME IT IS A FINANCIAL ARMAGEDDON.

Yes, it is true; this time it is different. Every recession has a catalyst that varies and creates its own pattern of events. To be successful in maneuvering through the land mines, it is important to understand the genesis of the crisis and the cause of the dislocation. In the tech bubble of 2002, investors bought into the story that a company with no earnings or solid business strategy could trade at astronomical prices. As this dream collapsed, those investors who were willing to own these companies lost their entire investment. Those investors who eschewed "cheaply" priced companies to own a piece of this nirvana did indeed lose all their capital.

In the housing bubble of 2007, investors and corporations believed that there was no limit to the amount of leverage they could afford. Today's issue (unlike those in 2000-02) is a problem primarily derived from the dysfunctional credit markets. Even facing a deep, lengthy recession and substantially reduced corporate earnings prospects, equities today are cheap, compellingly cheap-unlike in the 2000-2002 bear market. In fact, some believe (including the world's richest person) that this is an unprecedented buying opportunity, a chance of a lifetime. With the exception of certain excessively leveraged companies, most will weather through successfully. There should be no permanent loss of capital; in fact, we believe our companies will have stunning results.

Individual stock behavior in the present market turmoil is often anything but reflective of the actual investment merits of the companies involved. Company fundamentals are being overpowered by margin call pressures, forced hedge fund liquidations, panicky rumors, wildly fluctuating credit default swaps, and who knows what else. As the daily grenades are being lobbed, it is important to find solace and comfort from engrained instinctive training. As Warren Buffett succinctly states: "Be greedy, when others are fearful."

THERE MUST BE SOME THINGS TO WORRY ABOUT.

Yes, there are. This is what we worry about:

1. Are any of our mutual funds participating in securities lending programs where stocks in the mutual funds are lent to a counterparty who goes bankrupt? We ask the question and we hope that the managers of the funds that we have selected are truthful and as conservative and risk-averse as we are.
2. Do the mutual funds have enough cash to avoid forced liquidations in this panic selling? Although nothing is 100%, we try to insure protection by assessing several variables including the residual cash position of the funds, the implementation of redemption fees by the mutual funds that makes it much more costly to "flip" the funds that you own, the selection of institutional funds that attracts long-term patient investors not short-term traders, and the existence of back-up lines of credit which the funds can utilize rather than having to sell at distressed prices. Although we have not fin-

ished an investigation of each fund, to those that we have interviewed to date, most are experiencing net modest inflows.

3. Are there any aspects to Schwab's operations that present any tangential risk to our clients? Notwithstanding, our uneasiness with the money fund situation, which we previously reviewed, we have seen nothing that is risky.
4. In the midst of the unrelenting bad news, have any of the managers succumbed to the pressure of client demands? Our review of managers is continuous, in-depth, creative, and thorough. Despite the absolutely horrid returns, three of the managers in our portfolios were among the top 10 best performers in the Barron's third quarter review. We take heart in this statistic that we are still doing something right. We reserve the right to change our minds at any time about our level of comfort as this extremely volatile situation continues to develop.

OKAY, MAYBE, BUT FOR TODAY ONLY I'LL BELIEVE YOU: BUT DON'T EVEN THINK OF GIVING ME A TAXABLE DISTRIBUTION.

In a down year receiving a taxable distribution can feel like a double insult. However, all investors must remember that our managers sell businesses when they reach appraised value and the gains distributed represent positive **past** returns. We have just begun to receive information on the distribution of dividends and many funds are reporting capital gains, including Longleaf, Third Avenue, and possibly Fairholme at the present time. We are closely monitoring these announcements and will take actions to ensure that no client will pay a capital gains tax in 2008.

WHY DON'T YOU JUST BOOK A TAX LOSS ON THE ENTIRE PORTFOLIO AND GET BACK IN WHEN THE MARKET "QUIETS DOWN?"

There are three reasons why this strategy has fewer benefits than often assumed. (Be prepared: This explanation can be complicated!) First, the benefit of taking a loss this year versus paying a gain in the future is equal only to the difference between the tax offset this year and the net present value of the higher gains to be paid in the future assuming that you will buy back shares at the current price. It may be easier with an example. Let's say that you

bought shares at \$20 and sold them at \$10 to book the loss, the tax loss value is the 15% capital gains tax rate times the \$10 loss, or \$1.50 per share. If you then repurchase the shares at \$10 and sell them in the future for \$30, your capital gains will be \$20 versus \$10 had you not booked the loss previously. Assuming the same 15% tax rate, you would owe \$3.00 versus \$1.50 per share in taxes. *Selling is only worth the difference between the \$1.50 "benefit" today and the net present value of the \$1.50 cost in higher taxes tomorrow.* Second, critical to this math is the assumption that in the time you must wait to repurchase the shares, a share price move does not swamp the value of any tax offset. The time you must wait to repurchase shares is critical. In addition to the IRS wash sale rules, many of our mutual fund managers have short-term trading policies which prohibits trading in and out of Funds. In specific, Longleaf has a trading restriction of six-months. We do not want and will not take this risk with our client portfolios. Third, this example assumes that the capital gains rates stay at 15%. Many in politics and in the financial world are assuming that rates will rise. In fact, taken in the extreme, a case could be made for realizing all gains before the end of the year and saving losses since substantially higher tax rates will make them more beneficial to harvest in the future.

In closing, what has started as a U.S.-led downturn has spread into a deepening recession that is besetting most developed economies and is significantly slowing the previously booming developing world. The credit crunch has moved from highly leveraged financial firms into the broader corporate sector and beyond to municipalities and even Main Street. In

one way or another, we are all being denied credit or forced to pay punitive interest rates. Recessions suck. We are feeling massively deflationary events that will lead to a period of deleveraging, thrift, and frugality with lower world growth consequences and a temporarily lower standard of living. It will take time to restore equilibrium. During this time, it is in all of our best interests to conserve cash, postpone large ticket items, and be frugal. Most of our client portfolios for those in withdrawal mode continue to have a margin of safety to preclude forced selling, albeit diminished from what existed at the beginning of the year. For these clients especially, a note of caution is in order. Otherwise, we want to remind everyone that our money is invested alongside your assets. We feel the burden of the unrealized losses to the same extent as you do. Nevertheless, we continue to make substantial personal investment additions to these markets. Like some of you, we wish we had deferred our purchases, but we are very comfortable that in final analysis we will have navigated successfully through these challenging times.

We thank you for your trust in us; we respect you for your loyalty; we carry the burden of the leadership role that you demand from us during these extremely difficult times. Please do not hesitate to call if your sense of panic is overwhelming.

Respectfully yours,

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