ADDING VALUE

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2008 was off the charts in the wrong direction…as bad an investment year as most of us will likely experience in our lifetime. Stocks had their worst calendar year since 1931.

Many metrics suggest that stocks should at least provide satisfactory returns going forward and possibly something better. But the near term is much less clear. While it may be probable that we have seen the market bottom, we can't be sure.

We expect a lengthy and deep recession, but with a great deal of negativity already priced in, the longer-term return outlook is decent. We believe we will continue to see numerous opportunities created in this highly dislocated environment.

A TERRIBLE, HORRIBLE, NO GOOD, VERY BAD YEAR

What doesn't kill us makes us stronger. Nietzche

For investors, 2008 was a once-in-a-lifetime train wreck. The year was arguably the most painful in modern investment history. Almost every asset class was in the red for the year, with many deeply underwater, giving investors almost no place to hide. Government bonds were one of the few exceptions.

Clearly, we are now in the midst of a severe recession. Consumers are being forced to adjust to a new reality in which they finally have to pay down debt, increase savings, and thus spend less than before.

"Have you ever wanted something so bad that you'd actually save up the money to buy it?"

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We and others have been wondering since the late 1980's when the growth in household debt would slow or reverse. It took 20 years from the realization to reality, but the time has come. (This is why market timing doesn't work!) But as we look forward from here at beaten-down financial markets and an economy on the ropes, we ask the question we always ask: ***What expectations are currently reflected in asset class prices?*** We approach this question in many ways and consider the weight of the evidence in the context of how the broader economic environment might play out over the coming years. This exercise leaves us with conflicting evidence to digest.

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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ENCOURAGING SIGNS

Historical comparisons are sometimes helpful. There have been two extreme economic and investment environments in the last 80 years – the 1930s, and the 1970s/early 1980s. In both periods, investor confidence was crushed after lengthy periods during which returns were dismal. But as it turned out, both periods presented a great opportunity for long-term investors to buy stocks. This may be a similar time. These periods reflect the tension that investors always face – when risk seems greatest, it is usually a good time to invest and when risk is an afterthought, investors are likely to be disappointed with their returns going forward.

1. Historical Evidence: Trailing Risk Premiums

There are many ways to consider historical stock market performance. One is to focus on the risk premium, as shown in the following chart, which compares stock market returns to the returns an investor could have achieved if the money had instead been invested in a risk-free asset, such as T-Bills. Since we date this secular bear market as about nine years old (going back to the recession succeeding 9/11), we looked at the stock market risk premium over the past nine years (using month-end returns). To do this, we compared the S&P 500 returns to returns from three-month Treasury Bills. We then compared the returns to other periods going back to the Great Depression.

The takeaway is that by underperforming T-Bills by 59% over the last nine years (as of 11/30), the risk premium was one of the worst on record – matching the worst nine years during the Great Depression but not quite as bad as the worst periods that encompassed portions of the inflationary 1970s.

Worst Nine-Year Risk Premiums Since 1935

		Cumulative Return		Annualized Returns in Following Years			
Nine-Year Period Ending	Risk Premium	S&P 500	T-bills	Next Five	Next Seven	Next 10	Next 15
Dec-08	-59%	-28%	31%	?	?	?	?
Jul-82	-58%	52%	111%	29.7%	23.1%	19.2%	19.7%
Sep-74	-67%	-5%	62%	16.8%	14.4%	15.6%	17.2%
Mar-38	-56%	-46%	10%	13.0%	13.4%	11.9%	14.1%

** S&P 500 return less the T-bill return.*

On a forward-looking basis, what is very encouraging is that the long-term returns were quite good following similarly horrible nine-year periods for risk premiums. Also, the end of these nine-year periods fell close to the bear market bottom.

2. Valuation Evidence: Schiller P/E

There are many ways to assess valuations. Most now suggest that U.S. large cap stocks range from fairly valued to bargain priced. One metric that we have reviewed is the so-called Shiller P/E, named after Robert Shiller, the Yale professor. Shiller calculates his P/E based on an average of the last 10 years' earnings in order to smooth out short-term earnings volatility and he also inflation-adjusts his earnings and stock price levels. The current Shiller P/E is 15x normalized earnings, which is lower than most of the post-WWII period except for the early 1970s through the mid-1980s when inflation and interest rates were generally much higher. P/E's could go lower and stay in a low range for a period of years. But this level of P/E has generally been a good long-term entry point into the stock market.

3. Dry Powder

There is a mountain of cash sitting on the sidelines. In fact, since the advent of money market funds more than 30 years ago, money market assets relative to total stock market capitalization has never been higher. Some of that cash is likely to find its way into stocks and bonds at some point, especially with returns on cash so low.

4. Dividend Yields

For the first time since 1958, the S&P dividend yield exceeds the 10-year government bond yield. Indeed, a portfolio today of high quality, durable businesses similar to Jensen Fund or Yacktman Fund has a yield over 4.5%.

CAUTIONARY SIGNS

All of this evidence as it relates to the long-term potential in stocks is encouraging, <u>but the near term or timing of the turnaround is much less clear</u>.

Economic risk remains high. Policy makers have made it clear that they will do whatever it takes to support the economy, yet credit markets, though slightly improving, remain dysfunctional and the housing market remains highly stressed. And while a financial system collapse has been avoided, a

newly realistic consumer, attempting to reduce debt and increase savings, could mean an economic retrenchment that lasts longer than the consensus expects. The powerful media influence with constant comparison to the Great Depression, employment cuts and suicidal advisors injects a daily dose of pessimism.

"I suppose they'll expect a bailout."

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WEIGHING THE EVIDENCE

Despite the near-term caution, we think the weight of the evidence overwhelmingly suggests that investors are very unlikely to get hurt owning equities over the next five to 10 years and are likely to reap at least satisfactory returns. In fact, the manager of one of our mutual funds states: "You make the most money in a bear market, you just don't realize it." This is a justification for owning stocks with capital that is not needed in the near term. Moreover, periods of extreme dislocation usually create opportunities for significant value-added from active management. The entire market does not have to be a screaming buy if some portion of the market is. Based on our read of history as well as data that indicates extensive valuation discrepancies in the market currently, we believe that the next few years are likely to be good ones for active managers relative to their benchmarks. (After several years in which many of our managers underperformed (an unusual occurrence), this would provide a welcome tailwind!)

Thus far, this discussion has focused on stocks, but they are not the only game in town. We have also found opportunities in corporate bonds, high yield bonds and REITs. We are spending 12-14 hours per day evaluating, assessing, and investigating these future opportunities for your portfolio. While most people are willing to pay anything for no risk, we are willing to pay nothing for some risk.

LESSONS LEARNED

We exist successfully as organizations because we learn and adapt. Our knowledge, education, and experience gives us information to avoid permanent and substantial loss of capital. From prior economic times we learned the pitfalls of securitization, extreme leverage, inflation erosion, and business ethics. These lessons helped us avoid ownership in Bear Sterns, Lehman Brothers, Fannie Mae, and Countrywide Financial. *What we underestimated was the total collapse of functioning credit markets (unprecedented), the perilous hidden leverage at the investment banks, the absence of the CEO as a "risk" manager despite the astronomically high salaries, bonuses, and other perks, the laxity of financial market regulation and that government officials are probably worse perceivers of reality than private business types.* What makes this downturn so frustrating is not that we had any laxity in research, but that the accounting and regulatory rules did not provide reporting of vital information to make informed judgments, most importantly the amount of hidden leverage in the system. No amount of research could have unearthed the problems we face – the damage was to all asset classes in all countries to all experienced managers.

SUMMARY

The financial crisis that originated amid concerns over the subprime mortgage market deepened into a global credit crisis. It has been an unsettling time for most of us. One of the most difficult habits to cultivate and maintain at these times is **PATIENCE**. Patience is especially hard to practice when events are going against us. Unless we have great reserves of ego, humility, and supportive experience, the natural response seems to be to obsess about missed opportunities that would have led to gains or mitigated losses. Instead of participating in this unproductive activity, we are staying as a "learning" organization and reviewing the best course of action given the current circumstances

and the likely matrix of events several months or years from now. As such, most of the managers in your portfolio are not concerned with daily market volatility but with risks specific to individual businesses, industries, and assets. Rather than risk, volatile periods in the stock markets provide opportunities for attractive entry points. By all measures, the last 15 months (since the start of this downturn) have been a period of exceptional opportunities rather than a devastation of epic proportions. The last 45 days of the year have been a once-in-a-lifetime buying opportunity, not an open door to flee the market (as most market participants have determined).

This credit crisis has sent correlations of previously uncorrelated assets skyrocketing. Most of our managers believe that the real world is sufficiently dynamic and that models built on historical data are very unlikely to be reliable predictions of the future.

Rather than focus on volatility, it makes much more sense to us to focus on business risk. The central focus of our managers is to understand risks to the process of wealth creation:

- Threats to asset values
- Tenuousness of competitive position
- Management misalignment

This type of risk management strives to avoid permanent impairment or diminutions of the values of the actual businesses as assets, distinct from stock price declines. One or even two years of impaired earnings DO NOT LEAD to significant changes in a businesses' intrinsic value.

All managers have been actively buying wonderful businesses at truly extraordinary valuations, which cannot help but bode well for long-term performance.

Please have patience. While these are not the best of times, they are the times that create future opportunities.

Respectfully yours,

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