ADDING VALUE

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We are experiencing one of the most dramatic periods in American - and world - financial history. This business environment presents both challenges and opportunities. We are working hard to learn the lessons of the last six months, to respect and address your concerns, to provide a strong path forward, and to deliver thoughtful, consistent, and concise investment information. We always welcome your comments if we are doing a good job!

RE-START…RE-ASSESS…RE-STRUCTURE

Now that the last six months is behind us, we can take a deep breath and survey what has transpired. As the pundits say, always take advantage of a "teachable moment." Fortunately, there are many books on the shelves, articles in magazine publications, and eye witnesses on C-SPAN to help us on our journey to understanding what exactly happened in the last six months and to offer suggestions about where we go from here.

Phase One: Re-start. The first reference is a magazine article that appeared in the May 18, 2009 issue of The New Yorker entitled *The Death of Kings, Notes from a meltdown* written by Nic Paumgarten. This article is many pages long, very well-written, and includes an extensive list of antecedents of the latest financial fiasco. In Nic's well-written prose, ***"this crisis is the culmination of events and trends reaching back, depending on your perspective, four, seven, seventeen, twenty-two, twenty-seven, thirty-eight, sixty-five, or a hundred and two years. The sub prime-mortgage meltdown, the subsequent collapse of the wider real-estate market and then of securities based on real estate, and of the firms and funds holding those securities, and of the companies selling insurance against the failure of those firms, and potentially, of the insurers' counterparties, and so on: you could say that all this is merely the finale to a multi-decade saga set on Wall Street and Main Street, in Washington, Riyadh, and Tokyo. The causes are technological, mathematical, cultural, demographic, financial, economic, behavioral, legal, and political. Among the dozens of contributors and culprits, real and perceived, are the personal computer, the abandonment of the gold standard, the abandonment of Glass-Steagall, the end of fixed commissions, the rating agencies, mortgage-backed securities, securitization in general, credit derivatives, credit-default swaps, Wall Street partnerships going public, the League of Nations, Bretton Woods, Basel II, CNBC, the S.E.C., disintermediation, overcompensation, Barney Frank and Chris Dodd, Phil Gramm, and Jim Leach, Alan Greenspan, black swans, red tape, deregulation, outdated regulation, lax enforcement, government pressure to lower lending standards, predatory lending, mark-to-market accounting, hedge funds, private-equity firms, modern finance theory, risk models, "quants," corporate boards, the baby boomers, flat-screen televisions, and an indulgent undereducated populace."***

Whew! In our opinion, this statement is a comprehensive synthesis of the systemic financial risk that existed in the marketplace of which any person could express that they knew that a crisis was evolving, but no one could know the exact time and place of the tipping point. Several years ago, we

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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read with interest Charlie Munger's (Warren Buffett's partner) comments about derivatives in Poor Charlie's Almanack: The Wit and Wisdom of Charles T. Munger. Mr. Munger warns on page 113-114: "The nature of a financial institution is that there are a lot of ways to go to hell in a bucket…The system is almost insanely irresponsible. And what people think are fixes aren't really fixes. It's so complicated I can't do it justice here-but you can't believe the trillions of dollars involved. You can't believe the complexity. You can't believe how difficult it is to do the accounting. You can't believe how big the incentives are to have wishful thinking about (market) values and wishful thinking about the ability to clear. People don't think about the consequences of the consequences…To say accounting for derivatives in America is a sewer is an insult to sewage…I would confidently predict that most of the derivative books of this country's major banks cannot be liquidated for anything like what they're carried on the books at... I fear the consequences could be fearsome…I'll be amazed if we don't have some kind of significant derivatives-related blowup in the next five to ten years." *Poor Charlie's Almanack* was published in 2005.

Well, Charlie Munger was right, but about three years too early. He also anticipated the trillions that would ultimately be involved—but maybe even he can't believe the current multi-trillion tally. Furthermore, the degree to which the entire global financial system was correlated came as a surprise to many, including the hedge funds. Long touted as a way for investors to lock in "absolute return" in all market conditions, the industry suffered a traumatic 2008 when the average fund lost nearly 20%. Today, assets under management in the hedge fund industry have fallen about $600 billion and nearly 1500 funds have been liquidated. To add insult to injury, many hedge fund managers imposed "gates" to restrict withdrawals. Investors are still punishing hedge funds for these restrictions. It didn't help that several leading fund-of-funds had exposure to Bernie Madoff. At a recent symposium in Chicago, we re-created and attempted to find any portfolio, including those that contained hedge funds, that would have provided significant downside protection to investors during this sudden, catastrophic, highly correlated worldwide global financial crisis. Our clients should take some consolation that there wasn't a single opportunity to protect client portfolios except for those individuals, with an exceptional stroke of luck or unrelated circumstance, that had previously opted to convert to cash positions.

Phase 2: Re-assess. Since a March 9, 2010 market low, everyone in government is conducting an all-out campaign to make us feel better as quickly as possible. President Obama, with eloquence, sums up our current reassessment period as follows: "It's safe to say we have stepped back from the brink, that there is some calm that didn't exist before." The market seems to be reacting favorably to this happy news. Wright Associates' fully-invested client portfolios are up almost 40% since the market lows on March 9. Year-to-date through June 16, client performance is in positive territory.

Some observations to these "happy" words seem to be in order though. As William D. Cohan, author of House of Cards: A Tale of Hubris and Wretched Excess on Wall Street and contributing editor at Fortune, comments in The New York Times on Sunday June 7:

- The storm is not over by a long shot. Huge structural flaws remain in the architecture of our financial system. Six months ago, nobody believed that our banking system was well-designed, functioning smoothly or properly regulated, so why then are we so desperately anxious to restore that model as the status quo?
- Why is so much effort being put into propping up those at the top of the pyramid-the money center banks, the insurance companies, the hedge funds and so on?
- Instead of promising the imminent return of the good times, why isn't President Obama talking more about the importance of living within our means and not spending money we don't have on things we don't need?

- Is there any limit on bailouts?
- Why has Mr. Obama surrounded himself largely with economic advisers who are theoreticians and academics but not those who have worked in the trenches?
- Why is the government still complicit in making the system ever less transparent?
- Why hasn't President Obama insisted on public hearings over what happened during this financial crisis?

The upshot of all this and what we don't know is how information or lack thereof will affect consumer behavior. Questions such as:

- Have we learned our lesson? Banks still are able to take on massive amounts of risk and those in power before the crisis are still the ones making decisions post-crisis.
- How much, on what class, and when will tax rates increase?
- What will be the legacy of the biggest debt bill in history?
- How much will the personal savings rates of Americans be affected? The marginal propensity of the consumer to save more and spend less has very significant implications for future growth rate of the economy as well as future earnings levels and growth rates of many companies.
- There is a definite change in consumer behavior. As an example, the growth of private label brands poses a real threat to many branded consumer product companies.
- The Darwinian process may have helped those companies that have survived. Smaller industries means there is less competition for profitable opportunities.
- What will be the "new normal" with respect to economic growth, unemployment, and inflation?

All of these questions are keeping us and all of the managers in your portfolio very busy. Many managers relate generally and Sequoia Fund's managers relate specifically that: "In this environment, we find it very challenging to ascertain normalized earnings power for many companies-both those we own and those that we are considering owning-when we are not sure what "normal" will look like in the future." They continue to say: "We are not alone here. We have met with a number of CEOs of companies which we either own or are considering owning. When we ask them to estimate their companies normalized earnings power, many will volunteer that they do not know. When pressed to give a broad range, oftentimes they cannot, and usually decline to opine."

Investors face the constant challenge of keeping their investment wits and maintaining a logical objective framework for making investment decisions, and these challenges are magnified many times over in an environment such as the current one. It is only once in a generation that the landscape of Wall Street changes so dramatically over such a wide swath—it happened in the early 1970's and again in the savings and loan crisis of the 1980's and, of course, in 2008. The obsession with macro economic trends during these times completely overwhelms the interest in fundamental analysis. Everyone obsesses over forecasts on interest rates, economic growth, inflation, currencies, government debt, geopolitical events, commodity prices and the stock market. They totally disregard or lose interest in the characteristics of the businesses that are owned in the portfolios.

Phase 3: Re-structure. This generational change brings us to the third point in our review—when, why and how should we restructure portfolios. During these trying times, we learned a lot about client risk tolerance that was far superior to the information garnered from abstract worksheets and questionnaires. We learned a lot about capital market dispersal of risk which was revealed for what it really was: a global plague that spread dangerous risk to nearly all major financial institutions. We also confronted head-on the importance of making life-cycle financial choices that withstand the severe tests of extreme market dislocations. Retirement seems much more precarious when

our portfolio declines by 50% and we have no annuity income source.

On a day-to-day basis, we are:

1. Reviewing the purchases and sales of all the managers in the accounts, listening to conference calls regarding calculation of the intrinsic value of businesses, and trying to estimate if changes in consumer behavior will adversely affect the growth rates of many businesses;
2. Analyzing the plethora of new fixed income strategies that focus on performing credit opportunities and high-yield investments. Several managers that are highly regarded are launching new funds in August or September to take advantage of the inefficiencies created by the distressed debt situations;
3. Studying and researching the future of life-cycle saving and investing as it relates to individualized retirement solutions in portfolio construction. We realized that some client's "safety nets" were much more protective of retirement security than that of other clients during this downturn. This subject warrants much more careful analysis and is expected to be the subject of our next newsletter.

Finally, as a result of the significant realized capital losses that many of the mutual fund managers have had in 2009, we do not expect to have any significant capital gains distributions to worry about this year.

Thank you for your continued support during these trying times.

Respectfully yours,

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