

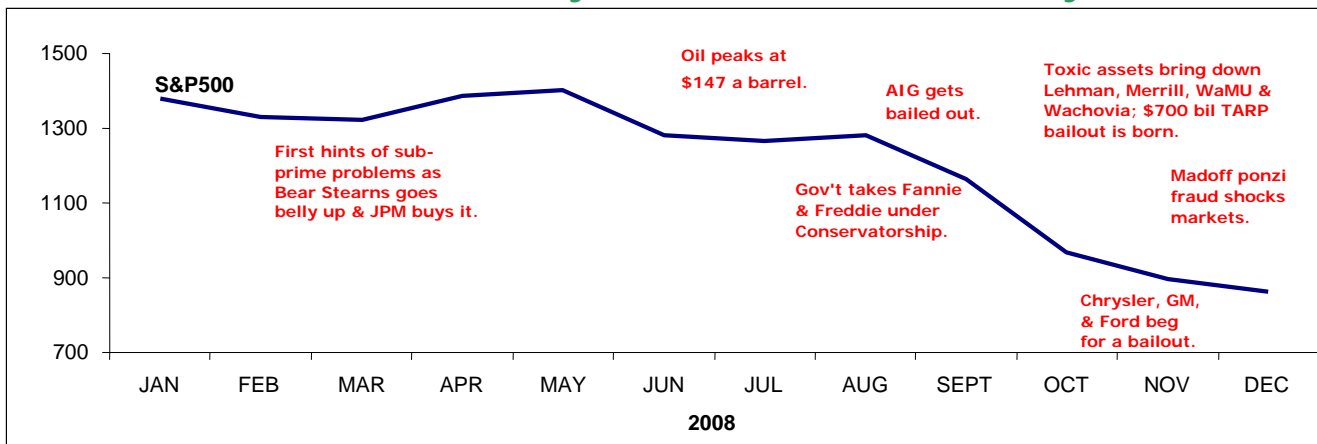


## QUARTERLY INVESTMENT REPORT December 31, 2008

Dear Investor:

As another year comes to an end, many of us have so much to be grateful for. In this time of economic crisis and fear our thanks become ever more acute as we hopefully focus on what is truly most important, our family and friends. We believe these attitudes are sharpened after witnessing the painful wounding of our financial systems and markets throughout most of 2008.

### **SUB-PRIME ASSETS, HOUSING CRASH, BAIL-OUTS, BANKRUPTCIES, FRAUD** The S&P500 starts the year at 1,468 and ends the year at 903



Our first shock was over the demise of Bear Stearns back in March. JP Morgan swooped in and bought the company for a song. By July oil peaked at \$147 a barrel and consumers began feeling a serious pinch in the pocketbook. Gas prices peaked at \$4.11 a gallon and a typical tank filled up for more than \$60. The summer ended in outrage at the lack in leadership at Fannie Mae and Freddie Mac; and by early September the government took both companies under Conservatorship, a fancy legal term that means that the government is in temporary charge of the companies (after giving them a \$200 billion lifeline). By the end of September we watched aghast at the uncovering of troubled and toxic assets that brought down Lehman, Merrill Lynch, Washington Mutual, and Wachovia. AIG was drowning too, and the government set up relief that could approach \$150 billion dollars to help stop the rest of the financial system from getting sucked into the risks from AIG's complicated asset insurance products.

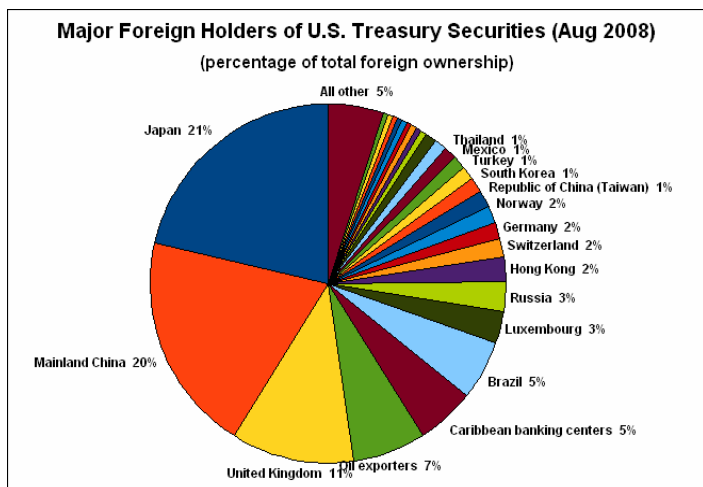
It's over, we said. Let the healing begin! After Thanksgiving we allowed ourselves to feel the possibility and hope for new leadership in Washington and looked forward to a peaceful holiday season. And then a Christmas Grinch called Bernie Madoff blew it all to smithereens. Madoff was exposed for running a ponzi scheme that scammed billions from many families, institutions, and charities.

All is not lost. People have lived through worse and our markets do recover. The sad truth about human nature is that negative commentary sounds more credible and intellectual than positive observations. But everything goes in cycles. While we are realistic about the depth of this recession and see upcoming months still painful for many people, with many losing homes or jobs or both, we expect to begin to see signs of recovery by late 2009. The stock market will begin to price itself for recovery, and investor fear of stocks will subside.

Most economic indicators look dismal right now. The recession, which according to the National Bureau of Economic Research officially started in December 2007, is hurting nearly every industry, demographic group, and region of the country. Further, the entire global economic community is contracting and export markets aren't picking up our slack. In November, recorded unemployment numbers rose to levels not seen in 15 years. We are at a 6.7% unemployment rate and can expect a climb towards 9% before things get better. It is fair to say that the true rate, which is difficult to measure, is pushing closer to 8% or 9%. That is nowhere near the 20%-25% rate of unemployment seen at the peak of the great depression. Also, between 1929 and 1932 the economic gross domestic product declined 30%. In this recession we saw our first decline of .5% in the 3<sup>rd</sup> quarter of this year and most estimates put 4<sup>th</sup> quarter GDP at a decline of 4.5%; this doesn't come close to the kind of economic retrenchment experienced more than 75 years ago. One more comparison to note is that in that depression more than a third of all banks failed. In this recession so far only 25 banks have failed though about 170 are on the FDIC's "problem bank" list. This is a tiny fraction of the more than 8,000 banks monitored by the FDIC.

**Why are we so optimistic that economic conditions won't deteriorate further?**

- Global investors still favor the United States
- Oil price declines are putting billions in consumer pockets
- Aggressive fiscal and monetary response to the financial crises



**Global Investment in US**

For a long time now cheap foreign financing has been good for US consumers, homeowners and investors. With our low domestic savings rate and record federal budget deficits, our economy has become increasingly dependent on foreign capital to cover government spending and boost private sector capital.

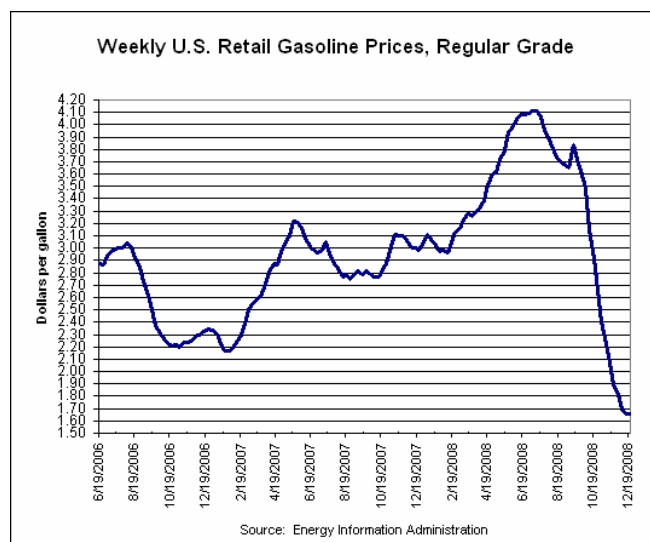
At the same time China, Japan, the UK, and oil-exporting countries have all benefited from recycling their currencies and investing in our safe and low inflationary financial system. With the global financial crisis in full swing we have been watching foreign investment trends carefully. Recent Treasury Department data show that while foreign investors have been dumping our agency securities, they have been piling into short-term treasury securities. This rush to global safety has lifted monthly inflows of net foreign investments in US securities to new record highs. Of course, foreign ownership of so much of our debt is always a concern since it makes us vulnerable should they decide to sell their holdings.

The confidence of foreign investors in our financial institutions has surely been badly shaken, but strength is a relative thing. The US has been hurt badly, but so have many other countries. Our bailouts and government interventions seem to have strengthened their belief in the viability and responsiveness of our non-market institutions to safeguard their investments. In the global competition, the US Treasury is still considered the safest place to invest. The US still retains the financial power to issue billions of dollars in debt at record low rates without its currency weakening.

## Oil Price Declines

It seems like only yesterday we were saving up errands for one car trip a week and wringing our hands at the inefficiency of mass transit.

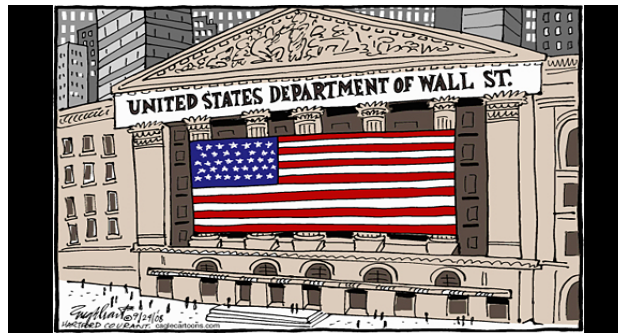
A barrel of oil under \$40 and gas at the pump under \$1.6 a gallon reflects how weak the global economy has become. As we said before, everything goes in cycles, and we expect cheaper oil to be a strong stimulant in the coming months for both business and consumers.



According to data from the Energy Information Administration for every one penny decrease in gas prices, consumers save between \$1.4 billion and \$1.7 billion annually. According to the Boston-based economic and financial information company Global Insight Inc., falling gas prices are like a \$230 billion tax cut for consumers, and should eventually help stabilize consumer spending.

## Aggressive Fiscal and Monetary Response

The Treasury and the Federal Reserve have committed so much money to save the economy that if ultimately it doesn't get saved it will be like missing a flea with a bazooka. To date the federal government has committed \$8.5 trillion. Most of the money, about \$5.5 trillion, comes from the Federal Reserve, which as an independent entity does not need congressional approval to lend money to banks or, in "unusual and exigent circumstances," to other financial institutions. About \$1.1 trillion of the



\$8.5 trillion is coming from the Treasury Department, including \$700 billion approved dramatically by Congress under the Troubled Asset Relief Program. The rest of the commitments are coming from the Federal Deposit Insurance Corp. and the Federal Housing Administration. Only about \$3.2 trillion of the \$8.5 trillion have been used so far, and some of it may never be used. Additionally the Federal Reserve has dropped the federal Funds target close to zero.

Though the process is far from perfect, we expect the flood of funds, low interest rates, low oil and commodity prices, and global investment to do the job of reviving the credit and housing markets. In fact, we anticipate the logjam to clear so much so that in a few years we will complain about a new bubble in some other asset class or industry. The government is clearly much more afraid of deflation and economic collapse than inflationary affects of flooding the market with money at present.

The new Obama administration has shown willingness to do whatever it takes to revitalize the economy. The details aren't clear but we may expect more billions for stimulus funding for alternative energy development, healthcare efficiencies, infrastructure construction projects, and massive efforts towards mortgage restructuring.

We will work diligently to maintain our portfolio out-performance in 2009 by continuing our focus on choosing companies that surpass their competitors on most balance sheet and market growth metrics. The prospects for growth in the stock market in the coming years are exciting and we remain as dedicated as always to finding value for our clients.

We will continue to maintain our personal investment approach and remain committed to meeting client financial objectives.

We look forward to speaking with you and wish you all a happy, healthy and prosperous 2009!

Sincerely,

Ellen P. Le, CFA  
President