



QUARTERLY INVESTMENT REPORT September 30, 2008

Dear Investor:

The financial markets are going through the most challenging of times since the great depression. We can sigh with relief that our government has finally, however awkwardly, come to terms with a financial rescue plan. Before we discuss its meaning and implications we believe it is important to step back and review how we got here.

HOW DID THIS CRISIS HAPPEN?

Once upon a time the world was consolidating...

In response to the great depression the Congress passed the **Glass-Steagall Act of 1933** which, as a reaction to thousands of bank failures during the great depression, sought to eliminate conflicts of interest by forbidding commercial banks from brokerage & investment banking activities and vice versa. The Act also created the Federal Deposit Insurance Corporation (FDIC) to insure bank deposits.

In the 1970's Congress **deregulated brokerage commissions**. This intensified competition and began to pressure what were once comfortable brokerage profit margins. Meanwhile, despite the Glass-Steagall Act, the walls between commercial banks and investment banks started coming down piecemeal throughout the 1960s, 1970s, and 1980s. By the mid 1990's Glass-Steagall was virtually obsolete and, with the exception of maintaining the FDIC, was fully repealed in 1999.

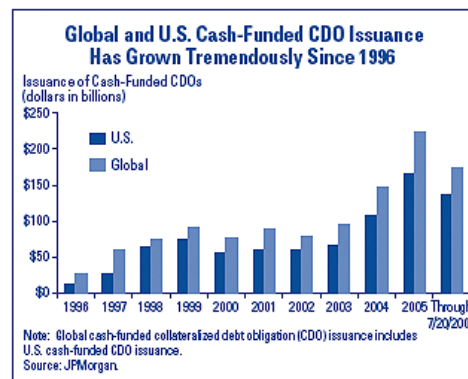
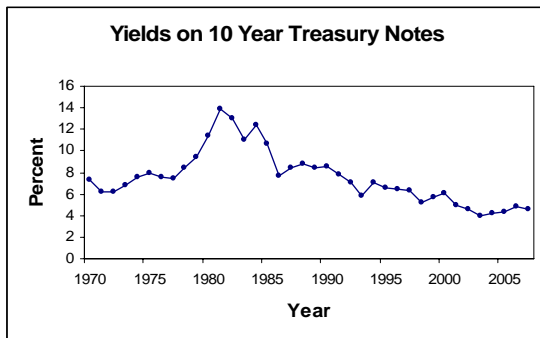
By this time the investment bank's *culture of risk* was pretty much mixed with the commercial bank's *culture of deposit protection*. The elimination of Glass-Steagall allowed banks to get into more lucrative investment banking and insurance products and services, which further pressured brokerage and investment bank profits. Likewise, thinner margins thrust brokerages and investment banks into the bank's realm of deposit taking by launching money market funds. Commercial banks, brokerages and investment banks all strove to grow in size and take on each other's business lines.

And money was created out of nothing...

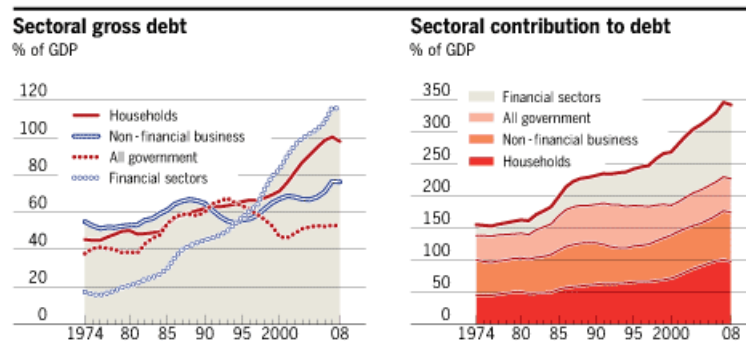
In addition to the massive deregulation and conglomerate growth of financial entities, by the mid 1980s **interest rates fell** and snazzy innovative securities called **derivatives** became popular. Generally, derivatives were developed to spread investment risks and convert illiquid assets into capital market securities. Low interest rates encouraged even more investment and lending. By the mid 1990s much of our financial system was operating by a model of leveraged derivative securities origination and distribution. The new investments had a value all of their own, thus adding **new cash (and debt) to the financial system**. Over the last 10 years a new type of derivative called Collateralized Debt Obligations (CDOs) grew dramatically (to more than \$200 billion by 2005) in response to demand for higher yielding investments. CDOs, a type of credit derivative, are structured finance products that mix high quality with low quality debt. In other words, sub-prime loans could easily be bundled with higher quality mortgages. The financial sector's debt contribution to GDP had grown to more than 30% of the total GDP!

COMPLEX DERIVATIVES!!

LOW INTEREST RATES!



FINANCIAL INDUSTRY DEBT!!! LITTLE OVERSIGHT!!!!



FT.com, Martin Wolf, 9/23/08

And China wanted to play...

Deregulation, financial mergers and acquisitions, and derivatives (if they stayed transparent) aren't bad policies in and of themselves. They help businesses to diversify and reduce risk. But in the 1990s we began to see **China** grow and develop an insatiable hunger for safe investments away from the Asian sphere, especially after the 1997-1998 Asian financial crises. China was saving almost 50% of its GDP which found a home in U.S. treasury and agency (Fannie and Freddie) securities. This huge demand for treasuries supported a strong dollar and the demand for agency securities opened the floodgates for more securitization creation.

All the while, as we are already awash in credit, the Fed **lowered interest rates** in response to the 2001 recession, the Bush administration **lowered taxes**, and credit derivatives expanded even more to soak up the capital. All these events made credit even cheaper and more available.

A home for every American...

As if all of this wasn't enough, beginning in the 1990s and all the way through to the height of the housing boom (that means during **both** the Clinton and Bush administrations) banks, the Department of Housing and Urban Development (HUD) and Fannie and Freddie sought to **expand mortgage loans among low and moderate income people**. This mandate to increase home ownership led to an appalling lack of regulation and outright deceptive mortgage lending practices. Lax lending funded even more derivative securitizations and also inflated home prices which instigated the cycle of borrowing to live beyond one's means.

As things unwound, major financial institutions (Bear Stearns, Fannie, Freddie, Lehman Brothers, Merrill Lynch, AIG, WaMu, Wachovia) couldn't hide from their plummeting asset values and the global finance system lost confidence. **Investors abandoned the credit markets in favor of the safety of treasury bills and the cost of short-term corporate borrowing went through the roof. Overall fear in the financial system concomitant with tight credit is why we need to be rescued.**

In hindsight, it is apparent that the credit boom may have been averted if the Fed had tightened lending rates, if the credit derivative industry was monitored, and if the mortgage industry was tightly supervised to ensure that loans were only offered to people who could actually afford their loans, inclusive of the terms in the fine print!

WILL AMERICANS BE RESCUED?

The \$700 billion recovery plan is one big bailout. A majority of Republicans and Democrats will finally come together with a rescue plan. It is unfortunate that the market credit conditions are so critical that something must get done fast, since the effects of the plan will be realized for years to come. We'd love for the markets to wait

a few weeks for the right, carefully thought out plan, picked apart and built by our most knowledgeable economic leaders.

It's mind boggling that in a short few months we've watched so many venerable institutions disappear. Although it is frightening to see the demise of brand names we are familiar with, **most** financial institutions are not being brought down by toxic assets or a "run on the bank". Yet. And, of course, that's why this rescue has to happen now.

The **rescue plan** will give the Treasury the ability to **buy securities from troubled companies**. It is disappointing that the bill doesn't specify the method for pricing the troubled assets for purchase and instead it states that the methodology will be published at a later date. It's tricky because the prices paid must be a balance between adequately recapitalizing and encouraging participation by troubled banks (pay above the current market value and closer to the present value of the future cash-flows on the asset) and getting the fairest price for the tax-payer (so we can profit from the sale of the assets down the road).

The bill states a promise of "protecting the interests of taxpayers by maximizing overall returns and minimizing the impact to the national debt". We don't mean to be too snide but we couldn't help but laugh at that upon reading the original House bill which remains the core of the new rescue plan. To put our annual contributions to our national debt into perspective, the federal government collected \$2.6 trillion in fiscal 2007 and spent \$2.7 trillion, generating a total deficit of more than \$150 billion. So if \$700 billion is ultimately required, this new rescue plan immediately asks for more than 25% of last year's revenues. And that's more than we spent on each of defense or Social Security or Medicare and Medicaid in 2007.

By issuing so much additional debt we are assuming that investors at home and abroad will continue to believe in our ability to grow as a nation and that our dollar will maintain its value. Right now that may appear problematic but we have seen the ebbs and flows of our economic and financial system many times before. We firmly believe that American's, all American's – Democrats, Republicans, large and small businesses, individuals, government agencies – will pull up their boot-straps and march forward with all determination to do what we do best, which is to innovate, create, and produce goods and services with the passion of excellence and efficiency.

But we digressed and now back to the plan itself...

The rescue plan will be run by a new government office under the Treasury called the Office of Financial Stability. Instead of a blank \$700 billion check, the funds will be issued in increments starting with an **initial amount of \$250 billion**. Congress will maintain oversight of the program and require regular briefings before doling out more funds. The government will have **an equity ownership stake through warrants**. The warrants will be rights to buy either common or preferred stock in the financial institution it funds. If the troubled entity is not publicly traded, the government's

participation will be through a senior bond instrument. The government will set both the warrant-to-stock exercise price and the bond interest rate.

The bill also includes an option for troubled companies to buy insurance on their troubled assets if they choose to sell in the private market. It is possible that companies may determine that insurance costs are not worth paying for.

There is a lot of verbiage in the plan about **capping executive pay**. Three important take-aways are: (1) Already existing golden parachute severance contracts are left alone but the bill does prohibit new severance deals. (2) No limits to executive salaries except to say that compensation above \$500,000 is no longer tax deductible (and that provision is only for companies participating in the plan). That doesn't put any ceiling on actual executive compensation. (3) The bill stipulates that bonuses must be returned if the targets they were based on prove to have not been met.

The plan mentions the ability of government to buy mortgages and securities to modify loans heading towards foreclosure, but the wording is vague and probably ineffective.

The Senate bill added a provision for the **FDIC to increase bank account insurance** from \$100,000 to \$250,000 per account. Other additions are for business tax credits (especially for alternative energy investment) and adjustments to the alternative minimum tax (so that approximately 20 million fewer people are hit with it). The bill gives the SEC the authority to suspend the mark-to-market ruling for securities. Marking-to-market requires companies to value their assets at current prices. This ruling didn't contribute to the financial crises; it magnified it as companies had to write troubled assets off their balance sheet. We think marking-to-market is appropriate and it would be detrimental to the system to remove it.

Separate from the rescue plan...

After this rescue plan is dealt with we would like to see heads roll at the many entities, both Federal and State, which **regulate the mortgage industry**. Many laws are on the books that were never enforced.

We are cautiously optimistic to see that out of this financial crises Congress is beginning to research the need for **regulation over the credit derivatives market**.

NOT A TIME TO PANIC MAINTAIN DIVERSIFIED INVESTMENT PORTFOLIOS

Over the last couple of weeks non-client investors have asked us questions such as...why have their advisors allocated their portfolios so heavily towards stocks? And why are they still invested in AIG shares? And why is their portfolio still so heavily weighted towards energy stocks? To questions like these we say **make sure you understand the competence and the motivation of your advisor**. Are they truly independent? Do they act as your investment fiduciary? Are they capable of

understanding and mitigating investment risks? **Do they act with undivided loyalty to you and do they understand your financial situation completely?**

Ascend Capital Management is proud to report that we have maintained diversified investments across bonds and various stock types. Many months ago we reduced our energy and commodity positions in anticipation of a global slowdown. Earlier in the year we sold our AIG holdings at close to \$35 a share (AIG currently trades near \$3) as our research revealed AIG's extreme exposure through insurance on sub-prime derivatives.

The key to successful investing is to know how to diversify smartly, at the lowest cost possible, in the best priced assets available. Warren Buffett likes to say that he isn't interested in trying to time the market right; he's just interested in pricing the market right. It is so important to be nimble and capable of recognizing and acting on necessary portfolio changes. If you can't do this on your own, do yourself a favor and relinquish the responsibility to a professional investor and fiduciary. The cost will be paid back in spades.

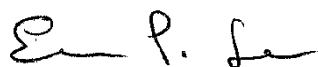
If you insist on managing your assets on your own, here are a few tips:

1. **Don't** hold more than 5% in any one stock.
2. **Do** have an allocation in high quality bonds.
3. **Don't** get sucked in to investment trends or stories that you don't understand.
4. **Don't** believe everything you read by investment celebrities.
5. **Do** continually research and stay current with all news and financial statements for all your investments.
6. **Do** have an independent investment advisor review your holdings periodically.

We urge you to be cautious but remain fully invested. There are many companies to invest in that have solid balance sheets and are able to withstand economic weakness. We believe in our country's ability to get past these critical times and remain a leader on the global economic stage.

We look forward to speaking with you and we will continue to invest with fortitude and zest.

Sincerely,



Ellen Powers Le, CFA
President