November 4, 2008

We don't ordinarily write mid-quarter letters, but these are not ordinary times. This letter has two objectives. The first is to summarize the current economic and financial situation. The second, and most important, objective is to talk about the future.

WHAT HAPPENED?

Although there are a number of causes of the market drop, one cause stands out as the most significant. In recent years, a very large number of risky mortgage loans were made to U.S. homebuyers. The capital for these loans came from the U.S. and overseas. Many loans were for amounts that equaled or exceeded the appraised value of the property backing the mortgage and were made with little or no credit checking on borrowers. In addition, many converted to variable-interest-rate loans after a short, fixed-rate period. As loan interest rates rose, mortgage payments increased, more borrowers got behind on their loans or defaulted on them, and housing prices began to fall.

As lenders began to experience increased losses on loans, they **significantly** reduced the amount of lending they would do. This caused an economic slowdown, and businesses and consumers became more cautious in their investment and spending plans. Falling company profit expectations reduced the demand for stocks and corporate bonds. At the same time, it appears that financial institutions, such as hedge funds and other financial institutions, began selling some of their stocks and corporate bonds. These sales by financial institutions were not necessarily done with a belief that these stocks and bonds were bad investments. Rather, the sales were related to financial issues these institutions were facing that required them to have more cash. These events simultaneously increased the supply of stocks and bonds available for sale and decreased the demand for them and led to sharp decreases in prices for corporate stocks and bonds.

Depending on what measure is used, the total return on the U.S. stock market has been between -30% and -40% over the 13 months ending with October 2008. International stocks, international real estate, and some commodity-linked assets also experienced large price decreases. In response to this, governments around the world are taking actions to improve the financial situation of lenders so they can and will begin making loans again and help eliminate the serious credit crisis. They also hope to reduce consumer and business pessimism so that a more normal economic situation will emerge. These actions are also intended to help stabilize the prices of stocks and bonds by reducing the need for financial institutions to sell them.

WHAT DOES THE FUTURE HOLD?

There are people predicting that the situation will continue to get worse in the future–at least, for a while. There are others who believe the worst is behind us. Either could be right because we are facing **many** uncertainties. We do not know how many mortgage loan or credit card defaults will occur. We do not know if real estate prices have bottomed out. We do not know how effective government actions will be at increasing lending. We do not know how much confidence consumers have lost, how much they will reduce spending, and how quickly their confidence and spending might increase if government actions appear to be working and the recent uptick in stock prices continues. We also do not know how cautious businesses will be to make new investments. The answers to these and many other questions will not be known for

some time. However, we believe the stock market's decline reflected most of this bad news and very little of the potential reasons for optimism.

A recession has almost certainly begun, but we do **NOT** expect a depression. The U.S. government made a series of policy mistakes at the time of the Great Depression that it will not repeat. Its policies increased interest and income tax rates and reduced U.S. exports to other countries. In addition, individuals and companies had much lower cash balances than is currently the case; there was much less of a government safety net, so persons who lost their jobs suffered a bigger loss of income; and there was no FDIC insurance on bank accounts, so bank failures led to a complete loss of account balances.

On the positive side, while we currently have a shortage of lending, there is no shortage of cash in the economy. Recent Federal Reserve data shows that the total amount of cash in savings accounts, CDs, and money market funds in early October exceeded the total market value of all U.S. companies. This percentage has been in the 30-75% range over the last 15 years, and its current level may be an all-time high. We believe this cash will eventually find its way back into investments in stocks and bonds and that their prices will increase as a result.

This is **not** to say price increases are right around the corner or that increases will be swift and dramatic. Prices may fall further, and their recovery may be slow and gradual. U.S. consumers and the federal government have been on a spending spree in recent years, and it will take a period of increased saving to restore their financial houses to a more solid situation. Reforms to Social Security and Medicare are also needed and may take dollars away from investment in private enterprise. As a result, we could be entering a period of subdued economic growth.

Despite all of this, we believe this is **not** the time to be selling growth investments. We believe investors can increase investment returns if they buy (or at least hold) when others are selling in panic or fear. In a recent television interview, Warren Buffett, one of the great investors of our time, was quoted as saying, "I have no idea what the stock market is going to do next month or six months from now. I do know that the American economy, over a period of time, will do very well and people who own a piece of it will do well." We share his belief. We believe that the mutual funds we have selected on behalf of our clients are repositioning their portfolios and buying companies at good prices and that investors in those funds will benefit when economic conditions improve.

Some of you have asked, "What can we do?" Whenever we do retirement projections, we are reminded of how much longer assets will last when spending reductions are made. We encourage you to review your spending to see if there is spending that can be eliminated or delayed without reducing your enjoyment of life. If so, spending decreases may be in order.

Our goal is to provide assurance and rationality in times like this. Human nature causes people to project recent trends into the future. We tend to think that both good times and bad times will never end, but neither prediction is likely to be true. We do not make knee-jerk recommendations nor suggest that you react hastily in response to the recent market conditions.

Best regards,

Jim Rook
Vice President and Chief Investment Officer

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