

Fourth Quarter 2008 Investment Update

Thankfully, 2008 has finally passed. Whether about the equity market, the fixed income market, the underlying economy or the businesses and consumers that comprise it, the news was discouraging, almost without exception.

Without reciting all of the statistical proof regarding just how bad it was, it should suffice to note that the Dow turned in its worst year since 1931, the S&P 500 its worst year since 1937 and the NASDAQ its worst year ever, topping even the debacle that accompanied the end of the tech bubble in 2000.

Put another way, 2008 was the worst year the investment community has seen in at least two generations. Throw in a few doses of Wall Street complexity, leverage and scandal and it was arguably one for the all-time record books.

One way to think of the past decade would be in terms of an ever shifting valuation bubble as both policy makers and investors sought to cushion the deflation of one valuation extreme with the creation of another. Thus, what started with the tech and telecom bubble in late 1990s eventually shifted, first to real estate, then to oil and other commodities and finally to treasuries.

The Abandonment of Risk

This last phase of the valuation bubble is arguably the most interesting, especially for value investors. With the yield on short term treasuries ending the year at zero, investors are, in effect, saying they see a mere return of principle as superior to all other investment alternatives. It is, quite literally, the complete abandonment of all risk.

In one sense, that makes life difficult for active equity managers, especially those with a deep value bent like us.

After all, value investing is about taking calculated risks in response to the fears of other investors. In another sense, it ought to set up a period of very strong performance; we have a wider, and more importantly, a deeper, than normal set of undervalued opportunities to choose from.

If that seems like an inevitability, its timing remains unknown, largely because the current environment represents something of a battle between two “heavyweight” forces.

Our Philosophy

As deep value investors, our view is that opportunities arise from emotional investors who are more concerned with market risk than business risk. We believe that near-term price movements are typically driven by hope or hype – reactions to recent news or events that are often irrelevant to a company’s long-term prospects. This price volatility is largely unrelated to volatility in the cash flows of the underlying investments. And so, over time, as investors react – and often overreact – to news, a company’s stock price often becomes disconnected from its underlying fundamentals. This creates opportunities for value investors. Our strict focus on the fundamentals – the operating environment, earnings and free cash flow – identifies companies whose stock prices have become cheap relative to their long-term normalized earnings power. Our portfolios consist only of companies that we believe have an outsized opportunity to appreciate in value.

In one corner is the macro economic outlook as represented by the average consumer. His plight seems unenviable, to say the least. After a long period of spending more than he should, he is now forced to change his ways, most notably by deleveraging his personal balance sheet in an era of falling asset prices for the two items that comprise the vast majority of his personal wealth: home values and retirement savings. He has no choice but to spend less, not just temporarily, but for well into the foreseeable future.

We think the current downturn in consumer spending is not a simple cyclical one but rather is an event that will “permanently” recalibrate consumption to bring it back into line with income. The consequences of such a shift are far reaching. We wouldn’t be surprised, for example, to see a wide range of retailers fail. There simply won’t be enough sales to absorb the retail industry’s collective fixed cost structure. The current debate over shutting auto dealerships may be one very visible manifestation of this dynamic.

In the other corner is the federal government desperately trying to stave off the deflationary effects of a retrenching consumer and a burst housing bubble. Almost daily, or so it seems, Washington announces yet another effort to “backstop this” or “provide liquidity to that.” The efforts seem likely only to intensify with the new Administration. As 2009 gets underway the talk is about new direct stimuli (tax cuts and spending combined) that may approach \$1 trillion.

Such efforts have always acted to stimulate economic growth in the past. While they’ve never been tried collectively, and certainly not on this scale, we find it hard to believe they won’t ultimately triumph (perhaps excessively, which is why many worry that we are ultimately setting ourselves up for a period of strong inflation).

The Triumph of Stimulus

As a result of that conclusion, our portfolios are positioned in a rather pro-cyclical way, essentially betting that sometime within the next twelve to twenty-four months housing will bottom, loan losses will peak and consumer spending will find a new, albeit lower, sustainable level from which to resume modest growth.

By then, the government should be focused on getting out of the banking/insurance/mortgage guarantee/auto businesses that it has now partially nationalized, looking to replace Treasury’s capital of last resort with new private funding. We believe we will get through this and that the American economy will continue to operate primarily as a system of free enterprise.

In this context, our portfolio’s turnover has slowed considerably. Because we believe we already have a collection of very inexpensive stocks, uncovering new names that are more attractive than our current holdings is hard to do.

Some 30-35% of our portfolios remain invested in a broad range of financials, from regional banks to a variety of insurance companies.

Notably absent from our portfolios are any significant investments in commodities, despite the beating they have received since mid 2008. While some are beginning to rank highly in our quantitative screens, our judgment is that, following the level of investment that took place in these

industries during the super cycle of the past few years, it remains too early to conclude confidently that all of that capital will prove to be productive. We see a high potential for significant write downs and very disappointing profits in the next few years. Our experience is that commodity cycles usually take much longer to turn than analysts and pundits expect.

Despite our generally pro-cyclical bent, the portfolio is notably devoid of retailers. To some extent this reflects our general belief that value investing and retailers are a difficult combination – troubled retailers of particular fashions tend not to recover once they lose their grip on their customers. In this cycle, however, a stronger macroeconomic force is at work, and it will damage the prospects even of non-fashion oriented retailers. We think the “permanent” retrenchment in consumer spending will expose America as being “over-stored” in everything from home furnishing chains and car dealerships, to shoe stores and even malls in general. As with commodities, therefore, we see a good likelihood for a period of surprisingly disappointing profits in the years ahead.

While there’s no way to know what 2009 holds in store, we do know that this *is* a stock market cycle and that all cycles eventually turn. With equity risk spreads at all time highs, a return to more normal valuations promises to provide a period of superior returns. And historically, no other part of the market does better than small cap value once investors begin to anticipate an economic recovery. With a portfolio that is much cheaper than the market according to most valuation metrics, we are well positioned for strong performance as the recession bottoms out and investors’ fears begin to subside. We had a taste of this in August and again in December when just a small change in psychology had a dramatic impact on our performance. Until then, we remain committed to our investment approach and confident that our clients will be well rewarded for their steadfastness.

Portfolio Overview

Performance	4Q2008	2008
Small Cap Value	-31.7%	-45.8%
SMID-Cap Value	-29.5	-46.8
Russell 2000® Value	-24.9	-28.9
Opportunistic Value*	-25.6	-35.9
S&P 500*	-21.9	-30.7

Net of management fees

*Inception: 1/18/2008

Portfolio Characteristics	Small-Cap Value	SMID-Cap Value	Opportunistic Value
P/E (ex. negative earnings)	12.2x	10.4x	N/A
P/B	0.8x	0.7x	0.7x
Dividend Yield	2.5%	3.2%	5.3%
Wtd. Avg. Market Cap.	\$1,027 mm	\$1,578 mm	\$4,857 mm
Number of Holdings	43	42	15

Disclosures:

1. *The Small-Cap Value, SMID-Cap Value and Opportunistic Value composites comprise discretionary accounts with no material investment restrictions. Net of fee performance results reflect the deduction of fees according to the applicable investment advisory fee schedule and brokerage commissions. The results also include the reinvestment of all interest, dividends and capital gains and were computed on a trade date basis. Weighted performance measures the average performance of all portfolios in the composite weighted by size. Performance results for individual accounts vary due to the timing of investments, additions/withdrawals, length of relationship, fee schedule and size of positions, among other reasons. Past performance is no guarantee of future results.*
2. *Composite Inclusion: Accounts that are open and fully invested for one full month are added to the Small-Cap Value and SMID-Cap Value composites at the beginning of the following month. Accounts that are open and fully invested at their first month end are added to the Opportunistic Value composite at the beginning of the following month. Composites include terminated accounts for all full months under management.*
3. *All investments involve risk including the loss of principal. The performance and volatility of an index may be materially different from that of a client's account. In addition, a client's holdings may differ significantly from the securities that comprise an index. The indexes have not been selected to represent an appropriate benchmark to compare the advisor's performance, but rather are disclosed to allow for comparison of the advisor's performance to that of a well-known and widely recognized index.*