

Third Quarter 2008 Investment Update

What started as a problem related to subprime mortgages has now become a full blown crisis impacting virtually the entire financial system. The “bailouts” of Fannie Mae, Freddie Mac and AIG have failed to stem the tide. One might even argue they made things worse by punishing equity holders and rewarding debt holders just at the time the system needs to be deleveraged.

As this quarterly report is being written, Congress has passed a much more broad-based and controversial solution; the economic crisis has transitioned from a financial community concern to the forefront of everyday American life.

No doubt about it: The headlines are scary, the problem complex, and the path ahead unclear. At its extreme, it has the potential to push the global economy into recession, perhaps deeply, as the effects of contracting liquidity spread from the financial system to industry, and ultimately, to the average consumer.

Not surprisingly, this potential is not lost on investors. Value spreads, which in a sense measure the amount of anxiety present in the markets are in record territory. Intraday volatility has increased dramatically. Most telling, perhaps, is the fact that our government has made addressing the challenge its highest priority.

In this context, it's tempting to ask why the right investment strategy isn't just to seek the maximum amount of protection possible.

In fact, many have done just that, pushing the yield on short term treasury securities down to almost zero (literally), while the spread on commercial paper relative to treasuries has widened to several times what it was at the start of the year.

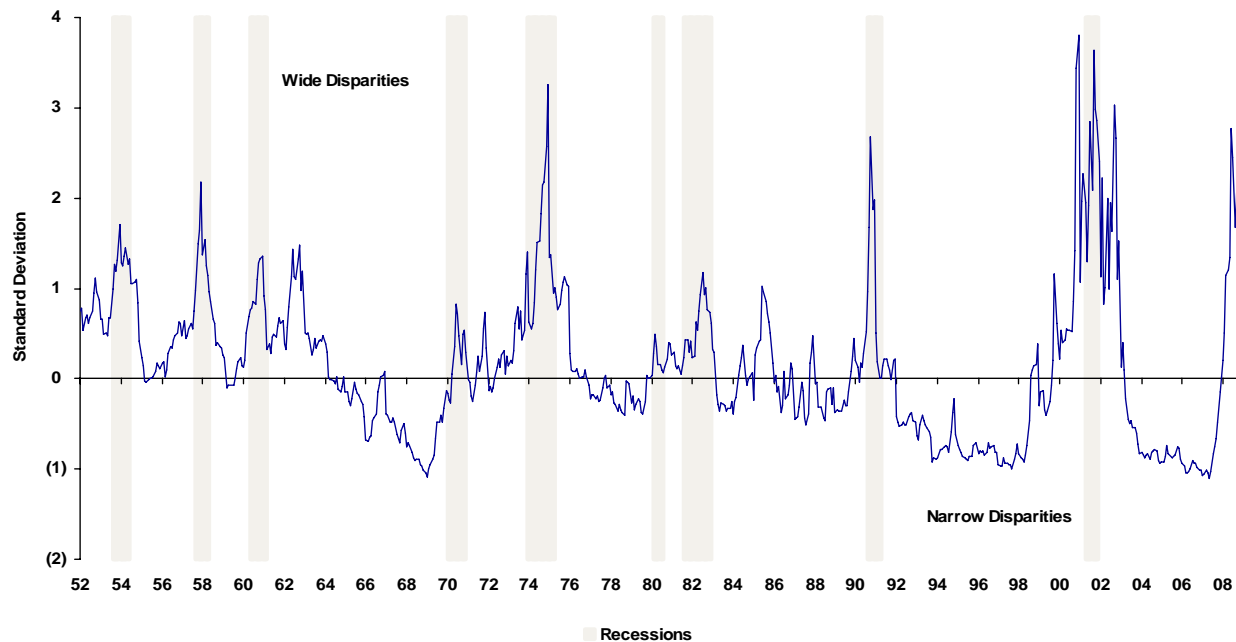
We believe a real value investor, however, cannot take such a stance. Value investing is based on the idea that the market is a tug-of-war between two unalterable human emotions. Greed makes things expensive. Fear makes them cheap. If nothing else, everyone involved in the markets today can probably agree that fear is omnipresent. It is an environment into which the value investor must step.

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.

Recognizing that investor psychology has become overwhelmingly pessimistic, however, is not sufficient to successful value investing. Beyond that, significant research is required to separate the winners from the losers. After all, to state the obvious, there will be losers. Valuation spreads aren't this wide for no reason.

Figure 1: Valuation Spreads



Source: Empirical Research Partners Analysis.
Valuation spreads represent the top quintile compared to the market average – 1952 through September 2008

In that context our most important research conclusions are the following:

First, as widespread and deep as the destruction of mortgage related asset values will be, the destruction will be less than the amounts currently embodied in most estimates and certainly less than that embodied in the most pessimistic figures. In part, this is because those mathematically derived estimates are starting to reach the bounds of reality.

Moody's, for example, now counts the current environment as its base case. It then assigns ratings to financial institutions based on a stress case which assumes an additional once in a lifetime environment is layered on top of that. For good measure, they then multiply that result by 1.3 to provide a "cushion." The fact that this implies something like an 80-90% default rate on all 2006 originated mortgages doesn't seem to bother them.

In part, our conclusion is based on a belief that many of the most pessimistic estimates are based not on the mathematics of default and recovery rates at all, but are being influenced by a complex interaction between short sellers (a new phenomenon during this cycle), credit default markets (a huge, new, unregulated wild-west type market), the rating agencies (who have given up their last claim to thoughtfulness and now rate to stock prices and CDS spreads), and accounting rules that force companies to value assets based on the actions of the first three factors.

Our second major conclusion is that, as difficult as this cycle is when measured in terms of deteriorating asset values, more damaging to shareholders will be the resulting need to restructure corporate balance sheets through the additional issuance of significant amounts of dilutive equity capital.

As a result, we have tried to focus our purchases on those companies that have already raised capital and cut their dividends as a means of preserving capital rather than trying to measure the extent to which the market has already “priced in” a potential capital raise. While, admittedly, we were early in this context with both MBIA and Ambac, it’s a philosophy that has generally served us well. In that spirit, during the quarter we initiated positions in National City Corp, Comerica, Key Corp, Marshall and Ilsley, and XL Capital.

With the exception of XL, all are regional banks whose dominant risk is not to mortgages per se but rather to local and regional homebuilders whose projects are struggling in the current environment. In each case, we have concluded that even under a drastic scenario in which 100% of the troubled loan areas are written off, the companies will remain more than sufficiently capitalized. Moreover, when we get to the other side of the cycle, these companies will be in the enviable position of having significant branch networks and core deposit franchises, attributes we suspect will be valuable as the entire financial system is forced to rely on something other than wholesale borrowed money to fund its operations.

On the subject of Ambac, late in the quarter we actually trimmed our position noticeably, for the most part replacing it with a position in Assured Guaranty Corp, another monoline insurer but one with much less exposure to mortgages and their derivatives. In fact, this far into the crisis, despite being priced similar to ABK, AGO actually retains its AAA rating, although we expect it to be downgraded in the near future as Moody’s and S&P extend their basic conclusion that being a monoline insurer is, by definition, incompatible with the concept of the AAA rating.

Conversely, it’s worth noting that one factor contributing to this quarter’s strong performance (both absolute and relative) has been the avoidance of most of the industry’s true disasters. With the exception of a smaller than normal position in Freddie Mac (and Fannie Mae in our SMID accounts) our portfolios were void of blow-ups. We owned no Washington Mutual, Countrywide, Thornburg, AIG, Bear Stearns, Lehman Brothers, Indy Mac, CIT or Wachovia to name a few, as our research indicated that the value of these franchises had become permanently impaired.

In summary, there’s no doubt that these are stressful times. We remain confident, however, about the path that must be pursued. If growth investors bet on the serial correlation of euphoria, good value investors root themselves in the mean reversion of fear.

We can’t claim to know what will come next. On the one hand, we can envision a scenario where the Paulson Plans begin to unclog the credit system, allowing real estate related assets to be valued more properly. On the other hand, we can also envision a deteriorating environment as those most desperate to unload assets do so at any price.

In general, however, we believe the array of countervailing forces (both external and market driven) will begin to take hold. Thus, with fear at an all time high, we are willing to bet that better days lie ahead.

All told, our flagship Small and SMID Cap portfolios are now approximately one third invested in financials. Our Opportunistic Value portfolio, a concentrated “best ideas” service is now entirely invested in that sector.

Portfolio Overview

Performance	3Q2008	YTD
Small Cap Value	13.8%	-20.6%
SMID-Cap Value	7.1	-24.5
Russell 2000® Value	5.0	-5.4
Opportunistic Value*	29.7	-13.9
S&P 500*	-8.4	-19.3

Net of management fees

*Inception: 1/18/2008

Portfolio Characteristics	Small-Cap Value	SMID-Cap Value	Opportunistic Value
P/E (ex. negative earnings)	13.5x	12.0x	12.0x
P/B	0.9x	0.9x	0.8x
Dividend Yield	2.0%	2.4%	3.7%
Wtd. Avg. Market Cap.	\$1,392 mm	\$2,023 mm	\$3,294 mm
Number of Holdings	42	39	13

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.*
4. *The securities discussed above were holdings during the quarter ended September 30, 2008. The stocks we elect to highlight each quarter will not always be the highest performing stocks in the portfolio, but rather will have had some reported news or event (e.g. new contract, acquisition/divestiture, financing/refinancing, revenue or earnings, changes to management, plant strike, product recall, court ruling, etc.) of significance. They do not represent all of the securities purchased, sold or recommended by the advisor, and the reader should not assume that investments in the securities identified and discussed were or will be profitable. All information is provided for informational purposes only and should not be deemed a recommendation to buy the securities mentioned.*