



I Want My Baby Back. You Can Keep the Bathwater.

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Once Again, Leverage Was the Cauldron of Capital Destruction

The continuing credit crisis, weak housing prices, diminishing consumer confidence, and higher energy, food and health care prices have continued to put negative pressure on the financial markets. The financial system's over-reliance on borrowing and the subsequent deleveraging of financial institutions and the consumer is creeping lower into the financial food chain, infecting smaller banks and consumer credit companies while, at the same time, spreading to international counterparts. Many argue we are already in a recession, yet at the same time, inflationary pressures are compounding the problems of a weak economy and a weaker consumer. The standard measure of inflation does not include food or energy, yet the prices of gasoline, other energy by-products, and food are placing increased pressure on an already stretched consumer. Like other cyclical events, these too will come to pass. The key question is when will markets begin to fully discount the bad news? We suspect we will experience a "U" shaped recovery and will discuss how that will influence our asset allocation decisions and manager selection choices.

The first half of 2008 saw gut-wrenching declines in equity markets as fear overcame greed. Stock markets around the globe have experienced violent sell-offs, discounting further unpleasant surprises. Through the end of July, stock market performance was as follows:

<u>Index</u>	<u>YTD Performance Through July 31, 2008</u>
S&P 500	-12.65%
Russell 2000	-6.02%
NASDAQ	-12.32%
EAFE	-13.45%
MSCI Emerging Markets	-15.68%

The Fed remains between a rock and a hard place. Should they raise interest rates to reduce the probability of inflation, slowing the economy in the process? Should they lower interest rates to stimulate the economy, risking higher inflation down the line? Should they do nothing and let market forces attempt to correct the problems that are creating uncertainty and chaos in the financial markets? We believe inflation concerns will ebb, causing the Fed to stay on hold for the moment. Another set of financial calamities (continued write-downs, bank failures, a strained FDIC, etc.) may cause them to lower rates once more.

Sell Now, Ask Questions Later

The unprecedented amount of capital destruction that has taken place over the past year is profound. Once vaunted global financial titans were forced to write down billions of dollars of assets, damaging balance sheets to the point to where their CEOs traveled the world, hat in hand, raising capital from foreign governments and other pockets of liquidity to replace the equity that leverage destroyed. This series of events, the root of which can be found in the housing bubble, caused investors to sell now and ask questions later. In some cases, the baby was thrown out with the bathwater. Companies with strong balance sheets, outstanding cash-flow and predictable earnings streams were jettisoned from portfolios without any regard to the fundamentals. The following is a quote from one of our managers. This is not a recommendation to purchase a specific security, rather an example of values that are still to be found in the wreckage.

“Ball Corp. Ball Corp. (BLL) is one of the world’s largest metal and plastic packaging manufacturers, primarily for beverages and food and was also a holding in 2003 and 2004. From October 2007 through January 2008, the stock dropped 25% as investors were concerned about difficult growth comparisons and announced plant shut-downs. We viewed this decline as a buying opportunity and began establishing a position in the low \$40s with the stock trading at 12x 2008 earnings and FCF, at the low end of its historical range. Ball operates in a recession-resistant industry, and from our earlier experience as Ball shareholders, we developed great respect for its management team. The balance sheet is in the strongest position in years, providing management the opportunity to enhance shareholder value, starting with its intent to buy back over 5% of Ball’s stock in 2008. Additionally, the Company is well positioned to expand its footprint in rapidly growing areas like Brazil, Poland, and other parts of Eastern Europe in order to meet the huge demand increases in these regions as metal beverage cans take market share from glass bottles. Having the opportunity to buy this company at 12x earnings and cash flow during a period of market turmoil is exactly the kind of opportunity we look for.”

While tremendous values will present themselves from time to time, emotion will win out over fundamentals as long as the news remains negative. Investors will have to perceive that housing prices have stabilized and the worst of the credit crisis is behind us before markets normalize.

Credit Constraint

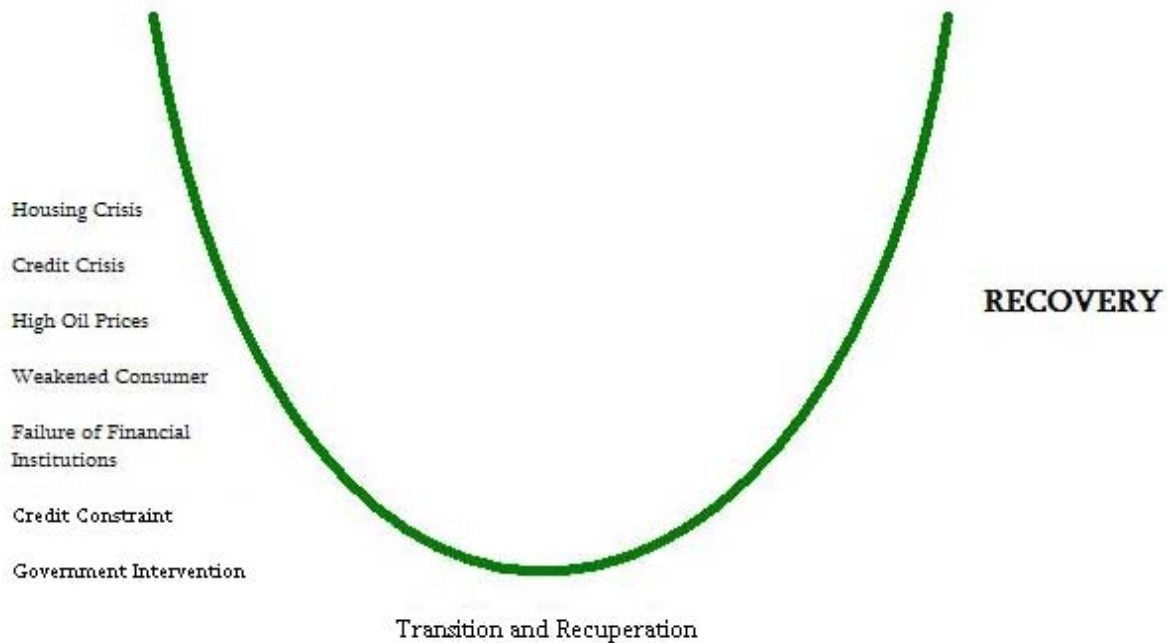
Borrowed money greases the wheels of the economy. Governments borrow money to build infrastructure and support social programs. Corporations need capital to expand and support infrastructure. Individuals borrow money to buy a home or finance a child's education. These are just a few examples of how borrowed money helps our economy grow. The credit crisis has had the effect of constraining lenders. A recent example of this is the decision by the major domestic automobile manufacturers to discontinue leasing cars to consumers. To quote an "old pilot", banks are unwilling or unable to lend for the following reasons:

- "Capital is under intense pressure from credit losses and accounting rules and investors have become increasingly skittish about injecting new equity.
- Inability to raise capital and uncertainty about the size of prospective losses restricts the financial system's willingness to lend; in fact, worse, is leading to reductions in availability through reductions in credit lines (from home equity loans, to credit cards, to C&I loans).
- In short, the entire economy is deleveraging; this is negative for economic growth because new activity can't get financing unless the risks are very low and the returns are high.
- Lack of credit availability leads to slower economic growth which in turn increases the likelihood and size of losses.
- This leads us back to step 1 and the cycle repeats in a reinforcing fashion."

The halcyon days of easy money are over and will remain so for the foreseeable future.

Do You Know Your ABCs (or, in this Case, VLUs)?

There are three basic types of economic cycle. The "V" shaped economy bounces back quickly from a slowdown, returning to growth in a rapid fashion. The "L" shaped trend begins with a precipitous decline followed by a long period of recession and/or deflation paired with a true sense of despair. Japan is a textbook example of an "L" shaped scenario. The "U" shaped trend begins with an economic slowdown followed by a period of sporadic uncertainty until, finally, growth begins again. We believe we are in the midst of the "U" as follows:



This cycle has been characterized by the excessive use of credit causing asset prices, particularly real estate, to become overvalued. Higher housing prices, low interest rates, and aggressive lending practices by banks and mortgage companies led the consumer to borrow aggressively, taking on too much debt. These mortgages were packaged into various types of debt instruments that were sold to mainly institutional investors. Large financial institutions applied immense amounts of leverage to their balance sheets, using mortgages and other risky financial instruments as collateral. In hindsight, it was a game of financial musical chairs. When the music stopped, the once liquid markets for these securities disappeared, leaving many banks, brokers, insurance companies, and mortgage originators holding the bag. These institutions need ongoing liquidity to operate their businesses. As the buyers disappeared, it became difficult to value these securities. At some point, capitulation will take place and these securities will be sold at fire sales prices that destroy equity. For example, on July 28th, Merrill Lynch sold CDOs (collateralized debt obligations) with a face value of \$30.6 billion for \$6.7 billion. Poof – \$23.9 billion disappeared (the securities had previously been written down to \$11.1 billion). Simultaneously, Merrill issued \$8.5 billion of new common shares in a secondary offering, diluting current shareholders. More write-downs are coming. Some will view this as the last step in the reconciliation of the credit crisis. Others will view this as the first step in a long rehabilitation process of our financial system. In retrospect, much of the economic growth of the last cycle was built upon a house of cards.

Markets and economic cycles are not perfectly synchronized. The stock and bond markets are discounting mechanisms. They anticipate future changes in the strength or weakness of the general economy and the earnings power of specific companies. Certain events cause opinions to shift to the positive or the negative, causing fluctuations in the prices of securities. Markets don't need good news to turn more positive. Stock market bottoms normally form before the trough in the economic cycle – when bad news stops; not when good news begins. We believe we still have some bad news in front of us. We expect to see continued pressure on the financial system marked by the failure of some regional and sub-regional banks and finance companies. Indy Mac was just the beginning. Sovereign wealth funds will not run to the rescue of small and mid-sized institutions. They too, like Merrill Lynch, will be forced to write down assets. Nobody will want to replace the equity.

The bailout of Bear Stearns did not mark the bottom. While more active intervention by the Treasury and the Fed may help to cool the hot spots, expect to see the economic slowdown spread to other countries around the world. This movie will be available in many languages.

It may take another six to twelve months for perception to turn. In the interim, good assets will be sold alongside the bad as global investors search for liquidity. The baby will continue to be thrown out with the bathwater. At some point the “good” assets, whether in equities, real estate or other asset classes, will begin to separate from the “bad” as investors refocus on fundamentals.

How Should a Long-Term Investor Be Positioned?

Investing is a lot like playing chess. Great chess players, like great investors, are constantly thinking about various scenarios and plotting the sequence of potential moves well ahead of time. For those of you who know us well, you're aware that we have been advocating lower volatility absolute return strategies in an effort to preserve capital in this difficult environment. We continue to believe that this is the right strategy. That being said, we're beginning to think about how to reposition our clients for a more constructive equity environment. There are no specific conclusions yet, but we are beginning to build a roadmap for tactical reallocations.

We are continuing to find outstanding investment managers. At least 40-50% of our time is devoted to manager research, whether that is staying close to our existing managers or seeking out new talent. The first half of the year brought three new managers into our stable. Each has a long track record of producing outstanding risk-adjusted returns. Our “long-only” managers have had a tough time. Some have fared better than the market; some have fared worse. The phenomenon of “throwing the baby out with the bathwater” created unusually high correlations with the general market for our long-only managers that have demonstrated low correlations in the past. We believe this will correct itself over the next several quarters.

Here are a few bullet points that summarize our current thinking:

- Stay overweight unleveraged long/short equity.
- Stay overweight unleveraged long/short fixed income.
- Own shares of high yielding stocks with predictable and growing dividends.
- Don't try to “catch a falling knife”. Plenty of money can be made when the downtrend reverses.
- Keep an eye on emerging markets. We don't advocate exposure now but they will provide outstanding opportunities somewhere down the line.
- Focus on value-oriented managers. They will outperform growth when the markets turn.
- Sell any commodity exposure. On a broad basis, commodity prices have peaked for the time being.
- Fixed income should be professionally managed. Hire firms with strong credit research teams.
- Don't panic. This downturn will pass. The key is to preserve capital now. It is easier to move toward risk than away from it.

We read scores of letters from various investment managers. The following are a few quotes we found interesting and thought-provoking.

“While it appears quite clear that most of the large, still highly leveraged and INTER-CONNECTED banking franchises will not be allowed to fail (through the continuing interventions of regulators and central bankers), the prospects for a quick resolution of these problems and a broader recovery grow dimmer.” *Macro Hedge Fund Manager*

“The “silver lining” in all this is that we are likely to have fantastic investment opportunities if we can preserve capital and be in a position to eventually play offense. I have been leaning towards growth and GARP-like investments over the past few years, and have maintained selective momentum-oriented positions in materials stocks. We will be shifting towards more traditional value as we see better opportunities develop.” *Long/Short Equity manager*

“We are constantly reminded of the fact that financial markets are “forward-looking”. Anyone would be hard pressed to identify what the market is ‘looking forward to’ at the moment, aside from vacation. The fundamentals are abysmal, but shorts can suffer significantly when Uncle Sam gets involved...” *Long/Short Fixed Income Manager*

“Although intrigued by what optically appear to be “cheap” stocks in the financial area, our inability to ascertain with comfort the twin issues of asset quality and earnings power have kept us from investing for the time being.” *Long-only Equity Manager*

“It is possible that we are in the early stages of a true shift in consumer spending and consumption. We must consider the impact of smaller, more efficient cars, the move towards alternative energy, the de-leveraging of the individual, and the evaporation of real estate wealth, to name a few.” *Long/Short Equity Manager*

“From the perspective of a long-term investor, there are some positives. First, there is an unprecedented amount of cash in money market funds, as well as sovereign wealth funds. Second, consumer confidence is at a level only seen at recession lows. Historically, this has been a good contrarian indicator in that markets have been dramatically higher in the year or two following such low levels. Also, the dividend yield on the S&P 500 exceeds the Federal Funds Rate for the first time since the market lows earlier in the decade.” *Long-only Value Oriented Equity Manager*

As always, please feel free to contact us directly with any questions or comments you may have at (973) 525-1000.

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