



We're Not Out of the Woods Yet

Stewart Massey
February 1, 2008
973-525-1000

Living in a Deleveraging World

(Sung to the tune of Madonna's "Material Girl")

Some banks gave me too much credit
I think they're OK
Now they want their money back
And I'm not sure I'll pay

They can beg and they can plead
But I can't re-finance
Now the boys with cold hard cash
Will buy the world and dance

We are living in a deleveraging world
My portfolio's beginning to swirl
You know that we are living in a deleveraging world
And my portfolio's beginning to swirl

The Fed is cutting so darn fast
And that's alright with me
If lower rates can't bail me out
I'll be in bankruptcy

Our economy's slowing – inflation's high
I don't know what to do
I just hope I have a job
'Cause interest does accrue

We are living in a deleveraging world
My portfolio's beginning to swirl
You know that we are living in a deleveraging world
And markets are making me hurl

2008 Outlook

Global markets entered 2008 in a quandary. Credit markets were clearly pricing in a significant chance of a recession. Equity markets seemed to hold hope that consumer spending, corporate earnings, and global liquidity would stay strong enough to buffer a significant economic slowdown. The bond market won. January brought one of the worst months on record for equities and the Federal Reserve Bank executed a series of unprecedented interest rate cuts that helped to stabilize equity markets...for now. In our minds, the debate should now be centered on how deep a recession the U.S. economy will realize and whether or not the slowdown will drag the rest of the world into the quagmire.

January's Storm

	<u>12/31 close</u>	<u>1/31 close</u>	<u>% Change</u>
S&P 500	1468	1379	(6.1%)
Russell 2000	766	713	(6.9%)
Nasdaq	2652	2390	(9.9%)
EAFE	2253	2044	(9.3%)
Japan Topix	1476	1346	(8.8%)
MSCI Emerging Market	1246	1089	(12.6%)
Shanghai Composite	5262	4383	(16.7%)
BSE Sensex (India)	20287	17649	(13.0%)
Brazil Bovespa	63886	59490	(6.9%)
US Treasury 5 year	3.44%	2.83%	
US Treasury 10 year	4.04%	3.64%	

2008 will present a challenging investment environment. The unrest caused by the housing and credit markets will continue to take its toll on the U.S. consumer and the financial service sector. We expect the early part of the year will be marked by continued turmoil and volatility in the capital markets. Investors should expect more unpleasant surprises and large “gap events” throughout the first two quarters of 2008. U.S equities are likely to continue their decline, creating buying opportunities in the latter half of the year. Government and municipal bonds will continue to rally as the economy slows and the Fed remains accommodative. Treasuries may overshoot their fair value on “flight to quality” rallies. The bond rally, however, will be limited as investors remain concerned about inflation. Investors should shorten maturities in anticipation of the next economic cycle. The dollar’s decline against developed market currencies will wane while emerging market currencies of higher growth economies will remain strong.

On The Brighter Side...

Chaos creates opportunity. I sat with an “old pilot” this afternoon who is in the process of starting up a global long/short equity fund. Formerly he was the president and chief investment officer of a large investment complex. He feels very fortunate to be able to construct his new portfolio in this investment environment and believes there will be a lot of “fat pitches” over the next 12-18 months. Some of the positive backdrop includes:

- The Fed is cutting rates aggressively. The 75 basis point cut on January 22nd followed by a 50 basis point cut on January 30th was an unprecedented attempt to stimulate the economy and pump liquidity into the system. The Fed appears to remain accommodative which should help to stabilize markets.
- Emerging economies, especially China, India, Brazil, and those of other Asian and Latin American nations will continue to grow, perhaps at a slower pace, thanks to strong domestic demand. Truly global companies will continue to benefit from these dynamic economies and a large emerging middle class of consumers.
- There is over \$3 trillion sitting in money market funds with declining interest rates. Some of that money will eventually move into stocks and bonds.
- The net exposures of many long/short equity funds are at a low ebb. Some of our managers have single digit net exposures. There is a lot of buying power that could be put to work on an opportunistic basis or when sentiment changes.
- We have seen significant price declines in the shares of high quality companies.
- Share repurchase programs and increasing dividends continue to reward shareholders.
- Mortgage re-financings will pick up as interest rates move lower. This will begin to take some pressure off of the housing sector.

- Liquidity is still out there. As we mentioned in our August 2007 strategy piece, capital is becoming predatory. Witness the many sovereign fund investments over the past several months. Here is a sample:

Date	U.S. Company	Govt. Controlled Fund	Stake	Price
May '07	Blackstone Group	China	10%	\$3B
Sept. '07	Nasdaq	Dubai – Borse Dubai	19.9%	\$1.8B
Sept. '07	Carlyle Group	Abu Dhabi – Mubabala Dvpt. Co.	7.5%	\$1.35B
Oct. '07	Bear Stearns	China – Citic Securities	N/A	\$1B
Oct. '07	Och Ziff Capital	Dubai – Dubai Intl Capital	N/A	\$1.29B
Nov. '07	AMD	Abu Dhabi – Mubabala Dvpt. Co.	8%	\$622M
Nov. '07	Citigroup	Abu Dhabi – Abu Dhabi Inv Auth	4.9%	\$7.5B
Dec. '07	Morgan Stanley	China – China Investment Corp.	9.9%	\$5.58B
Dec. '07	UBS	Singapore	N/A	\$9B
Dec. '07	Merrill Lynch	Singapore – Temasek Holdings	9.4%	\$4.4B
Jan. '08	Citigroup	Singapore – Singapore Inv Group	N/A	\$7B
Jan '08	Citigroup	Kuwait – Kuwait Inv Authority	N/A	\$3B
Jan. '08	Citigroup	Saudi Arabia – Prince Alwaleed I	N/A	\$2B (est.)
Jan. '08	Merrill Lynch	Kuwait, South Korea, Japan	N/A	\$6.6B

Our Worry List

We believe there are a number of trends and events that will continue to have a negative influence on equity markets and that will push interest rates lower. We're not in panic mode, but these potential factors will weigh on the market. In no particular order, here's what is keeping us awake at night:

- We may see a continuing string of write-downs in the financial service sector. While banks and investment banks have written off billions in bad debt, it is very difficult to value some of the more illiquid instruments. Market expectations are that most of the CDO and subprime mortgage write-downs are behind us. If they aren't, this will fuel negative sentiment.
- While the U.S. financial institutions have started cleansing their balance sheets, it appears that European institutions are well behind the curve. I still believe there is the chance of a significant bank failure in Europe. At the least, look for a series of "surprise" write-downs.
- The structured derivatives market has trillions of dollars of obligations sloshing around. Each one of those contracts assumes that the counterparty credit is sound and that each of the contracts will settle. The failure of a financial institution to perform on their end of the bargain would be catastrophic for the capital markets. This would create wholesale selling of equities and a flight to quality in the Treasury markets.
- Some corporations will have difficulty financing or re-financing debt. Credit spreads will continue to widen. Capital spending will slow.

- The large bond insurers (AMBAC, MBIA, FGIC) are deeply troubled. There is \$2.4 trillion of enhanced credit obligations on their balance sheets. Many of these enhanced bonds have been re-rated down to their true underlying credit. Those that will be hurt the most are municipalities and other issuers who need insurance to help sell their securities. Even if a rescue plan emerges, it will impair the ability of issuers to raise capital. This is not good for economic growth. Please see the chart below which illustrates MBIA's recent price action.



Courtesy of bigcharts.com

- Credit will become less available as banks, with less capacity to lend, become far more selective about creating new consumer loans. It will be far more difficult to secure a jumbo home mortgage or an auto loan. This is negative for consumer spending generally.
- Unemployment may rise, continuing to weaken the profile of the domestic consumer.
- Corporate earnings may be readjusted downward as a slowing economy begins to affect business. Companies with a truly global footprint will do OK. Domestic-oriented shares will continue to have a difficult time until there is evidence of an economic rebound.

It will take time for the economy to digest the credit crisis, housing bubble, and the associated knock-on effects. A good deal of deleveraging still has to take place. We believe the cautious approach is the best course of action over the near term, but that opportunities will arise.

What To Do Now

Investing in an environment where balance sheets are deleveraging, the consumer is under pressure, inflation concerns are still on the horizon, and capital has shifted into predatory hands is difficult at best. Here are a few notable quotes from some of our investment managers:

“Many of our “winners” of last year were particularly hard hit. Several investments were down 25-30% with no change in their underlying business.”

Long-only equity manager – January 31, 2008

“Experience tells us that when stocks become decoupled from their underlying fundamentals, it is almost always a buying opportunity. Experience also tells us that when this decoupling occurs, investors invariably give up logic to fear and emotion, and portfolio managers can never be 100% sure it is the market that is incorrect, and not themselves. This is human nature.”

Long-biased equity manager – January 28, 2008

“Clearly the case for housing hurting economic activity is “old news”. I believe we have entered into a recession. The sectors of the stock market directly affected by domestic consumer slowdown, primarily financials and retail, are now cheap on a long-term basis. We have been building positions in both of these sectors slowly as valuations have become compelling.”

Long/short equity manager – January 16, 2008

“The notional value of derivatives outstanding is over \$500 trillion, with a market value of over \$11 trillion. There are over \$20 trillion of equity linked derivatives outstanding. The notional value of credit default swaps tripled from the end of 2005 to mid- 2007, and have reached over \$42 trillion, according to the Bank for International Settlements. A 1% default rate could produce several hundred billion dollars of losses for issues of swaps and equity derivatives, creating a major second wave of crises.”

Fund of funds manager – January 31, 2008

“...I remain concerned about inflation and inflation expectations...My view is that if oil and other commodity prices do not break down shortly, the Fed may be forced to stop easing and perhaps even increase rates...”

Long/short equity manager – January 16, 2008

“Great investors make themselves better by surrounding themselves with people who are smart, creative, and excited about what they do...Great cultures make people reluctant to leave, even when the economic payoff from leaving appears highly attractive.”

Fund of funds manager – December 31, 2007

“We think that the supply and demand correction due to degraded sentiment against Japanese equities has pretty much ended in 2007. With the recent drop in the market, the Japanese equity market’s valuation as a whole is at the lowest level in thirty-three years.”

Long/short Japan focused equity manager – January 22, 2008

“...for the first time in four years, good fundamental research can produce profits on the short side...selected relative value strategies that have a volatility component will become more attractive...”

Fund of funds manager – January 22, 2008

“The year 2007 was of historic significance for municipal bonds. Many of the assumptions that served as the foundation of the municipal market had been compromised. The events of 2007 highlighted the importance of a disciplined risk management process...Investors learned they could not rely solely on rating agencies and bond insurers to preserve their principal against credit risk and spread volatility.”

Tax-exempt fixed income manager – January 2008

Given January’s results, we were surprised by the great disparity of returns amongst our managers. In summary, here’s how we’re thinking about how to approach investing in the current environment:

- We expect equities to experience continued volatility with a downward bias in the early part of the year as markets continue to digest the extent of an economic slowdown and the ongoing credit crisis. We are sticking with time-tested managers that have a demonstrated a record of preserving capital during difficult market periods. We expect to see a wide disparity of returns between managers.
- Unleveraged long/short equity and long/short credit will continue to provide the best risk-adjusted returns. We will continue to overweight portfolios with these types of managers.
- The Fed will continue to cut interest rates. Credit spreads are likely to continue to widen. Fixed income should not be “self-supervised”. Bond portfolios should be structured and overseen by professional managers proficient in credit research.
- Inflation will remain a concern. We may experience a slowing economy with rising prices of goods and services. Upward price pressure will remain on food and oil. Inflation concerns may place a cap on a bond rally.
- Opportunities will arise as we move through the latter half of the year. Continued declines in emerging market equities, high quality financial service stocks, the consumer sector, REITS, MLPs, and technology will create buying opportunities.

As always, please feel free to contact us directly with any questions or comments you may have.

Important Disclosures

This letter is being furnished on a confidential basis to the recipient for discussion purposes only and is not intended as investment advice. This letter is not to be transmitted in whole or in part without the prior consent of Massey, Quick & Co. LLC (Massey Quick). Massey Quick makes no express or implied representation or warranty with respect to the accuracy or completeness of this letter. Massey Quick has no obligation to inform the recipient when the information herein is no longer current.

This letter does not constitute an offer to buy or sell, or a solicitation of an offer to buy or sell any securities or interests of any entities, or to provide investment advisory services.

This letter is based upon information Massey Quick believes to be reliable. However, the information set forth herein does not purport to be complete and is subject to change.

Certain information contained herein may constitute “forward-looking statements,” which can be identified by the use of forward-looking terminology such as “may,” “will,” “should,” “expect,” “anticipate,” “project,” “estimate,” “intend,” “continue” or “believe” or the negatives thereof or other variations thereon or other comparable terminology. No representation or warranty is made as to such forward-looking statements.

The use of this letter in certain jurisdictions may be restricted by law. Prospective recipients of this letter should inform themselves as to the legal requirements and consequences of such use within the countries of their citizenship, residence, domicile and place of business.