

INVESTMENT REVIEW AND OUTLOOK

When greed and leverage have done their worst, one plus one still equals two.

We paraphrase an old Samuel Johnson quote to characterize both the problem and the opportunity created by the current chaos and panic in the financial markets. Global stock markets are in the grips of a once in a lifetime financial crisis, brought about by the bursting of a debt bubble that was global in scope and decades in the making.

The breadth and depth of stock market declines this year have been nothing short of stunning. The following table is illustrative:

YTD performance through 10/14/08

Major Indices

S&P 500	-30.86%
MSCI World	-35.64
Nikkei	-30.41
EAFE	-38.92
BRIC*	-51.76

*Brazil Russia India China

Widely Held Mutual Funds

Growth Fund of America	-38.5%
Fidelity Contra Fund	-31.3
Fidelity Magellan Fund	-42.7
Janus Fund	-34.0
Calamos Growth Fund	-42.0

The current crisis cannot be blamed exclusively on irresponsible borrowers, greedy Wall Street CEOs or incompetent politicians and policy makers. At a minimum, they are all to blame. As BCA research notes in their October 6, 2008 report, *the debt bubble, was the result of “an abnormally long period of low interest rates, a breakdown of regulatory oversight, and extreme complacency (to put it mildly) on the part of borrowers and lenders.”* To the hall of blame, we might add the major rating agencies who put their AAA imprimatur on over a trillion dollars of dodgy mortgage backed securities. The failure of these securities proved to be the straw that broke the camel’s back.

Whatever the cause, the result has been frozen credit markets, plunging stock markets and a loss of confidence in the entire financial system. The crisis quickly claimed an entire industry. The investment banking industry, as we know it, no longer exists. The landscape of the commercial banking sector has been forever altered as well: First by multiple failures and shotgun marriages and, later, by governmental bailouts. Massive re-regulation and/or quasi-nationalization are yet to come. In the words of James Grant, “the Bush administration has had to socialize capitalism in order to save it.”

The good news is that the financial crisis is now in late innings. The bad news is that the second order effects on the global economy are only just beginning to be felt.

The U.S. is entering into the first consumer-led recession in 17 years. This will bring with it rising unemployment, a sharp retrenchment in consumer spending and a decline in capital spending. Euro area economies may be in worse shape, as ECB monetary policy remained hawkish well into the current crisis even though their financial sector was facing similar challenges to those in the U.S. Although they seem to have gotten religion more recently, the European set-up looks eerily similar to that of Japan in the late 1980s. The bottom line is that despite aggressive reflationary efforts on both sides of the pond, a global recession is probably already baked into the cake.

Readers of Moody, Lynn & Co. letters will recall that we have been extremely defensive in our asset allocation and portfolio strategy since the beginning of the year. ***Relative to policy norms, our cash levels are the highest in the firm's history.*** While this defensive positioning dampened portfolio volatility and helped to minimize losses, the magnitude of the market meltdown in October overwhelmed nearly all strategies, including ours.

Governments Ride to the Rescue – Don't Fight The Fed(s)?

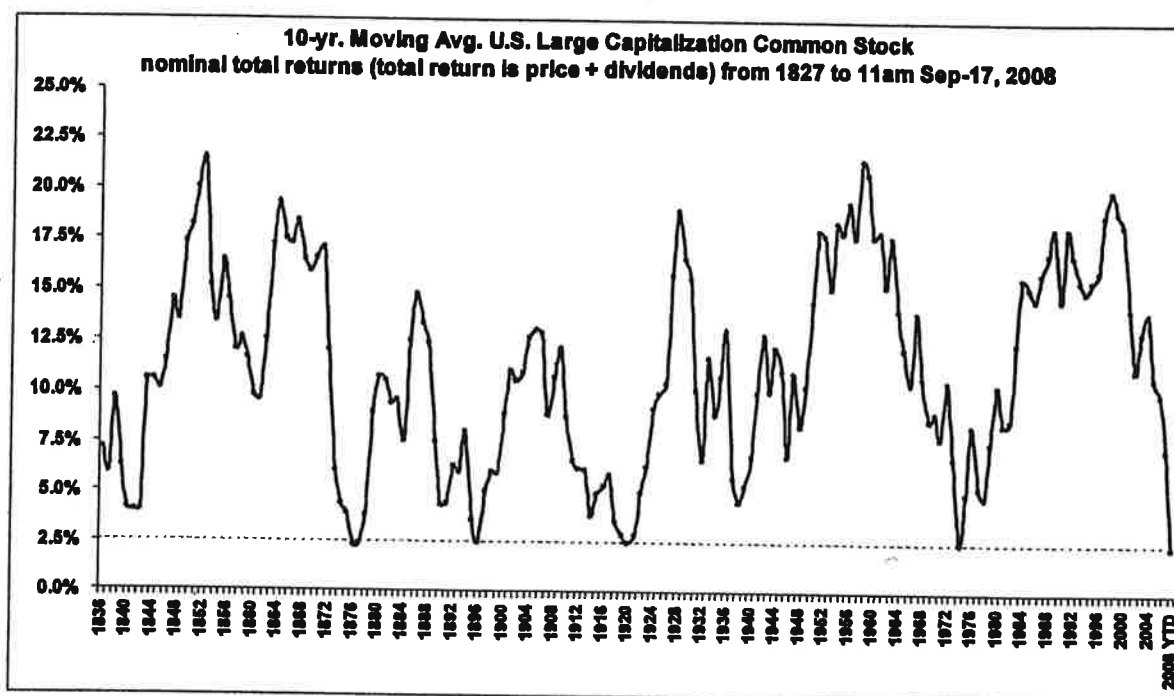
In a formerly U.S. centric world, the old “don't fight the Fed” axiom worked well in the singular. The idea was that once the U.S. central bank took action to stimulate the economy, it was unwise to bet against them. In the new globally interconnected economy, the actions of our Federal Reserve alone cannot do the trick, particularly in the face of a worldwide credit crisis and financial panic. ***Governmental actions of the past two weeks, first with globally synchronized rate cuts and then with coordinated direct capital infusions to prop up the banking system, were as encouraging as they were unprecedented.*** While massive fiscal and monetary stimulus efforts are unlikely to prevent the U.S. and other G7 economies from sliding into recession, they could well lessen the severity of any downturn. More importantly, the no holds barred response of the authorities takes the risk of a generalized banking collapse off the table and reduces the odds of a vicious debt deflation.

Why Hold Stocks if Recession is Unavoidable?

If the long term objective is to earn a return well in excess of inflation in order to cover expenses, maintain purchasing power and grow capital, then a portfolio *must* have an equity-orientation. Strategy tilts to increase or decrease exposure from time to time can be effective, particularly if applied with a dose of contrarianism. However, the concept of being “out of the market” until full clarity is reached, while seductive, simply doesn't work. (Witness the one day 11% jump in the S&P500 on October 13th!) Attractive long term stock return statistics are a function of a surprisingly concentrated grouping of large gains over short intervals. One needs to be in the game in order to capture the benefits. So while the current economic fundamentals may look bleak, in the words of Warren Buffet, “you want to be greedy when others are fearful and fearful when others are greedy.” We are beginning to see attractive opportunities against a backdrop of record mutual fund redemptions, margin calls, forced liquidations by hedge funds and a media narrative dominated by doom and gloom. ***Amidst the chaos of a financial panic, cash flow is still cash flow and a good business is still a good business.*** There is a mountain of cash on the

sidelines earning meager returns. That cash will need to be redeployed less fearfully over time if investors are to achieve long term objectives. After all, stocks have *already* crashed. We will continue to prudently seek out great businesses with strong balance sheets that are well positioned for growth both here and abroad.

In the near term, the news flow will likely continue to be disquieting and markets will remain volatile. The paradox of investing, however, is that in difficult environments the opportunity to earn high future returns actually *increases*. The following chart depicts the volatility of stocks over the very long term. We can't know what the next 6-12 months will bring, but the chart clearly suggests that stock market levels and trailing returns are at historical extremes.



Source: "A NEW HISTORICAL DATABASE FOR THE NYSE 1815 TO 1925: PERFORMANCE AND PREDICTABILITY" William N. Goetzmann Roger G. Ibbotson Liang Peng Yale School of Management This paper can be downloaded without charge from the Social Science Research Network Electronic Paper Collection: July 14, 2000 For 1926-present we used Ibbotson Large Capitalization U.S. stock market total return and in later years the S&P 500 total return.

In the current unsettled environment we would encourage all clients to check in with us at any time.