

Year End 2008 Report

Performance:

We were among the best performance in a very difficult investment year. But virtually all investors are welcoming an end to 2008 as almost every asset had dismal performance. The S&P 500, Dow, and NASDAQ all had horrendous 2008 losses of 38%, 34%, and 41%, respectively. (To put these losses in perspective, the markets first reached these levels in 1997 and now have wiped out 5 to 6 years of gains for the average investor.) Major foreign markets, in general, fared just as poorly, with declines ranging from 33% in the FTSE to more than 60% in the Shanghai Composite Index. Traditional portfolio diversification did not protect investors at all as almost all assets declined precipitously.

There were only a few ports in the storm outside of a select few individual names that did well, and we were fortunate to have the bulk of our exposure in them. Only gold, cash and bonds, and the Japanese Yen are in positive territory for the year, but (with the exception of the Yen) only marginally so.

So 2008 was bitter/sweet. Although the markets finally woke up to the realization of the credit crisis we have discussed (and prepared for) over the last several years, the unwinding of the leverage in the system still wreaked havoc on just about everything. I am rather disappointed to have positioned portfolios well in advance for what I knew was an inevitable market dislocation, and yet still was not quite able to give positive performance on the year.

Although our losses were dramatically muted relative to the equity markets in general, *any* losses are painful. But we were fortunate to have the bulk of our exposure in two of only a few assets that did do well: cash and gold. But these assets were only marginally positive, and were offset with moderate losses in our foreign currency exposure and more severe losses in energy and silver (which declined roughly in-line with the broad market indices).

From a portfolio management standpoint, this was an exceptional year as we continue to perform vastly better than what the broad market averages are handing the average investor. Despite the largest calendar year decline in 77 years for the markets, we remain *relatively* unscathed. However, I am certain you would agree with me that relative performance is of little solace to absolute returns.

So you can see why I have mixed emotions about 2008. I have been anticipating this type of market action for quite some time, and have prepared portfolios accordingly. Despite my analysis leading to significant outperformance in both good and bad markets throughout this turbulent decade, I still underestimated the impact of the current de-leveraging process. While *only* a portfolio void of *any* exposure (or outright negative bets against the market) was likely to perform much better than our portfolios, it is still frustrating to have had the correct analysis (generally speaking), but not have solid gains this year to show for it... But I believe this disconnect will be short lived.

Outlook:

Let's begin with the most simplistic outlook: the stock market. Many believe that the market is "cheap" because it is down so much. However, *value* in the market is relative to the earnings stream of the companies that make up the market. As you already know, that earnings stream has declined rather dramatically, and I suspect you would agree that the prospects for a significant rise in earnings next year is rather weak.

Unfortunately, the market does not believe that earnings will be weak next year. In fact, based on Standard & Poors data, estimates for the market indicate an expectation that earnings will increase 26% in 2009. This seems extremely unlikely in my opinion, and should those expectations not be met, the market may still have plenty of room to fall.

Those estimates are based on "operating earnings," which generally presume that the "bad stuff" should not be included. So it is possible that if enough "bad stuff" is excluded from earnings reports, it may still be attainable. However, the market still is not "cheap." Using GAAP earnings (the only figures from which we can compare historical data on an apples to apples basis), the market is still trading at 20 times earnings. This figure, 20x, is extremely expensive, and is more indicative of a historical market top than any semblance of a market bottom. So I believe that it is highly unlikely for any significant stock market gains next year, and that there is a far greater chance of additional declines as investor expectations are disappointed in an already highly valued market.

One bright spot in equities, where I do see value is in the energy complex. I clearly underestimated the magnitude of the decline in the price of oil since July, and this contributed to the energy sectors extremely weak performance over the last six months. However, the sector is outright inexpensive, trading at 6 times earnings and yielding 2%. Now that oil is under \$40 per barrel, estimates have come down for next year, but the sector is still only at 7 times 2009 estimates and represent more than half of the total markets' earnings. Having the lowest multiple and by far the most earnings of any sector of the market, this area still represents tremendous value, in my opinion, regardless of where oil trades in 2009.

Bonds, on the other hand, are an entirely different story. They are just as absurdly valued as stocks in my opinion (if not more), however they do have one major benefit going for them. The Fed has announced that they will print money to buy bonds in an effort to keep interest rates low along all maturities of the yield curve. So they may go lower, and therefore, bond prices may continue to rise.

But this is a dangerous game. Artificially propping up the price of bonds (and keeping the interest rates low) will not work indefinitely. Tying up money for up to 30 years to get 2.6% or lower per year, or to stretch for more yield by taking credit risk from a company in a severely weak economy, both seem like very poor investment choices to me. I anticipate maintaining cash for our "safe" money, even if it merely means a return *of* our principle, and not a return *on* our principle.

Currencies and precious metals are the final assets to discuss. But before we delve into the outlook, let's recap the biggest component of what should, in the long run, affect their prices most: monetary policy.

The Federal Reserve has expanded their balance sheet by more than \$2 trillion this year to roughly \$3 trillion. Previously, the Federal Reserve would only take U.S. Treasuries as collateral for funds received. This is no longer the case. They now take many other assets, primarily distressed assets that nobody else is willing to buy. We cannot know for sure what they now have on the "asset" side of the ledger because the Fed will no longer provide this information (another new policy in 2008), but regardless, this was a couple trillion dollars created out of thin air to buy assets that, in many cases, nobody else was willing to purchase.

Now let's add in the Troubled Asset Relief Program, or "TARP." This is the \$700 billion relief program for the financial institutions, of which, not a single penny went towards the original intent of the bill. Hank Paulson changed what he believed was the best use of this money, and primarily has handed it to financial institutions of his choice, just hoping they would lend it out. It is common knowledge that these funds are *not* being used for additional lending by the banks.

The above figures are *in addition to* the \$30 billion given to J.P. Morgan to buy Bear Stearns, the \$128 billion and counting given to AIG, the \$200 billion given to Fannie Mae and Freddie Mac, the \$306 billion given to Citigroup, the \$17 billion given to the auto makers, the hundreds of billions of dollars given to other corporations in (now perpetual) term auction facilities (TAF's)... and many others that simply have become too cumbersome to remember.

Our President-Elect, Barack Obama, has *also* proposed an additional \$725 billion stimulus package, which is in addition to the \$500 billion stimulus package proposed by Speaker of the House Nancy Pelosi. And we can't forget the \$160 billion stimulus package from earlier this year (called a "tax rebate").

Let me save you from having to get your calculator. That is more than \$5 trillion, and I only named the ones I could easily remember. Trillion, with a "T," of money created out of thin air. We are already a debtor nation, so this is not money we have in the bank. We are creating it by printing money and/or issuing debt. More than \$5 trillion (some report it at closer to \$8 trillion by now but who really knows?) created in a roughly \$13 trillion economy. A trillion here, a few hundred billion there... this is starting to add up to real money, and the implications of this type of monetary policy are staggering.

This is what is called quantitative easing. The Fed Funds Rate is now at 0% (although they called it a "target of 0% to 0.25%" because with rates that low you can't really keep it very precise). Ben Bernanke stated in a 2002 speech that he knew how to prevent deflation from happening: he could simply drop money from helicopters if need be. And this is what those helicopters sound like.

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This is inflation in its purest form, and while there is still a debate as to whether or not deflation will happen or inflation will happen, from a monetary standpoint, there is no doubt that this is inflationary, as it is a decline in the real value of money. As we create more money with no tangible asset to support its creation (i.e. no gold standard), the relative value of each unit of money is worth less. The unwinding of debt and leverage can still cause prices to decline in both tangible and paper assets (as we witnessed in the third quarter of this year), but that is not the same thing as deflation.

Setting the semantics debate of inflation versus deflation aside, these policies should, over time, act to weaken the value of the currency and increase the value of finite resources priced in that currency. The obvious, and most logical assets to benefit from this massive increase of the money supply, is the precious metals. Furthermore, any central bank that either restricts their money supply or simply creates money less rapidly than we do on a relative basis should also see their currency rise relative to the dollar.

Gauging the various central banks' policies relative to ours has become a bit more difficult of late, so I am doing less in foreign currencies for the time being. However, the case for the precious metals as an investment could not be more clear. Demand for physical metal continues to increase despite any price declines in the paper market. And it remains difficult, if not impossible, to obtain physical gold or silver unless you are willing to pay a significant premium to current spot prices. Furthermore, the gold market has recently gone into backwardation, a term describing that physical ownership today is more important than having the right to buy it for a specified price in the future (and paying the current holder a storage fee). This "backwardation" is quite rare, and last happened in gold in 1999 just prior to a significant increase in price.

These factors contribute to an increasingly bullish outlook for the precious metals and select currencies. However, the biggest difficulty in the current market environment remains gauging the level of any additional de-leveraging which could occur again in the near term and pull assets down with it. These invisible catalysts are nearly impossible to discern in their timing, so we remain quite liquid for the time being with large amounts of cash. But the risk of additional de-leveraging is subsiding, and when a lower risk opportunity arises again to add to the metals, select currencies, and possibly the energy sector (which hold the most bullish outlooks for the reasons described above), we should be able to get absolute performance back in the black in reasonably short order. The fundamentals certainly support this.

I wish you all a very Happy New Year and a prosperous 2009. As always, should you wish to discuss these or any other topics in more detail, please do not hesitate to let me know.

Sincerely,

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