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Market Commentary

The equity markets delivered their worst quarter since 2002 with the broad US market, as represented by the Russell 3000, returning -9.5%. From the October 12, 2007 peak through the March 14 trough the decline has been 16.6%. While YTD losses in small cap stocks have been comparable to large caps, since the October peak the Russell 2000 declined a full 20% through the March 14 bottom. Non-US stocks have not fared better. The MSCI EAFE lost 8.82% while the MSCI Emerging Market Index returned -10.9%. Despite the losses in stocks, sometimes what one does not own is more important than what they do own. The quarter saw near complete wipeouts of leveraged hedge funds, exotic credit instruments and even one investment bank. The Federal Reserve finally stepping in to provide guarantees to spur a sale of Bear Stearns rather than have it fail and face liquidation – which would have certainly sparked a much larger financial crisis. Estimates of total losses from the subprime debacle - to homeowners, lenders and investors - are surpassing the $1 trillion mark. Bernanke fortunately appears to be doing a good, if thankless, job of walking the tight line between preserving the liquidity of the overall financial system and creating a moral hazard by bailing out speculative activity – the Bear Stearns sale which will be a huge loss for shareholders and (hopefully) Bear Stearns management – is a good example of this.

The banking sector is in extreme disarray, with continuing losses and weak balance sheets impairing its ability to lend, particularly among the larger money center banks and Wall Street firms. For the most part, the diversified, "unsophisticated" main street banks remain in sound shape. Anecdotal evidence suggests that they are stepping in to fill the void in lending activity left by their larger competitors.

While not unsurprising given the proliferation of novel and highly leveraged instruments, the magnitude of the volatility and lack of liquidity in the credit markets surpasses anything in recent memory, perhaps since even the Great Depression. The equity markets, on the other hand, have experienced a rather mundane correction. The declines in stock values reflect the expectation of a recession and slower economic growth – this is the expected risk from investing in stocks (as opposed to the unexpected risk of, say, a AAA rated bond trading at pennies on the dollar). At its peak last fall, the multiple of the S&P 500 to trailing 12-month operating earnings was just above 17 times. This is not an extreme valuation level - in fact it was the lowest ratio in the preceding 10 years. Irrecoverable losses in stocks come from one of two sources; either buying a business that ceases to exist at its current level, or by paying a ridiculously high price for the asset. Neither of these factors applies to the majority of traded stocks today. The S&P 500 currently trades at around 13.5 times consensus estimates of 2008 earnings, which equates to a 7.4% earnings yield. This is particularly attractive compared to a 1.4% yield on Treasury Bills – a negative real rate of return given inflation expectations.

High levels of volatility can make performance comparisons difficult, if not impossible. On any given day during the quarter, the relative performance among various indexes and investment managers varied widely. We saw managers in the space of weeks go from 100-200 basis points of underperformance to comparable levels of outperformance and vice versa. The reason is that at these levels of volatility the

valuation function of the financial markets gets swamped by the liquidity function. Forced sales of assets by leveraged investors drove prices rather than fundamental attributes. This has created many compelling values for skilled management to exploit.

Owning quality businesses without leverage is the key. We have been pleased overall with how our investment managers have done this. The question every investor must ask themselves is would they buy their portfolios today at current prices. A combination of a core of quality holdings with opportunistic allocations to areas where assets are available at distressed prices is in our view the optimal investment strategy. By avoiding leveraged hedge funds, exotic credit instruments and paying premiums for bond "alpha" that is really beta, clients are in a prime position to not only recoup losses from the market, but to capitalize on current weaknesses.

One historical precedent would be the Panic of 1907, where the insolvency of a few highly leveraged speculators spurred a cascade of forced sales of securities and bank failures. J.P. Morgan famously led a consortium of banks to step in and buy quality assets and provide credit to solvent institutions – much like the role Federal Reserve is playing in this crisis. The Panic was short lived, with close to a full recovery by the end of the following year. Similarly, current valuation levels lead us to believe the recovery in the broad markets will happen over a much shorter time period than the 5+ year period it took the S&P 500 to recoup its 2000-2002 losses. Importantly, if the experience of past downturns is any guide, the bulk of the recovery will likely take place over a few trading days - which makes trying to time an exit and entry point into stocks exceedingly difficult, if not foolish.

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