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Memo

Date: September 23, 2008

To: Investment Clients

From: Mark Pellegrino, Chief Investment Officer

Subject: Where Have All the Banks (and Insurance Companies) Gone?

They're still here. They just have different names now, or at least look very different than they have over the last 100+ years.

Today I'm wearing a shirt that has a *Bank One* logo on it. I worked for this Columbus-based bank for a number of years prior to coming to the West Coast. Glancing at the logo on my sleeve, I'm struck by how much the landscape in the financial services sector has changed between the 1990s and today. Toward the end of my time there, Bank One went through a significant merger with First Chicago / NBD, and then was acquired by J.P. Morgan shortly after I left, marking an era where strong banks merged with other strong banks with the intent of creating larger and even stronger banks. Did it work every time? No, but it's a stark contrast to today, where a modestly sound bank is "asked" to acquire a teetering-on-the-edge-of-insolvency bank. Let's review the changes:

- Bear Stearns now has a J.P. Morgan sign on the door.
- Fannie Mae and Freddie Mac – who between them own or guarantee almost $5 trillion in American mortgages (70% of the market) – have been seized by the government, after the biggest surge in mortgage defaults in at least 3 decades.
- Lehman Brothers has filed for bankruptcy protection after failing to find a buyer, and has since sold parts of its business to Barclays.
- Merrill Lynch is soon to be called Bank of America.

- American International Group (AIG) has been given an $85 million bridge loan by the Fed to maintain its solvency, and will be selling parts of its business to service the loan.
- Morgan Stanley is considering an acquisition by Wachovia, and Washington Mutual is considering the same with Citigroup and J.P. Morgan -- both moves intended to keep the acquired firms solvent.

Are these types of collapses unprecedented? Perhaps in degree, but not in their existence. Remember the S & L crisis in the 1990s, the collapse of Barings in 1994 and Long Term Capital Management in 1998, currency crises in both Asia and Russia, 9/11, and the Enron and WorldCom panics? We've been there before, but it's human nature to want to quickly forget the bad things that happen in our world. You'll notice, however, that our world didn't come to an end because of these things. Perhaps that's some perspective we all need when the media blasts each newscast with doomsday scenarios.

Speaking of bad things, investors have certainly had their share of negative news (beyond the turmoil in the financial sector) on which to concentrate. U.S. home prices continue to decline and inventories of unsold homes continue to build, while some forecasters suggest we may not see a turn in the housing market for another 2 years! Is the commercial real estate market far behind? Perhaps not. Troubled consumers are dealing with higher unemployment rates, declines in their home prices, difficulty in getting credit, still-high prices at the gas pump and grocery store, and declining values on their investment portfolios. Since the consumer makes up two-thirds of the American economy, this has caused a significant slowing in economic growth. And these economic issues aren't just confined to the U.S. In fact, there's a reasonable chance that we could see a global recession (read negative GDP growth) if the current slowdown accelerates.

The government has drawn from many lessons learned during previous crises, including Japan's banking crisis in the 1990s, as well as the Great Depression. With historic missteps and successes in mind, they've launched numerous actions intended to stem the many issues affecting the global economy and financial markets. The first round of actions, taken earlier in the year, included the Fed's lowering of interest rates and injections of liquidity into the banking system, along with the Treasury's economic stimulus package. Later actions by the Fed have included bailout packages for Bear Stearns and AIG; the consideration of a formal procedure for facilitating disposition of assets when an investment bank fails; a broadening of the types of collateral that financial institutions can use to obtain loans from the Fed; a provision that allows securities dealers to post equities as collateral for cash lending; a temporary arrangement that allows banks to lend money to their own brokerage subsidiaries; a concerted effort with other central banks around the world to inject additional liquidity into the world banking system; and an arrangement for 10 banks to each chip in $7 billion to create a $70 billion pool of funds to lend to troubled financial institutions. These latest moves have signaled that the Fed remains focused on averting a systemic collapse of the financial system. Aside from this primary goal, they are also attempting to prop up demand in the housing and consumer sectors, while fostering an environment that provides for writing off bad assets and allowing insolvent financial institutions to either be acquired or fail. This last objective has presented a "moral hazard" for the government. However, by taking the rescue option off the table for Lehman Brothers, they have clearly signaled (albeit inconsistently) that there are limits to its role as "backstop-in-chief", and that bailing out too many firms would encourage more risk-taking in the future. Of course, they must achieve all of this while keeping inflation at bay. Can they? Maybe, but we remain unconvinced. The reason: We're talking about the unwinding ("deleveraging" is the word now used in our industry) of a 25-year credit bubble. The sheer volume of bad debt that must now be worked off of balance sheets is a monumental problem unto itself. I've heard this process referred to as an "adverse feedback loop". Deleveraging puts downward pressure on home prices. That, in turn, forces financial institutions to deleverage more. To complete the chain, falling home prices squeeze consumers, forcing them to cut back on spending, which puts off a housing recovery, further weighing on home prices… and thus, the cycle continues until the bad debt has been largely eliminated. The one thing the government has yet to do is use public funds to directly recapitalize the financial system. Directly injecting taxpayer money into the system, as was done by the Resolution Trust Corporation (RTC) in 1989 during the S&L crisis, was thought to have been generally successful. Perhaps this is our ray of hope, but unfortunately the government has been reluctant to pledge public money to this cause, a cause that would certainly be unpopular in an election year and even in the first year of a new administration. We're keeping our fingers crossed and, as I'm writing this, there are rumors on Wall Street that this possibility may be this weekend's big financial news.

Lest we be too gloomy, there are some reasons for economic optimism out there. The rescues of Fannie and Freddie have already helped lower mortgage rates. Crude oil prices have collapsed by about $40 / barrel in just the last 2 months, providing needed relief at the pump. We've witnessed a sudden, swift upswing in the U.S. dollar, which appears sustainable in the near-term. It's not much, but we'll take every little bit of good news we can get right now.

The defensive measures we've executed over the past 24 months, and particularly throughout the course of this very difficult 2008, have made a big difference in preserving principal in your portfolio. For all of the reasons I've just illuminated, we remain in our defensive posture. That means maintaining equity exposure well below long-term strategic targets, while seeking out those asset types that are protective in nature. Specifically, just this week we decided to begin taking another round of defensive measures, including (a) continuing to draw down equity positions [with an emphasis on overseas equities] (b) eliminating exposure to Global High Yield Bonds and (c) paring our exposure to Emerging Market Debt. The only asset types to which we'll be committing new dollars include (1) high quality, ultra short duration domestic debt vehicles and (2) multi-strategy hedge funds. The domestic debt vehicles offer the opportunity to pick up 2+ percentage points in current yield, while suffering very little in potential principal fluctuation. Hedge funds, due to their absolute return nature, offer a great "hiding place" during this bear phase of the cycle. For as long as this bear market continues to be with us, our twin goals remain the same:

(1) Protect principal in the best way we can
(2) Build out a "war chest", or cash reserve, that we can use to take advantage of the really great buying opportunity that will present itself when this bear cycle ends and we move into the next multi-year bull cycle

It is to those ends that we do what we do in your portfolio.

We've received a number of inquiries over the past week regarding Fidelity's financial stability and the safety of their money market vehicles in the face of the Primary Fund's "breaking of the buck" in their money market funds. As to the issues of Fidelity's stability, I've attached a piece that Fidelity sent to us, as I thought it would be helpful for you to hear straight from Fidelity's mouth. Suffice it to say that we're confident in Fidelity's scope, risk controls and financial stability. Those strengths that were evident in the comprehensive due diligence process we conducted when we chose Fidelity as our custodian are still in evidence today.

As to the safety of Fidelity's money market vehicles, we've just conducted a new round of in-depth due diligence on those funds. Here is a summary of our findings:
The Fidelity money market vehicles have de minimus exposure to Lehman Brothers debt. Their exposure to AIG paper is minimal and Fidelity is confident that those instruments will pay full principal value at maturity. Finally, Fidelity has no exposure whatsoever to Washington Mutual debt. Further, Fidelity is arguably the most substantial investment custodian on the planet, its reputation is at stake and it is well capitalized. Under those circumstances, if Fidelity were in any danger of breaking the buck on its money market vehicles, it would likely do everything possible to protect its reputation, including perhaps committing the firm's capital to those funds. Therefore, we're confident that these funds will not break the buck and that they remain safe vehicles for "parked" dollars, as we work our way through this bear market cycle.

While it's never pleasant delivering the kind of news we've been forced to deliver over the past year, I'm sure we collectively believe it's worse living it. Nonetheless, it's what we believe, and because we believe it, we'll continue defending portfolios and watching the volatility and sentiment indicators for signs that this down side of the cycle is over. Unfortunately, there are moments in the markets where "duck and cover and get out of the way" feels like the best approach. This is one of those times.