

July 11, 2008

### **Moving Forward from the Subprime Fallout**

The second quarter of 2008 just closed with the U.S. stock market (as measured by the Standard & Poor's 500 Index) nearing a 20% decline from its October 2007 peak (-8.6% in June alone). Accordingly, this is a good time to share some thoughts about recent market experience, our expectations for the future, and some steps we are taking in view of the trends we observe.

#### A Curious Bump, Then The Fall

As we wrote in our August 2007 newsletter, poor lending decisions and speculative use of debt over several years led (among other effects) to a bubble in housing prices and subsequent write-downs on housing debt. We identified the strain on consumers from high debt and falling housing prices and forecasted falling corporate profits and lower buyout activity. We also expected financial institutions to deleverage their portfolios as their access to credit became constrained. The sum of these effects, we wrote, meant that investors should expect declines in their equity portfolios. Measured from mid-August 2007 when we composed our letter, the S&P 500 is off about 9% through the end of June 2008.

Clearly, we didn't expect stocks to rally 11% from August to October last year as the Federal Reserve started cutting interest rates. Like raucous partygoers who binge even while the cops are on their way, market participants bid up stocks without regard to underlying fundamental problems. The rally exaggerated stocks' subsequent fall (-18% from the October peak to June 30). This helps explain why stocks overall may not be cheap at current levels. In effect, roughly half the fall is the give-back of a rally that made no sense.

While lower rates may have temporarily led to some "irrational exuberance," we give the Fed high marks for taking some creative approaches to keep credit markets functioning. As a result, the worst of the actual credit crisis appears to be over, although we still must live through its effects on the economy and expect to see some lingering moments of excessive credit constriction.

*Hoge Building  
Suite 800  
705 Second Avenue  
Seattle, Washington  
98104-1711*

*Phone 206/382-4414  
Fax 206/382-4412*

### Expectations for the U.S. Equity Market

We expect returns from the U.S. stocks over the next few years will be modest (perhaps 4-8%, compared to long-term averages of 10-11%) and inflation will remain significant. U.S. consumers have little savings and their houses are worth less than they previously thought; they need time to repair their balance sheets and will be challenged in doing so while gas and food prices remain high. Private equity buyout activity is off 75% from a year ago and will likely remain low for a while. Exports are strong, but will likely slow as the global economy reacts to our slowdown. Corporate profit margins, which are at historically high levels, are being squeezed by higher costs for materials, overseas labor and capital. Inflation is a real concern due to high import prices, growing global demand for commodities and the weak economy's potential effect on the Fed's willingness to fight inflation.

The economy and recent market performance have been compared to 1973, and indeed there are similarities (*e.g.* oil crisis, Mideast war, and inflation). This has spawned speculation as to whether we face a similar "lost decade." While each era has its own challenges and characteristics, it's worth taking a brief look at that period, considered to be one of the most bleak for the market in the last 80 years. Large capitalization U.S. stocks lost 17% of their value in 1973. In 1974 they lost another 30%! Nevertheless, even including 1974, for the five years through 1978, U.S. large-cap stocks averaged annual compounded total returns of 4.3%. For the ten years 1974 to 1983, they averaged 10.6%. Small-cap stocks averaged 28.4% during those ten years and commercial real estate also performed well. Of course, inflation eroded the value of those returns, but the point remains: the attractiveness of returns depends on the period you measure and the breadth of asset classes examined.

### Larger Themes; What We're Doing

We believe that the credit crisis and its fallout for the economy is the latest chapter in a story animated by several themes that we have been observing for some time. These themes are summarized well in the enclosed interview with Mohammed El-Erian, formerly head of the Harvard endowment and currently Co-Chief Investment Officer at PIMCo (our largest bond manager).<sup>1</sup> We discussed slow U.S. growth and higher inflation above. Other themes in the article include strong growth of foreign economies and foreign central banks reducing their holdings of U.S. Treasury securities.

Our clients have robust allocations to international equities and this will remain an important tool to capture global growth. We also recommend commodities for most client portfolios, both as a hedge against inflation and for their balancing effect. Given long-term fundamental supply constraints, robust demand and increased concerns about

---

<sup>1</sup> We ask that readers that would like a copy of this article contact our office.

inflation, we are maintaining an allocation to commodities for now, despite the chances or even the probability for a near-term correction in some commodities.

For some time, we have been exploring other asset classes that we believe could benefit client portfolios by helping to dampen volatility while providing good returns. For example, El-Erian mentions these classes in the article and more in his recent book<sup>2</sup> when suggesting that individual investors can benefit from allocating their portfolios similarly to university and foundation endowments. We are developing a program for adding alternative investments to client portfolios and will communicate with you more about this in coming months. We must navigate this area carefully due to the wide divergence of manager performance and the restrictive nature of some asset classes.

Finally, we continue to have faith in the long-term productivity of our economy and the work of the managers we select for client portfolios. This is best said by Davis Advisors (managers of Selected American Shares and the Clipper Fund) in their most recent letter to shareholders:

While we acknowledge the weighty concerns of the moment, . . . [i]n the nearly four decades of our firm's history, there have been prolonged bear markets; wars; recessions; an oil crisis; a hostage crisis; periods of double-digit interest rates; inflation and unemployment; political scandals; stock market crashes; the September 11<sup>th</sup> attacks; and much more. Despite those setbacks, the stock market has managed to compound at double-digit rates of return and Selected American Shares has been very successful over the time our firm has managed the Fund. That span of time includes environments resembling today's in some respects as well as circumstances that were arguably far worse.

A key to our long-term success in the investing business has been a determination to look beyond many of the *important* but *unknowable* factors that are commonly featured in day-to-day news headlines and to focus instead on what is *important* and *knowable*. That brings us squarely back to the fundamentals of the businesses we own in the Portfolio, their managements, the durability of their earnings power and competitive strengths, and our assessment of their current valuations. By isolating these key drivers of business results, we can make rational long-term investment decisions despite short-term uncertainties.

---

<sup>2</sup> We are happy to send a copy of the book, *When Markets Collide* (McGraw Hill, 2008), to clients who would like to read it. El-Erian provides a surprisingly approachable review of recent financial phenomena, an explanation of the causes and suggestions for coping in the future.

July 11, 2008

Page 4

Although U.S. equities may not be substantially undervalued, several of our managers, especially those who focus on out-of-favor companies, have been able to purchase stakes

in good companies at reasonable prices that were formerly too expensive. Typically, the process of realizing value on those purchases takes 3-5 years to play out. As said by Shelby Cullom Davis, founder of Davis Advisors, “you make most of your money in a bear market, you just don’t realize it at the time.”

Please call us if you’d like to talk. We always look forward to hearing from you.