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Newsletter
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Fourth Quarter 2007 - Review

The S&P 500 struggled in the fourth quarter falling 3.3%, led lower by the only two industry groups that posted negative performance for the year: Financials (-21%) and Consumer Discretionary (-14%). Our cautiousness towards these two industries largely accounted for our out-performance during the quarter and year. The other themes that served us well during the year were emphasizing large-cap over small-cap and growth over value. We see no reason to change strategy at this point.

As uncomfortable as last quarter was 2008 is off to a dreadful start. Investors are fleeing stocks as recession fears proliferate. The U.S. consumer, who has been the "energizer bunny" since last stumbling in 1990, is finally starting to show some cracks. Consumer spending is down and credit defaults (mortgage, credit card, and auto loans) are up as housing prices fall nationwide and employment weakens. The credit crisis continues to spread. Commercial real estate is showing strains. The municipal bond and structured product markets are under stress because monoline debt-insurers are crumbling. Finally, there is the uncertainty regarding counter party risk in the financial markets. Unfortunately many hedges put in place by financial firms have turned out to be worthless because the entity backing the hedge is in trouble. These conditions are not a surprise to us and a strong argument could be made that the economic deterioration is more than reflected in stock prices.

Despite the steady drumbeat of bad news there are positive forces that should support stock prices. Although the growth rate of the developing economies will slow somewhat, overall growth is still positive and strong. Global interest rates are low and falling which will soften the downturn. There is still plenty of liquidity in the markets: foreign investors are buying U.S. assets aggressively taking advantage of low prices and a weak dollar. Best of all there are plenty of bargains for the long-term investor. In spite of the gloom, many companies are doing well, have bright outlooks and bargain valuations. For example, General Electric navigated choppy conditions in the US in the fourth quarter to deliver a rise in profits, boosted by the strength of its international business which for the first time represented more than 50% of their revenue. There are plenty of similar opportunities which are well reflected in our clients' portfolio positions.

The Fed has the power to positively affect investor confidence by aggressively reducing interest rates. We applauded the 75 basis point reduction in the Fed funds rate that was announced on January 22, 2008. We don't believe 1970s-style inflation is a problem or long-term interest rates would be rising not falling. A bigger risk is deflation since property values and stocks, two major asset classes, are declining. Bernanke is a serious student of deflation which is why we believe the Fed will continue to move forcefully to alleviate the pain of falling asset prices. Ultimately lower rates and increased liquidity is very positive for stocks. Once the crisis has past the Fed can take the rate cuts back if inflation becomes a problem or another asset bubble starts to form. This was Greenspan's mistake: he wasn't aggressive enough on raising interest rates during the tech bubble in the late 1990s or the housing bubble more recently.

The silver lining to downturns is that they create a lot of value. We know from experience that the best buying opportunities occur during periods of stress like today. Warren Buffet has said that it pays to be greedy when others are fearful, and clearly the markets are fearful right now. All stocks get punished in corrections including those companies that continue to grow in value. As a result, our strategy will be to try to improve the quality of our portfolio. Our guide during this process will be to continue to underweight the U.S. consumer while emphasizing ownership of companies with significant foreign exposure, attractive valuations and strong balance sheets. We are pretty confident that volatility in 2008 will not all be on the downside as risk has reached the peak levels met when the market last bottomed in 2002 (see chart below). At some point much of the current gloom will dissipate, the outlook will brighten, and stocks will likely move higher.

Thanks again for your business.

Jim Tillar, CFA and Steve Wenstrup

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