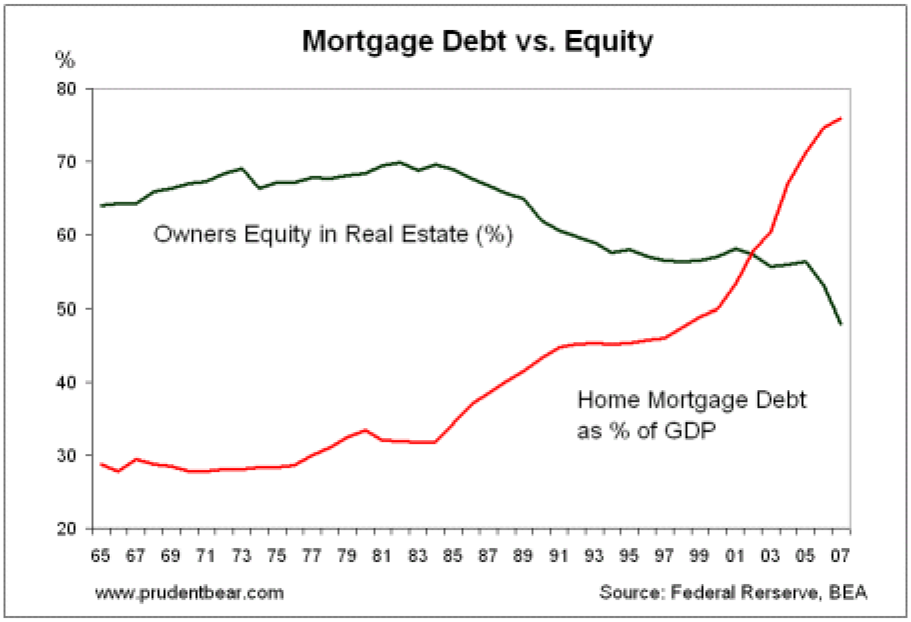
December 31, 2008

Year End 2008 – Pain, Patience & Endurance

We have closed the books on 2008, a year which by all accounts was a sea-change of dynamics around the world leading to substantial losses in virtually all sectors of the stock market. The massive structural collapse of the world-wide financial system hit the stock market directly and rapidly expanded into virtually all corners of the world economies ushering in recessionary conditions. The equity markets reacted rapidly, re-pricing most assets down approximately one third to one half of previous values. In essence we saw many holdings return to pricing levels of five years ago.

Money has become scarce and expensive, triggering massive adjustments that have reversed a decade long run-up in asset prices. The problem is complex, so complex that the politicians, CEO's, economists and general public are struggling for solutions. The unintended consequences of cheap money fueling a boom in unsecured housing debt by millions of Americans, quickly spiraled into a global economic meltdown that is astonishing by any scale.



The collapse of the housing market and the subsequent collapse of the equity markets, base commodities, and oil are once again a reminder of the quiet emergence of speculative bubbles that creep into the financial markets, and burst in an instant. While we have experienced speculative bubbles in the past, none have possessed the capacity to take the worlds banking and credit system to their knees. In due course, we hope the coordinated global stimulus spending will deliver similar results to like action in our history. We must be aware of the possibility that planned outcomes may not mimic past success. The news and statistics that we expect over the first half of this year will be dismal; layoffs are underway, businesses are closing, and governments are scrambling.

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Is there hope for a recovery in portfolio values? When might we see a return to previous levels? Is it different this time versus other stock market meltdowns? These questions are front and centre in investors minds. Devaluation of one's wealth alters plans, causes anxiety, and ushers in uncertainty.

All historical data suggests the market will recover, at least to some extent. Perhaps this time is no different. What we do know is that a staggering amount of money was washed out of the market. A mountain of this money (the derivatives, asset backed mortgage instruments, and complicated Wall Street paper) was not really real cash in the first place. It is now gone forever. That point aside, there is loads of capital sitting on the sidelines. Mainly it is money that investors pulled out of the market (often at the last minute), in order to provide some mental relief to the implosion. This money will likely hibernate until some sign emerges that the worst is behind us and there is light at the end of the tunnel. Then, as history has repeated on each occasion, the dollars plow back into the market with a vengeance.

We closely analyze the financial condition and relative industrial strength of the companies that we invest in. Based on standard financial metrics, a number of equities are trading at significant discounts to normalized valuations. Dividend yields are at all time highs, some corporations have substantial cash reserves and others are weathering the storm just fine. Despite these attractive metrics, we must gauge who will maintain dividend payouts, execute well within their sector, and surface as a candidate for price appreciation and recovery. While it is difficult to predict the outcome and duration, we are most confident that the equity market has finished the bulk of pain related to this crisis. We have all suffered the pain and now the game becomes one of patience and endurance.