August 2007

Dear Investor,

The investment landscape has changed dramatically over the past six weeks, and as a result the stock market has been quite volatile. After hitting a high at 1555 in mid-July the S&P 500 declined to an intraday low at 1370 just 5 weeks later. Although there has been much talk about this being a normal correction within an ongoing bull market, the underlying causes of this decline haven't been anything like previous corrections over the past 3 years. Previous corrections in stocks have occurred in relative isolation from other markets, but this time there have been some rather severe changes in the credit markets that, along with the stock market, will likely affect the real economy going forward. These events could very well be the tipping point for the economy and the stock market appears to be adjusting to that new reality.

While it is certainly possible that the worst *could* be over for stocks at this point, it appears more likely that we have only seen the market's initial reaction to these events. As we'll discuss below, the fallout from the ongoing housing downturn reached a new level this past month, and while the changes in the credit market have been swift and severe it will be some time before those changes have their full impact on the real economy. For this reason and others detailed below, there is ample reason to be cautious on stocks for the time being.

Our overriding goals are to preserve your capital, and to make investment decisions that carry the best chance of maximizing your long-term return without risking significant loss. With that thought in mind, we'll spend some time this month going over how the investment landscape has changed over the past 6 weeks, and then follow with a general discussion about investment management during periods of risk and highlight some of the steps we have taken to address the current market environment.

Recent Events in the Credit Markets

Prior to this past month, there was a relative serenity in the markets regarding the downturn in residential real estate. Even though prices had begun to decline in many states, inventories of homes on the market and delinquencies were on the rise nationwide, and sales continued to slow, the general sentiment seemed to be that the effects from the real estate downturn would be contained and not affect the broader economy.

Part of the thinking behind this outlook went as follows: people who had poor credit and/or relied on creative mortgages to buy a home in the past several years would likely go through some rough times, but since those people only make up a very small part of the overall housing market, the vast majority of homeowners would make it through in fine shape and the risk of a slowdown in consumer spending is therefore minimal. Whether or not we agree with the logic and the conclusion, that line of thinking (or something close to it) has been the working assumption on Wall Street over the past year.

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While the housing downturn up to this point has not had much of an impact on the broader economy, two events over the past 6 weeks almost ensure we will see a broader economic impact going forward. The first event, which we discussed in last month's letter, was the disclosure by Countrywide Financial that the rate of delinquency among their prime borrowers had begun to rise. This dispelled the myth that the negative effects of the decline in home prices would be largely contained within the sub-prime realm, and increased the likelihood that a broader slowdown in consumer spending was ahead.

The second event was the sudden realization that the risk of these defaulting mortgages was held by investment funds and banks all around the world, many of which were not fully aware of how exposed they really were to the US housing market. This created a large "unknown" about where the fallout would be felt and effectively shut down the market for certain types of asset-backed securities. This in turn has had a severe impact on the availability and cost of some types of mortgages.

Many people are not fully aware of how the average home mortgage is created today, and how it has changed recently. Here is simplified, perhaps melodramatic, illustration. In times past, you went to your local bank to get a loan to buy a house, and if that bank concluded that giving you a loan was worth the risk they would lend you the money out of their own deposits. You might get the image of George Bailey in *It's a Wonderful Life* trying to prevent a run on his small building and loan by telling a mob of local citizens that he didn't have their money - that it was really in the homes of all their neighbors (which incited the crowd even more). What he really meant was that he had taken their deposits and loaned the money to other people in the town so that they could buy a home. So we could say that back then real estate was much more of a local market, because demand for homes and financing the mortgages was more a function of local dynamics.

Today however, while the demand side of the housing market is still a relatively local phenomenon, the financing side has gone global. Companies that provide you with a mortgage generally do not hold on to that loan themselves. Instead, they group a bunch of mortgages together and sell them as a bond to some investor who may be anywhere around the world. Since those who originate the mortgages are far removed from those who end up holding the risk, it's no surprise that as the mortgage-backed bond market took off lending standards in general declined. As the companies who sold mortgages were no longer on the hook if the loan went into default, the emphasis over time shifted from loan quality to transaction volume.

The investors who buy these bonds, including hedge funds, pension funds, banks, investment funds, etc., are looking for the cash yield that comes from the homeowners making their mortgage payments every month. So while you may think your mortgage payments may be going to your broker and the company or bank they represent, that money is really being passed through to financial institutions and investors around the world who bought a bond that held your mortgage as collateral. This all worked out great until mortgage delinquencies on some of the poorest quality loans began to rise, which increased the perceived risk of buying these mortgage-backed bonds.

The rise in delinquencies did two things to the market for these bonds. First, since many of these bonds contained clauses that required the companies that sold them to buy them back if delinquencies rose above certain levels during a grace period, many mortgage companies have gone bankrupt because they did not have the cash to buy the bonds back. This has been the fate of many large mortgage companies over the past year. So while investors had bought these bonds thinking they could sell them back if delinquencies rose, as these companies went bankrupt and closed their doors it became clear that selling the bonds back would in many cases not be an option.

Second, as it became apparent that the delinquency problem was spreading to mortgages of prime borrowers, the perceived risk of all mortgage-backed bonds that were not sold by Fannie-Mae or Freddy-Mac (the government sponsored mortgage companies) increased dramatically. Since bonds Freddie and Fannie are presumably government-backed, the mortgage bonds they sell are presumable more safe that those sold by other companies that are not backed by the government – like Countrywide, for example. However, Freddie and Fannie are restricted to dealing with relatively conservative loans, and most of the problem areas in this crisis have been large "jumbo" loans and in more exotic adjustable loans that are solely in the realm of fully private companies.

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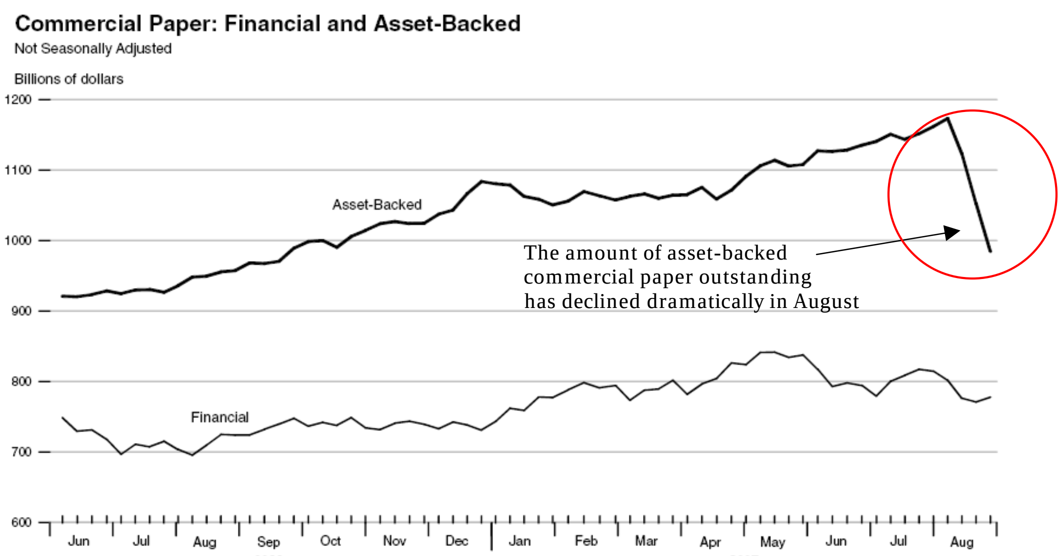
The net effect of all this was that as news came out that delinquencies were rising in all types of mortgages, the market for these mortgage-backed bonds dried up. Fewer investors were willing to buy them directly from mortgage companies, and no one was willing to buy them in the secondary market from other funds looking to off-load their risk from the US housing market.

On August 9th, BNP Paribas SA, Frances largest bank, announced that they were halting withdrawals from two investment funds because it could not fairly value the holdings of the funds. The problem was that since there were no bids for some of the mortgage-backed bonds they held in the funds, they could not accurately price the bonds. And since they could not accurately price all the holdings of the funds, they could not cash out investors at an accurate price for the entire fund. Since these funds were supposedly safe "money market" funds, the news sent shockwaves around the world and seized up the credit markets further. All of a sudden it was not clear where or how deep the exposure to the faltering US housing market was, as similar liquidity problems suddenly appeared in Germany and in Asia.

In the days following August 9, the European Central Bank, the Federal Reserve and other central banks around the world pumped billions of dollars into the banking system to avoid a more several credit market disruption. The actions of the central banks likely prevented the problem from snowballing immediately into an avalanche, but it has had little effect on the deepening trend of risk-aversion to asset-backed bonds in the marketplace.

Since then is has been almost a daily confessional as investment funds and banks from all around the world disclose their exposure to the US sub-prime mortgage market. In a series of events reminiscent of the fall of Long-Term Capital Management in 1998, there have also been a number of leveraged "market neutral" hedge funds that have been bankrupted by this shakeout, and many more that have seen their asset base shrink dramatically over just a few weeks. For example, Goldman Sachs' flagship $8 billion Global Alpha hedge fund declined 12% in the two weeks prior to August 3rd, and by August 10 was down 26% for the year.

The changing investment landscape for mortgage-backed bonds is having a severe effect on the entire asset-backed bond market. Since early August there has been a dramatic drop-off in the amount of asset-backed commercial paper outstanding, which includes mortgage-backed securities, as investors have shunned the entire market. The chart to the right shows commercial paper debt outstanding from June 2006 through mid-August of this year. The decline in the red circle on the far right is the largest contraction since 2000.



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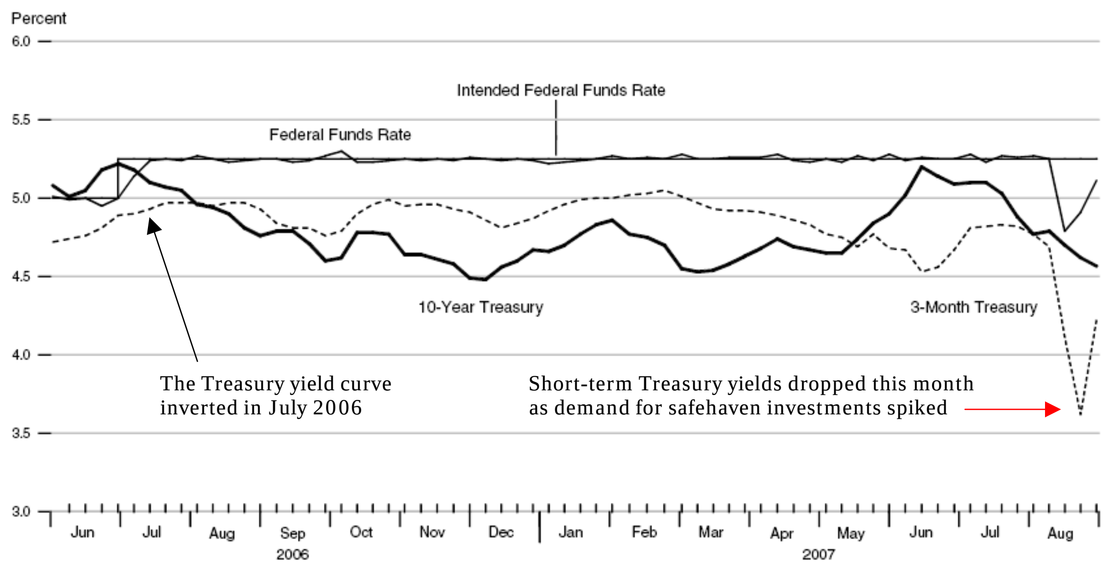
In fact, commercial paper outstanding has shrunk $244 billion, or 11%, over the past 3 weeks, according to Bloomberg. This decline in investor willingness to buy asset-backed bonds has continued despite the Federal Reserves efforts to calm the markets, and will have real economic effects going forward. When companies have trouble selling short-term debt to fund spending, that spending necessarily slows down.

As investors have shunned asset-backed debt, they have turned to the relative safehaven of Treasuries. The chart below shows the yields of various Treasury debt and the Fed Funds rate, and as you can see the yield on short-term Treasury bills fell precipitously in August as investors purchased Treasuries to replace asset-backed bonds in their portfolios. After trading above 4.5% over the past 2 years, the yield on 3-month bills fell as low as 2.4% intraday at the height of the buying frenzy several weeks ago. As of this writing it remains at 3.91%, more than 1.3% below the official Fed Funds target rate at 5.25%.



With the exception of a brief excursion this past June by long-term bonds, the entire Treasury curve has remained below the Fed Funds rate since July of 2006. This has been a strong signal that the market views the Fed Funds rate as out-of-step with the economic environment. With the events of the past month the entire Treasury yield curve has moved lower, with the yield on the 10-year bond moving down to 4.5% from a high of 5.3% in June. The action on the short and long end of the Treasury curve strongly suggests the Fed will be forced to move its target Fed Funds rate lower soon, but so far they have held steady. As we discussed last month, the Fed is stuck between the growing problems in housing and the continued rise in inflation – and they appear to be in an even tighter corner now.

Unfortunately for the housing market, the lower rates on Treasuries are not translating into a better environment for getting a mortgage. In fact, just the opposite is happening. As the willingness of investors to buy mortgage-backed securities has dried up, so too has the willingness of mortgage companies to offer *non-conforming* loans (loans that cannot be re-sold to Freddie or Fannie) that they are not willing to carry on their own books. In other words, since mortgage companies are no longer able to off-load the non-conforming loans they originate to investors on the form of asset-backed bonds, they are now being more careful about the loans they offer since they will actually have to hold the risk themselves. Call it a small return to the days of *It's a Wonderful Life.*

This has translated into higher interest rates and stricter lending standards for many types of mortgages, and it will certainly dampen demand for housing going forward. The National Association of Realtors estimates that 4 out of 10 (40%) of first time homebuyers in 2005 and 2006 bought their home with no money down, with loans that are unlikely to be available to them today. And in many parts of the country over the past few years, people have been using adjustable-rate mortgages because the low initial rates allowed them to afford a home that they otherwise could

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not afford with a traditional fixed mortgage. But these loans no longer offer the cost advantage they used to: the average rate for a 1-year adjustable mortgage recently surged to 6.5%, even as the average rate for a 15-year fixed mortgage is at 6.1%.

The bottom line from all this is the credit market is quickly re-pricing the risk of mortgage-backed securities, and these changes are going to translate into a decline in housing demand going forward due to fewer people being able to find financing they can afford. While the decline in home prices over the past year has already set records, it has happened up to now with most mortgages freely available to almost anyone. Now that we are seeing stricter lending standards and higher interest rates it's highly likely we'll see a more severe erosion of home prices going forward.

This week both the Fed chairman and the President have tried to reassure the public that help is on the way (sort of). The President announced steps to aid homeowners who are behind in their payments, by broadening the scope of the mortgage insurance provided by the Federal Housing Administration. However, this is estimated to only provide aid to potentially 80,000 households out of the millions that are faced adjustable-rate mortgage resets over the next year. And Ben Bernanke, the Fed chairman, said that the Fed will do what it can to "limit the adverse effect on the broader economy that may arise from disruptions on the financial markets." It appears likely they are going to lower rates in the next few months to combat tightening credit conditions, but they are clearly trying to look calm and collected about it.

Those steps are all well and good, but unless they can reconstruct a vibrant mortgage-backed bond market (which they can't), the shift away from mortgage-backed securities we've seen over the past month will likely continue to limit the options of potential home buyers and those looking to refinance. In the next year we will see the peak in the number of adjustable-rate mortgages that will begin to reset higher from the lending binge in 2003 and 2004, so this tightening of lending standards really couldn't come at a worse time. Declining home prices and fewer available loan options have the potential to significantly slow consumer spending as more people come to terms this new reality.

So it appears that we have entered a new phase of this housing bear market, and the stock and bond markets certainly understand this. With the market's newfound aversion to mortgage-backed securities, the risk of a recession has increased significantly and with it the likelihood of a bear market in stocks.

Investment Management during Turbulent Markets

As I've mentioned to a number of you recently, 2007 will likely go down as a transition year when the most important thing we do is to make the adjustment from the market we've experienced over the past several years to the market we will likely see over the next year or two. Before the last bear market began in 2000 there was plenty of time to switch over to a more conservative strategy after stocks had posted huge gains in the prior four years, but it did mean letting go of stocks just when the crowd was most enamored with them. That is never easy, but it is almost always rewarding in the end.

Bear markets and recessions are about de-leveraging the financial system and the economy, and those who de-leverage early are the ones who come out ahead when all the dust settles. *If* we are about to enter a recession and bear market, the best way to head into it is with as little exposure to leveraged investments as possible. The best investment strategy during such times is one that is relatively conservative while at the same time providing protection against inflation.

Over the past month I may have talked with you about moving your account into a more conservative portfolio. With the exception of those who have dedicated funds in the *Commodities Focus I* portfolio, all of our accounts are now either being managed under the *Hedged Growth* portfolio or the *Absolute Return* portfolio. These conservative portfolios are positioned to ride out the current volatility and provide protection in case of a more significant decline.

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The *Hedged Growth* portfolio has recently been trimmed down to a 50-50 long/short ratio, with roughly 30% of the portfolio is cash. This ensures that the trend of general market will have little effect on your account, while preserving the potential of gains from the spread between our long and short positions. There are always individual stocks that present us with good opportunities on the long side and short side, so remaining invested in a market-neutral stock portfolio like this one can provide returns even when market conditions deteriorate.

The *Absolute Return* portfolio is also positioned conservatively, with approximately 25% in cash. Treasury bonds have recovered over the past 2 months and have erased the technical damage of the May-June decline, and this has given us a good opportunity to lock in a high yield (relative to what we will likely see in the near future) and also the potential for capital gains. We have sold our energy trusts, which appeared to have lagged the price of oil this year in anticipation of a downturn that now appears underway. Most other positions in this portfolio are either fully or partially hedged. The few exceptions include positions unrelated to stocks that are being held for speculative gains, and positions held to provide an inflation hedge.

With short-term interest rates currently above 5%, cash is a valuable and under utilized investment option in the current environment. However, over the past month it has come to light that some money market funds have revealed sub-prime mortgage exposure and the potential for losses beyond what any reasonable investor would expect from such a fund. In light of this I put in a request to our broker earlier this month to provide a detailed summary of their cash management strategy. You should have received an email from them on Wednesday detailing this, and I am quite satisfied with their response. Cash in your account is not exposed to any of the risks that have been popping up in some supposedly safe money market funds.

If stocks decline over the next year as appears likely, these portfolios will preserve your capital until we see better value in the market and the fallout from the housing slump has passed. If, against the odds, the market is able to continue its bull market into 2008 after the current volatility subsides, we have the flexibility to take a modest long exposure in stocks with our current cash position.

That's all for this month – if you've made it this far through this long letter, then I congratulate you! If you have any questions about any of the recent issues we've discussed or would like to review your account and it's positioning, please don't hesitate to contact me.

Sincerely,
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