

## QUARTERLY COMMENTARY

### Fourth Quarter 2008

I write this year-end commentary with very mixed feelings. There is some significant intellectual satisfaction because we have been warning for more than a decade of the unsustainability of the debt and leverage-laden condition that permeates the economies of the United States and most of its major trading partners. This has been the primary driver of cascading stock prices since the fall of 2007.

At the same time it is terribly distressing to witness the wealth destruction that has occurred throughout the world. It has made serious dents in the wallets of wealthy and ordinary investors alike. Vast numbers of retirees have lost needed resources. Many workers face the prospect of added years on the job to rebuild depleted retirement funds. And taxpayers are now potentially being called upon to contribute for generations to absolve many of the super-wealthy of their financial sins.

2008 was an epic year. The S&P 500 declined by 37%, the second worst annual return since modern records began in the mid-1920's. It trailed only 1931's loss of 43.3%. Risk-free U.S. Treasury Bills provided a meager return of just 1.3%. Because U.S. monetary authorities opted to drop short-term interest rates virtually to zero, long maturity U.S. Treasury bonds did extremely well, but the fear of credit failure penalized corporate and municipal bond returns.

Except for those who stayed in essentially risk-free investments, investors found no place to hide in 2008. In fact very few long-term investors escaped double digit portfolio losses. In that context we are pleased to report that portfolios for which we made all asset allocation decisions finished just below breakeven, ranging from zero to minus 2% for the year. While that was extremely strong performance relative to the destruction across the investment landscape, it was disappointing because it was the first full year negative return in the 23-year history of our managing investments.

That brings us to 2009 and beyond. Uncertainty abounds in both the economy and the securities markets. Well-respected analysts are making increasingly dire forecasts. Many see housing prices falling another 15% to 20%. Most see unemployment rising at least to 9% or into double digits. Some argue that real unemployment is already closer to 15% when taking into account the underemployed and those who have given up looking for jobs.

The industrialized world continues to experience the negative consequences of failed residential real estate loans. The United States is beginning to experience growing problems with loans for commercial real estate, automobiles, credit cards and student tuition. Economist Nouriel Roubini, who has been extremely accurate with his highly negative forecasts, makes the case that

when loan losses from these other sources are eventually added to residential real estate losses, they will exceed the \$1.4 trillion of bank and broker dealer capital (as of Q3 of 2008), leaving the banking system borderline insolvent.

Merrill Lynch's North American Economist David Rosenberg makes the case that we are very likely in a depression today. He argues that massive deleveraging remains ahead. History teaches us that deleveraging cycles last for years. Since the fall of 2007, about \$1 trillion of bad debt has been recognized or written down. Rosenberg asserts that to revert to the long-term mean ratio of total private sector credit market debt to national income, another \$5 trillion has to be eliminated. If that even approximates tomorrow's reality, there is tremendous remaining danger to asset prices.

The willingness of the Fed, Treasury Department and Congress to throw at the problem amounts of money that would have been inconceivable just two years ago shows their recognition of the enormity of the crisis. They are taking unprecedented steps and creating financial obligations that may burden taxpayers for generations. We all have to hope that their proposed rescue packages succeed. They could, of course, and our securities markets could rise appreciably if consumer and investor attitudes can be turned from pessimism to optimism.

On the other hand, the problems are severe and are the result of more than two decades of excessive borrowing and spending accompanied by too little saving. To correct those excesses American households face the need to repair their personal balance sheets. Such action will lead to increased saving and decreased spending, a wise personal course perhaps, but contrary to the public need for a revival of the free spending era. Time will tell whether or not the Government's proposed stimulus package reignites the public's willingness to spend freely.

In a still slowing economic environment, corporate earnings forecasts are highly questionable. Even accepting optimistic earnings forecasts, stocks today are not cheap, except relative to the historically excessive valuations of the most recent decade. By the time-tested measures of price-to-earnings, price-to-dividends, price-to-book value and price-to-cash flow, stocks today have not even retrenched to long-term median levels, despite their recent huge price declines. That is testimony to the excesses that stock prices achieved in the bubble years. On valuation alone, it is likely that stocks will underperform their long-term norms over the next five or ten years.

Valuations notwithstanding, stocks are long-term oversold following the extreme declines of the past five quarters. Almost certainly they will experience a significant rally in 2009. The only question is whether such a rally will commence from near current levels or whether the probable bounce will follow another costly decline.

Even if this bear market is fated to go much lower, and there is no certainty of that, it is safe to predict significant rallies. All major market declines are interrupted by significant rallies. Even during the worst stock market crash in U.S. history from 1929 to 1932, an 89% decline, there were six rallies ranging from 20% to 48%. Mission's approach of adding to stock holdings on market declines and reducing positions on significant rallies allows us to benefit from such volatility even when the market's general direction is down.

Economic uncertainty and the lingering threat of the still deflating debt bubble warrant our continuing cautious overview. While maintaining a low risk posture, we will continue to add strategic positions in equities, as we have over the past few years, when prices decline and good opportunities present themselves.

Longer maturity Treasury bonds are not attractive at current historically low yields, but there will come a time to purchase high grade corporate or municipal bonds when we believe the default risk has diminished. We are carefully assessing that level of risk in a highly uncertain credit environment.