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Dear Valued Investor:

As we wait for indications that the bottoming process is working through, we had another bad week. The Dow fell 473 points over the week ended last Friday, more than erasing the 401 point gain the prior week. And international equity markets started out this week badly, with Hong Kong's Hang Seng equity index down 12.6%, Japan's NIKKEI 225 index down 6.4%, the FTSE index down 1.7% and so on. Emerging Markets have really been hammered, especially equity markets in countries that have a heavy reliance on energy, materials, or precious metals production and sales. In Brazil, for example, the Bovespa Stock Index fell 6.5% and is down 64% in dollar terms so far this year.

With the carnage overseas, U.S. equity markets finished with the Dow dropping "only" 2.4% today. There are some grounds for this better relative performance. We are energy and commodity importers, so those price declines will benefit our economy down the road. Also, while the dollar exchange rate has been rising, it remains well below the 2002 peak and still offers, in my opinion, a solid competitive advantage to U.S. companies that export and compete with foreign companies. Finally, Federal Reserve and Treasury programs aimed at restoring our financial system are starting to kick in. Today one, in my opinion, very important program started – the Federal Reserve's Commercial Paper Funding Facility (CPFF). This program will provide a backstop to qualified issuers of commercial paper (CP), giving these issuers the ability to get three-month CP loans from the Federal Reserve at near-normal rates. CP borrowing had fallen by $366 billion (25%) over the last six weeks, another credit area that seized up after the AIG/Lehman failures and that has created much stress on many traditional borrowers. There are more programs coming. It is nice to see that not everything barreling around the corner at us is bad news.

So why have equity markets continued to have so many bad days? There are a whole host of factors, but two now stand out. First, the swift fall in oil and other commodity prices has had an immediate negative impact on the producer economies and stocks, but the benefits to consumer economies and stocks, importers or users of energy and commodities, tend to show only after a lag of six months or so. Second, a new source of downward pressure on markets appears to have come from hedge funds.

Hedge funds that actually hedge risk and thereby reduce risk have generally done relatively okay (though most are still down). However "hedge" funds that were actually using leverage to make long risky bets on all sorts of things, like troubled debt, long energy, and other commodity bets or risky positions have been hit very hard by the credit crisis, and now their investors are reported to be fleeing in droves. No one has a full view of this market, because it is yet another unregulated part of the global financial system that will likely have to be completely rebuilt and subjected to significant regulatory oversight. However, for now I, among others, am guessing that there has been a lot of forced selling.

These leveraged "hedge" fund portfolio price declines coupled with investor demands for redemptions have delivered a double whammy to equity and fixed income markets around the world. It appears that managers of such troubled "hedge" funds have had to throw everything not bolted to the deck overboard to keep their funds afloat. One problem is that the stuff bolted to the deck is likely to be the really risky junk assets, the "illiquid" assets that cannot be sold (or liquidated) easily. Meanwhile, the relatively good or "liquid" assets are being sold. These managers appear to be selling all sorts of securities without, in my opinion, much regard to price. AAA municipal debt securities, equities with low valuations, investment grade corporate bonds, etc. have been dumped at what look to me like fire sale prices.

And while we have heard from bunch of hedge fund managers that they are okay and have raised a lot of cash, there is no way to know for sure, and given the lack of regulatory oversight, in the main I tend to distrust much of what is said. I have heard way too much from way too many financial institutions over the last year that just was not true. One important gauge I am watching here is, strangely enough, the Japanese yen exchange rate.

Many "hedge" funds used something called the "carry trade" to borrow money to lever up their portfolios. The idea was to borrow in Japan at a very low interest rate and use the yen denominated proceeds to buy assets anywhere in the world for their portfolio. This process in effect put the funds in a short yen and long some other currency exchange rate position. So, as they have been selling stuff out of their portfolios, they have been eliminating the short yen exchange rate positions. As a result, the yen has soared since the beginning of September, rising 17% against the dollar and 37% against the euro. A slacking in the yen appreciation may mean hedge fund selling is tapering off. So far, that has not happened. And, hedge funds still foolish enough to have that carry trade on their books are getting hammered by the appreciating yen. Good grief, another bad movie script!

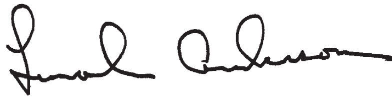
All of these bad movie plots we have seen play out over the last few months have common themes: high prices (housing, energy and other commodities) followed by a price crash, very bad security selection with very high leverage, hidden problems, deep flaws in the financial system, and a lack of regulatory oversight. Alan Greenspan, in testimony last week, said he was astonished at how bad things were at many large supposedly sophisticated financial institutions at the heart of our financial system. While I deplore the lack of regulatory oversight on his watch as Fed chairman, I have to agree with his astonishment. So, is there more bad news likely to come barreling around the corner at us? Almost certainly. But there will also almost certainly be good news as well. And we just have to deal with what the markets have already priced in.

I know that, in this global financial market meltdown, fundamentals do not matter to many investors, but I do think that fundamentals will become important once again when forced selling and panic selling subside. For example, by my calculation, the stock market value of all U.S. non-financial corporations is now down

to about 44% of their aggregate net worth. The municipal debt market appears to be pricing in widespread defaults on AAA general obligation bond defaults. Meanwhile, despite facing huge new issues of Treasury debt that will be coming to finance the Treasury and Federal Reserve programs, the yield on the two-year Treasury note is only 1.5% and the 10-year Treasury note has a yield of only 3.75% (compared to a 10-year AAA general obligation yield of 4.5%). While I do not think it is time to step in and buy more risk, I also do not think it is the time to be a seller of risk either. With a longer-term view, "risk free" securities look overpriced and therefore actually more risky, and "risky" securities generally look increasingly underpriced, therefore becoming less risky as their prices fall.

I will continue to try to offer what insight I can into what is driving the markets, and where we may be in the bottoming process, how long or deep this recession will be, and how well or badly government agency efforts to return our system to better functioning are working. As always please call your financial advisor with questions or concerns.

Sincerely,



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* There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

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