CONCORDE

Concorde Investment Management

INVESTMENT PERSPECTIVE
FEBRUARY 2009

Concorde periodically provides a written perspective about the economy and investment markets during confusing times, such as now. These periods tend to leave investors without the comfort of benchmark norms or a good sense of the context in which to make prudent investment decisions. Given the dramatic events unfolding before us, it seems to be an appropriate time to step back from the volatility of daily markets, from the hyperbole of the financial and popular press, and from the self-serving spin of the political process, and to consider the current macro situation and, more importantly, how the current economic environment and probable outlook should impact investment strategies and objectives. Yogi Berra insightfully said: "Predictions are very difficult, particularly about the future." And, while nothing is certain, we feel there are some well grounded conclusions that can be reached by considering the current situation and the probable realities of the next few years which should govern investment decisions.

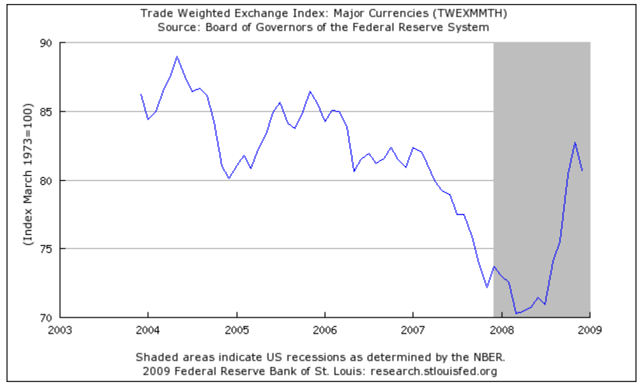
WHAT IS DIFFERENT ABOUT THIS FINANCIAL AND ECONOMIC CRISIS? The uniqueness of the current turmoil lies principally in the confluence of several major factors, any one alone of which would have been significant, but in combination have proven to be dramatic. It is this contemporaneous intersection of several factors that is noteworthy.

- Economic globalization and the mobility of savings around the world led to low interest rates and over-availability of credit that fueled excesses in consumption and asset values.
- Complex financial instruments and opaque financial structures hid much of the pending problems of excess debt and speculative asset inflation and thereby precluded the opportunity of more gradual market driven corrections.
- For eight decades, real estate values, in general, never declined in a meaningful or sustained way, and the apparent "certainty" of the asset class led the way to excesses in the sector.
- The US is effectively the framework for the world's economy, and is its largest component (26% of global GDP), so when the US has problems in the now globalized and synchronized world economy, the impact is felt in all markets.

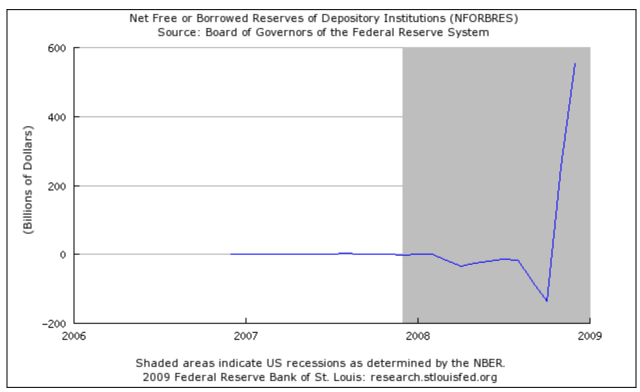
In 2008, the concerns were whether the interconnections and operating protocols of global financial markets would collapse and cease to function. The concerns rose to the level of near panic and created the first of two crises — a crisis in the financial system.

Although the risk was real, the collapse never came. Governments and central banks around the world came together, in a mostly cooperative approach and in a distinct contrast to behavior in the events leading to the Great Depression in the last century. While the credit markets are not yet functioning effectively, the likelihood of a failed global financial system has all but disappeared. However, actions taken to avert the system failure, and the incessant sensationalism of the press in forecasting the possibility of financial Armageddon, are, in some cases, compounding the problems and creating an unfavorable economic context for the coming years. Many of the corrective and stimulus actions themselves will have characteristics and consequences, some of them unintended (such as the spilling over of the financial system crisis into the real economy or the possible direct or indirect nationalization of some major banks) that will undoubtedly compound the turmoil and complicate future recovery.

The major effects of the crisis in the financial system are becoming clear:

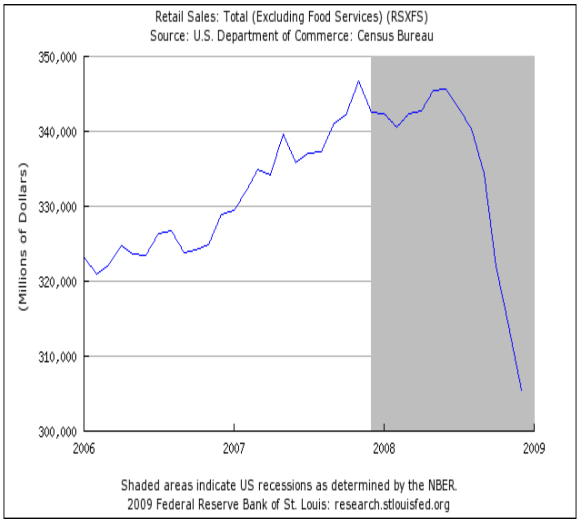


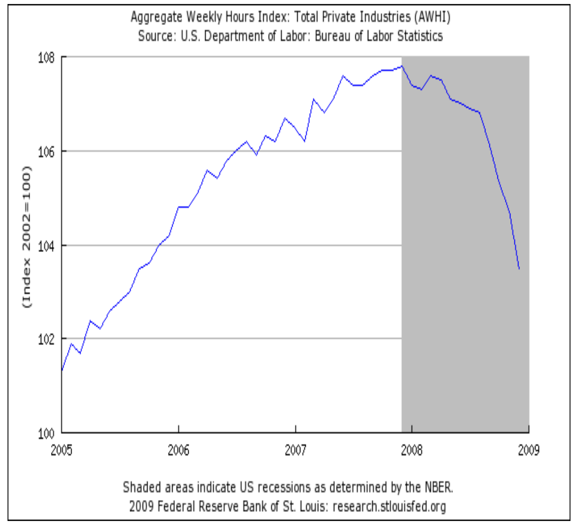
Flight to the US dollar, due to fear, and not based on the relative merits of economies, as the currency that is seen as safe in periods of global turmoil**.** The result is significant declines in the values of international currencies relative to the dollar and the concomitant impact on global trade, global economic activity, and competitiveness. Drops in commodity prices due to declining global economic activity, while good for consuming nations, are problems for emerging commodity-based economies and are causing trade, the lifeblood of the global economy, to slow.

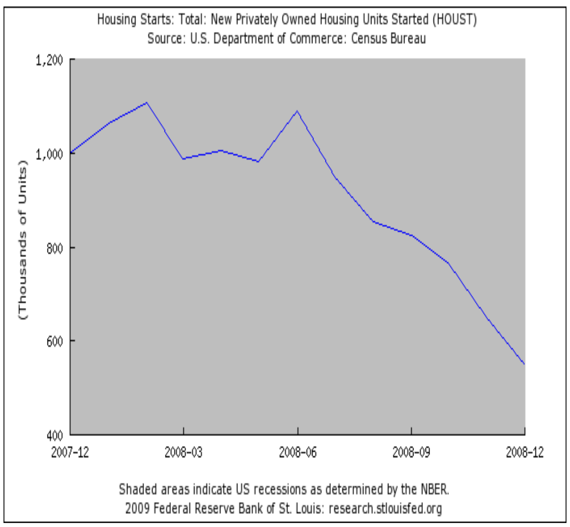


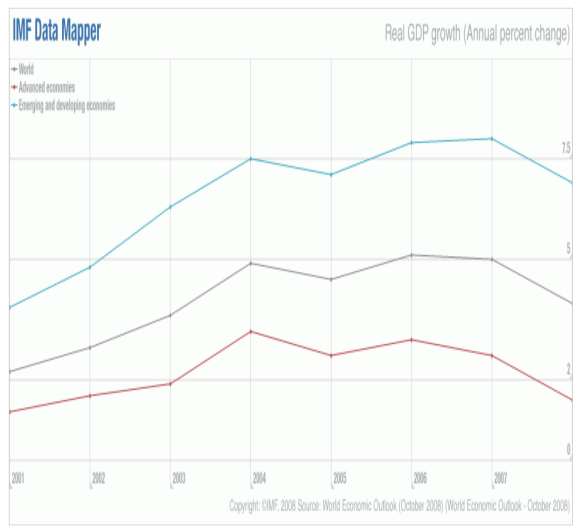
Dramatic decline in credit availability and lending, brought on by a circular process of interrelated cause and effect. The lack of lending activity can be seen in the chart that depicts excess unlent reserves in the banking system. This began with asset write-downs in the banking system, particularly real estate and mortgages, but also included credit default swaps, collateralized debt obligations, and other speculative financial products. The write-downs cause lender concerns over the solvency of their own balance sheets and those with whom they do inter-bank transactions (counterparty risks). These concerns lead to reductions in credit availability, which has had obvious adverse impacts on the business sector's ability to conduct ordinary business and which, in turn, ultimately impacts the viability of businesses, jobs and consumer sentiment. Finally, the cycle compounds as declines in economic activity cause more asset write-downs resulting from failing businesses and strapped consumers who are unwilling or unable to consume or pay mortgages. The spiral can be very destructive if not interrupted.

Precipitous drop in overall economic activity, due to actual or anticipated decline in consumer purchases, defensiveness of corporations regarding capital expenditures and expansion plans, limited availability of normal credit, cutbacks in state government expenditures due to foreseen budget deficits, the dramatic slowdown in international trade, and the interrelated impact of all of the above on unemployment. The coming government stimulus packages (which appear to be primarily ideologically driven social agenda spending by Congress rather than "stimulus") is ostensibly aimed at reversing these trends as soon as possible, particularly the availability of credit.









Stunning rise in government related debt and market intervention, led by the US Treasury and Federal Reserve Bank and followed by major governments around the globe. The stated purpose is to, first, avoid collapse of the financial system due to lack of liquidity (plenty of assets but of unknown value) or prevent insolvency of key institutions (assets which have no value or severely impaired value). And, second, to stimulate renewed economic activity in general, if by no other means than to guarantee that the financial system will continue to function and provide credit availability.

While the actions of global governments and policy changes by Central Banks (including the US Federal Reserve) have been criticized, and there are certainly a number of things being done that will undoubtedly have adverse unintended consequences, the collapse of the global financial system was nevertheless avoided. That said, thoughtful additional actions of grand scale will be required in order to successfully maneuver through the current difficult times. For example, the orderly selling of private sector assets acquired by governments during the crisis is necessary to prevent ongoing clumsy public sector incompetence in the private sector, must be included in the unwinding of steps taken during the crisis. Perhaps the single most important follow-on action is reducing the massive liquidity injections and growth of the monetary base in order to avoid inflation. The potentially most damaging unintended consequence of the stimulus efforts is inflation, and the stage has been set for the perfect storm of high inflation and slow growth unless the monetary base is reduced as the crisis subsides.

Uniform and abrupt impact on financial markets. The impact on the global financial markets was abrupt (majority of the initial impact was over approximately three months and is continuing), uniform (no place to hide regardless of style, manager, underlying asset fundamentals) and widespread across sectors, asset classes, and regions (a global phenomenon), as can be seen in the charts below. The decline of the US stock index (S&P 500) in 2008 was the largest since 1931.

GLOBAL STOCK MARKET SECTORS - 2008	
Financial Stocks	-54%
Industrial Commodities	-52%
Capital Equipment	-47%
Technology	-44%
Energy	-38%
Consumer Cyclical	-36%
Telecom	-34%
Consumer Staples	-23%
Medical	-17%

Sources: Sanford Bernstein

GLOBAL ASSET CLASSES PERFORMANCE - 2008	
Global Stock Index	-41%
Emerging Markets	-53%
International Developed	-43%
US Stock Index	-37%
Global REIT index	-48%
US Corporate Bonds (Investment grade)	-5%
US Municipal Bond Index	-1%

Sources: MSCI World Index; S&P 500; FTSE EPRA/NAREIT Global REIT Index; Lipper Short/Intermediate Municipal Bond Index; MSCI EAFE International Index; MSCI Emerging Market Index; Barclays US Investment Grade Corporate Bonds Index

About the only financial assets that held up were those of the US Treasury and US Government Agencies with explicit or implied guarantees of the government. These asset types experienced significant gains as investors from around the globe moved to the perceived safety of the US dollar. Fundamentals of underlying businesses and assets did not matter as the forced liquidations by institutions, resulting from redemption demands and fear-driven wholesale exit by investors, drove prices across the board below rational levels. The result has been that for time horizons of three to five years, and not just three to five months, most asset classes are below intrinsic value.

There are therefore some conclusions about what is different about this crisis. The uniqueness of the current situation is that the excesses in the world's largest economy, many of which were hidden from view, ultimately triggered the first of two interrelated crisis situations. The first crisis was the very integrity of the global financial system and it in turn caused a second crisis in the "real" economy due to the impacts brought on by the financial system problems and the corrective actions taken to avoid its collapse. The reaction in the marketplace was an abrupt and across-the-board fear-driven sell-off which has pushed valuations in equities, credit instruments and real estate below intrinsic values.

WHAT MIGHT BE REASONABLE EXPECTATIONS? In 2009, the second of the two interrelated crises will be at the forefront. Concerns will be how to get the global economy to resume a reasonable activity level for growth in employment, for normal functioning credit markets, for increasing trade, and for balancing consumption versus saving and investment. Terminologies such as "recovery" or "back to normal" are not likely appropriate since they suggest a return to certain recent characteristics in business, consumer and governmental behaviors that have been painfully exposed as not sustainable.

Economic output, and the basis for growth, is traditionally thought of in four components: Consumption, Investment, Net Exports and Government Purchases. John Maynard Keynes, the father of modern economic theory, attributed all economic downturns in output to the lack of sufficient aggregate demand. With three of the four components of economic demand significantly impaired, governments around the world have become the "demander" of last resort. Government intervention is shifting from the purchase of troubled assets to the outright ownership of assets, typically in the form of preferred stock of selected companies and banks that are seen as critical to the global or domestic economies. The actions taken thus far by governments in dealing with the financial system crisis, along with the characteristics of the new economic realities, have set the stage for a very difficult period in the global economy.

The timetable and process to achieve 'normalcy' in the context of the new realities will have a number of important characteristics:

> **The metrics of economic activity will almost certainly decline further** as the world looks for the bottom in terms of asset prices (particularly real estate) and employment. Unemployment could reach double digits in the US and many major developed economies. Since employment growth tends to follow corporate profit growth by 9-12 months, the specter of reversing the tide of rising unemployment is well into the future. In the US, with almost 40% of the CPI comprised of energy (10%) and housing (30%), headline inflation could approach zero in coming months. But without effective management of the monetary base, inflation could reignite dramatically in coming years. Deficit spending by governments for stimulus purposes will reach very high levels and will cause cries of concern, but some government spending is unfortunately necessary.
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> It is important not to be overwhelmed by the hyperbole of the press, which often uses terms such as "unprecedented" when referring to the current recession. Thus far, the current recession has not reached the depths of the 1982 recession in terms of population adjusted unemployment which rose above 10%, or population adjusted home sales which were 30% lower than today, or in terms of the surge in oil prices (inflation adjusted) or interest rates. That said, the declines are not yet finished nor are the excesses even close to being worked through, and the current recession may very well exceed the 1982 downturn and become second only to the depression of the 1930s.
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> **Lower debt levels will eventually be the new norm.** Certainly governments, in the short term, will utilize massive amounts of deficit spending and incur the associated sovereign liabilities in attempts to stimulate economic activity and restore financial system liquidity. Government ownership of troubled assets has the effect of socializing many of the failed assets by absorbing losses through outright purchase of assets or institutional credit

guarantees. In contrast to governments, businesses and consumers will be de-leveraging. It's been said that "We have learned that free money makes us stupid" and it came in the form of easy credit and lower underwriting standards. Easy credit ("free money") will not be the standard procedure going forward and, in fact, there is a real risk of overreaction in the form of excess regulation and excessively conservative risk aversion which could retard achieving a balanced normalcy in the credit markets.

Increased government involvement in the private sector for much of the developed world, in terms of ownership, credit guarantees (including direct or indirect nationalization of banks) and intervention through taxation and regulation, will intensify the risk of unintended consequences as often seen in command economies, and the concomitant adverse impact on efficiencies and growth of free economies. *Governments will no longer primarily be the "referee" but will actually be a player in the game itself.* Increased taxation in the US, in particular, is troubling since it may be driven by the ideological redistribution of wealth — a failed concept in economic terms — or the need to pay down excess government debt, just as the rest of the world has been moving to lower taxation and thereby becoming more competitive. As already stated above, but worthy of emphasis, there is also a risk of the insidious type of intervention of allowing inflation to be the tool used to pay-off the huge debts being incurred by governments to avert the financial crisis and restart economies.

The magnitude and systemic character of the economic problems virtually preclude any possibility of a quick fix. The "crisis imperative" will likely not provide sufficient political capital to expedite the array of solution components necessary to get things back on track. Moreover, the opaqueness of many of the issues makes the correct policies less than obvious. For example, the US$30-50+ trillion of notional value attributed to credit default swaps (CDS), of which only a small portion are actually hedging exposure to underlying assets and securities, are essentially speculative. It is beyond the specter of making them all "money good" and therefore the method to unwind or eliminate them, without a renewed crisis in the financial system, remains unresolved. The CDS issue has the potential to make the sub-prime mortgage debacle look modest in comparison.

The more normalized metrics of asset valuations will reassert themselves in the intermediate term and well ahead of the improvement in economic activity. Financial markets, which are by nature forward looking, tend to anticipate an economic rebound 6–12 months prior to the improvement in actual economic activity. Equity market prices are currently forecasting a pessimistic 40%+ decline in earnings from current levels and the debt markets are implicitly forecasting excessively high default and low recovery rates, as a result of expectations of a severe recession. While this recession may indeed be longer and perhaps deeper than any in post WWII history, and the recovery may be sluggish by historical standards, markets will nevertheless anticipate the economic recovery and begin to generate improving performance, and perhaps even noteworthy returns, in the early stages. The issue is more 'when' than 'if'. Credit markets may have already begun a modest recovery.

There have been 11 recessions in the US since WWII with the longest (2) having a duration of 16 months. This 12th one, which began in late 2007, is nearing that length. In all but one, stocks declined during the first half (-6.3% average) and grew significantly in the second half (+15.4%). The associated bear markets for equities (using the S&P 500 as the proxy) lasted an average 12 months and had an average decline in stock prices of -23.2% and a performance of +35% in the first year after the bear market was over and a total average performance of +173% to the end of the subsequent bull market. Perhaps most importantly, it has taken, on average, two years to get back to even after the beginning of a bear market, except for the most recent bear (April 2000 — September 2002) which took five years.

Closing the gap between stock prices and underlying value will likely take longer than during typical bear markets. Assuming there is a gap between rational value and current stock prices for many high quality companies, the key questions are how big is that gap and what will cause it to close. (There are only two ways to close the gap — the metrics of valuations must decline or stock prices must increase.) There are three valuation factors that favorably impact stock prices: (1) profit growth, (2) low and declining interest rates and, (3) low tax rates. US corporate profits in recent years have been at historical highs of around 7.6% of GDP and historically profits have tracked GDP growth. With GDP growth likely to be very weak for several years, general growth in profitability does not seem probable, although some companies will do well. The second factor, interest rates before risk adjustments (government issues are considered risk free), are already depressed by the recession, and with the concern that all of the stimulus actions by governments around the world could be inflationary (unless governments shrink monetary base as the crisis subsides), risk free interest rates are likely to increase. Finally, the huge spending programs, whether stimulus or ideologically motivated, will result in debt and deficits. The government will undoubtedly turn to revenue generation (tax increase) ultimately. Therefore, the environment of slow profit growth, rising interest rates and rising tax rates, make the likelihood of significant and sustained rise in the stock prices difficult, but not impossible to imagine. On the other hand, valuation metrics notwithstanding, stock prices could rise to close the valuation gap simply due to very favorable market conditions. In the current market there is significant liquidity being injected in the economy for stimulus, enormous amounts of investment liquidity is already on the sidelines due to risk aversion (earning almost nothing) and there are reasonable, if not favorably low, stock valuations on balance. All things considered, conditions are such that stocks, domestically and globally, should move up, regaining some of the recently lost value, once the bottom of the recession can be seen, but growth from that point forward should appreciate only moderately for a few years due to the economic headwinds of slow profit growth, rising interest rates and tax rates, as discussed above.

There have been four major deviations of stock prices from underlying intrinsic value since 1970: the oil crisis of the early-mid '70s; the real estate and banking crisis of the late '80s; the tech bubble in early 2000s; and the current global credit crisis. The adverse impacts on investment portfolios were almost unavoidable in each period, such as the case in the current uniform and abrupt downturn, but the downside was compounded by those who did not take advantage of the opportunity presented by the wide divergence of price from intrinsic value and did not maintain a longer term view. In any event, the uniqueness of the current recession and associated bear market suggests it will take longer than average before portfolios are restored and that much of the appreciation will occur in the early stages of the turnaround, but, as in the 11 other examples (which occurred in all manner of economic and market environments), recovery in lost value will occur.

There are therefore some reasonable conclusions that can be drawn about expectations. Expectations must be set with the backdrop of a domestic and global economy that is weak and still declining. Reasonable expectations are for a slow "recovery" to begin at some point, but toward a different "normal" in terms of economic activity and in terms of the performance of investments. The process in the near term will be dominated by government policies of huge stimulus spending, likely wastefully and ineffectively executed. However, the "crisis imperative" might open the door to address certain unsustainable US government policies (Medicare, Social Security and Energy) that are the Achilles' heel for US long term fiscal integrity. The "new normal" will undoubtedly be characterized by intrusive regulation in many sectors, particularly the financial industry, lower availability and use of credit than seen in recent decades and dampened global economic growth rates for the foreseeable future. The road to the new destination will be bumpy, politically and economically, but investment performance will ultimately be governed by more normalized metrics and there will be a recovery in values.

WHAT ARE THE RIGHT STRATEGIES FOR INVESTING IN THE NEW CONTEXT? Investing, by definition, involves risks – some manageable and some not. Prudent strategies, regardless of markets and economic conditions, should always focus on distinguishing the two and dealing with each accordingly. It goes without saying that prudence is not seasonable and the "right" strategies always have a healthy dose of it.

Manageable risks are those that can be impacted by thoughtful investor actions such as avoiding overreactions to market conditions (good or bad), establishing realistic return expectations for given market and economic outlooks, and carefully evaluating risk versus returns for specific investment choices.

Unmanageable risks are those which are the "un-knowables" that manifest in sudden and often unexpected ways. The existence of unmanageable risks is relatively easy to see in hindsight, but it can be severe, as recent events have demonstrated. The unmanageable risks are the primary reason investors should adopt conservative structures such as allocation of investments among different asset classes (investment policy), diversification within asset classes as well as among classes, and the disciplined maintenance of allocations and diversification.

When the context is referred to as the road to the "new normal" it may seem cliché to emphasize old and tested strategies, but it is precisely that insight that can provide grounding to investment decisions.

Avoid the tendency to overreact to market conditions (good or bad) and remain consistent to basic tenets of investment that have been proven out in all manner of markets and economic conditions. That is not to say to turn a blind eye to obvious risks or not to adopt defensive positions in periods of high risk conditions (highest grade debt instruments, low volatility equities with solid balance sheets and free cash flow, low leverage, etc.), but radical shifts in policy rarely produce acceptable performance.

For example, while the allocated portion of a portfolio to equities depends on factors and objectives specifically associated with the portfolio owner, the probability of successfully timing exit and entry into the equity markets is low. Recent examples of the difficulty in timing were in 2000 and 2003. In the year ending in late 2000, over US$200 billion flowed into US equity mutual funds, perhaps motivated by the significant upside of the previous few years and just prior to the 27% decline in the S&P 500 over the following twelve months. In the year ending in early 2003, redemptions exceeded inflows to equity mutual funds, influenced by several years of poor performance and just prior to the 35% performance for the next twelve months ending in February of 2004. While near term market performance remains to be seen, another example of overreaction may prove to be the liquidations of equities during the current crisis.

Establish portfolio performance expectations at reasonable levels commensurate with the context of the likely business and economic environment of the coming years. Our view, which we wrote about in the early part of this decade, was that the coming years would require defensiveness and lowered investment return expectations and a well diversified asset allocation. *Recent events have not changed that view*.

The specter of increasing taxes, for either the ideological redistribution of wealth or pay-down of huge government debts, or the possibility of an impaired credit system for an extended period and trends to de-leveraging (government stimulus deficits in the near term notwithstanding), will likely contribute to an extended period of economic slow growth. Moreover, de-leveraging in the financial market will keep downward pressure on asset prices and de-leveraging of consumers will all but eliminate the debt fueled consumption of the recent past.

The general performance of various asset classes will be dependent on the economic realities of the near and intermediate time horizon. Equity returns during the transition, and for the subsequent period of slower economic growth, are therefore unlikely to be as high as the 1980s and 1990s. As we have written about many times, equity investment returns should regress to a trend that reflects growth in earnings or free cash flow rather than increases in the metrics of valuation. Since profits tend to track GDP growth and stock prices tend to track earnings growth, a period of slower growth would suggest lower stock price appreciation. Debt instruments, other than US Treasuries, are likely to be more carefully priced with regard to risk and may demonstrate more reasonable and sustainable returns. That said, current weakness in risk credit (bonds) has created investment opportunities not available since the early 1980s. Tangible asset classes, particularly those for which leverage played an important role, will likely not see the returns of recent years. Therefore, short term rebounds notwithstanding, investment returns, within acceptable risk levels for passive investors, will be more challenging to generate and returns in general will be lower in the foreseeable future than in the ‘80s and ‘90s.

Maintain exposure to equities and favor Value style over Growth style. Since 1982 stocks have increased at an annual compounded rate of 12.5% (using the S&P 500 as the proxy through 2007), about half of which was appreciation and half was the result of reinvested dividends; however, if an investor was out of the market for the 40 best days, the returns would have been only about 5.4% per year. The critical element therefore, is that one must be in the market in order for capital to have the chance to be productive. The best five year performance for the US stock market (+367%) began in 1932 in the midst of the Great Depression. The next best five year performance (+267%) began in 1982, the worst recession post WWII, during which there was double digit unemployment and interest rates. The markets are likely in a trough period which precedes a recovery in value.

In the case of financial asset equities, valuations overshot in the '90s and they have overcompensated to the downside in recent years, with the climax in 2008. In the late '90s, US markets were at the end of a 15 year period (one of only two in history) during which stocks averaged 18% compounded returns, well beyond the average growth rate of corporate earnings. Stock prices had become overpriced relative to underlying corporate performance. Just as the equity bull markets of the '20s and '60s were followed by difficult bear markets of the '30s and '70s, the '90s have been followed by the first decade of the new millennium. Just as commodities became under-priced in past decades and recently over-priced when their economics became detached from the merits of supply and demand, valuations ultimately succumb to market balances. Just as real estate, particularly residential, became over valued relative to the metrics of value to rents, or relative to sustainable mortgage loads for owners, prices ultimately seek equilibrium. Valuation metrics will return to historical long term norms.

RELATIVE PRICING IN THE EQUITY MARKETS

	YE 1997	YE 2008
Global Stock Index [1]	22.8	22.8
Global GDP (US$ Trillions)	$35.9	$69.2
Global Earnings per share (TTM)	$10.09	$21.29
Price/Book	2.9x	1.4x
Global Dividend Yield	1.8%	3.9%
US 10 yr Treasury Yield	5.7%	2.2%

[1] MCSI ACWI Index (includes emerging markets)

Source: Alliance Bernstein; IMF; Bloomberg; MSCI

Investment philosophy or discipline ("style") remains an important consideration. Since 1949, Value style has outperformed Growth style in 41 of the quarters, Growth has outperformed in 37 of the quarters, and other periods were neutral as to style performance. However, Value style has outperformed Growth style in 50% of quarterly performance versus 25% for Growth over the most recent decade. In the coming lower leverage environment, companies that can self finance their growth (a typical characteristic of Value style equities) should be better performers.

Maintain a diversified and balanced asset allocation. Asset allocation has traditionally had more of an impact on long term performance, in the realm of capital preservation and productivity of capital, than solely relying on any single asset class. While the current environment might suggest modifications to investment policy by adding more balance to debt and equity, it is nevertheless diversification that is the critical characteristic. Recent dramatic downside performance in the real estate and equity markets, brought on by the unseen factors that triggered crisis in the financial markets and in-turn the real economy, underscores the axiom that no one class of asset is sufficient for an investment portfolio.

It is important to remember that stocks have outperformed bonds 68% of the time for all three year rolling periods over the last 40 years. But, in an environment where exemplary growth in corporate profits will be difficult to create, the debt side of investment allocations may actually perform as well as equity assets in the intermediate term. If there is there anything to be learned from history, it is that valuations are ultimately tied to the underlying performance of tangible assets and businesses, and those valuations can be too high or too low depending on the market.

The twin concepts of allocation and diversification offer both the defensiveness to unmanageable risk and the opportunity to participate in longer term performance.

There are therefore reasonable strategies that should be adopted based on how we got into this current situation and what we can expect in the near to intermediate term. The appropriate strategies and policy guidance are vital to the preservation and productive deployment of investment capital. In a significant transition such as the current one, investment strategy and structure during the change must not have the same over-reactive characteristics as the transition itself. Investors should maintain an asset class diversified portfolio with exposure to equities that is appropriate for their particular circumstances. It is imperative to set realistic expectations for performance in the new context and focus on long term intrinsic values and realize those periods of unrealistic over or under valuation ultimately give way to rational metrics. Most importantly, investors need to prepare for the new context of business and investment consisting of a higher tax environment, increasing government intervention in "free" markets, reduced availability of credit for speculation or consumption, and the possibility of re-igniting inflation.

In summary, the main themes for observing the current financial and economic crises and adopting appropriate strategies are profound but rather straightforward.

- We are in a transition period, an interregnum with regard to the standards of the conduct of business, personal economic behavior and the role of governments directly in the private sector. Some of the key concepts include less leverage, more accountability and increases in regulation and transparency. For all of the difficulty in making the transition, the end result has the potential to be better than the unsustainable path we were on.
- 2008 was the year of the crisis of the financial system and 2009 will be the crisis of the economic system. While the former has been averted in the near term, assuming it is unlikely that major policy blunders will be made, the latter is still to play out. Ironically, in contrast to history, it is the crisis in the financial system that triggered the economic crisis, rather than visa-versa. The metrics of global economic activity will probably worsen, and perhaps significantly, before improving. The initial phases of the unwinding of the over leverage has set the stage for a severe recession and the possibility of the resurgence of inflation. The total process will more likely be long and sluggish, by historical standards, rather than a rapid bounce back.
- One major characteristic of capitalism is the regression to the mean of economic activity, business practices and asset values after the inevitable ups and downs, the booms and busts, and the tendencies to excesses and overreactions that come with mostly unregulated activities based in self interest. As a result of the significant selloffs in essentially all risk markets, the current valuations of many securities likely represent an opportunity for the

truly long term investor to maintain or initiate positions with meaningful appreciation potential.

- The merits of an investment strategy that incorporates asset class diversification, and not reliance on one asset class, remain viable. Most significantly, overreaction to temporary circumstances can cause damage to preserving capital and generating reasonable returns. While periods of unrealistic over or under valuation ultimately give way to rational metrics, it is important that investors prepare for the new context of business and investment consisting of higher tax environment, increasing government intervention in "free" markets, reduced availability of credit for speculation or consumption, and possibly high inflation.

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