REED CONNER BIRDWELL
INVESTMENT MANAGEMENT

INVESTMENT STRATEGY LETTER

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Confirming the Existence of the Pony

It is difficult to express in words just how difficult a year this has been for investors, and we are disappointed in our inability to preserve investor capital in the worst financial market seen by nearly anyone presently alive. While our Large Cap strategy outperformed many peers and our benchmarks, our Small Cap strategy had a dismal year and our All Cap strategy was somewhat in between. Our International strategy ended its first year in a similar state to Large Cap, outperformed its peers and benchmarks, but shared the difficulty of spending relative performance.

While we had a well-developed and researched sense that things would be tough this year and we consciously attempted to avoid most of the obvious burning fires in the financial world, we grossly under-estimated some of the "second derivative" effects of the financial crisis. These would include the real snare of a global recession to which no company is immune, no matter how "recession resistant" a business model claimed by senior management; the large and frighteningly arbitrary intrusion of sovereign entities into any number of financial markets and corporate entities; and the truly breathtaking avalanche of asset sales from nearly every walk of financial life, compounded by the urgency of de-leveraging and true self-preservation.

"Now we just have to sit back and wait for the Fed to bail us out."

That's one heck of a backdrop with which to begin Reed, Conner & Birdwell's 50th year of managing assets, but we enter 2009 with an unwavering commitment to long-term, research-driven, concentrated value investing, servicing clients from a position of complete integrity, and sustaining a collegial working environment that is challenging and fun. We feel strongly that our long-term success has been the result of being rooted in these core beliefs, current dents aside, and it is exactly our confidence in these long held beliefs that supports our contention that we are currently presented with what are possibly the best investment opportunities seen in our careers. The history of financial markets is that the best returns are achieved from the ashes of the most difficult markets, and as the peak to trough decline in equity markets across the globe approaches that of the 1930s, the odds have moved rapidly in favor of equities.

2008 was clearly a bear market in discrimination, as the obvious and painful truth is that there was simply no place to hide outside of actual cash (depending upon what bank held it), Treasury bonds and/or having a net short position. Global or domestic markets, investment grade or high yield bonds, commodities, private equity, small cap or large cap equities, hedge funds or fee based management all had their worst year in nearly anyone's memory. Noted investor and rapper 50 Cent in a recent interview with the Canadian press stated the obvious: "I sit with my investors and business managers and accountants looking at the numbers and I'm, like, 'Yo, the values of stocks in different areas that I invested in are decreasing!' So I take the loss like everyone else." The lack of discrimination in the past year's dismal showing is also evident in the opportunity set going forward, as there are currently terrific values in many asset classes. Our takeaway with this letter is that it is crucial for any value investor to lean against the wind and take advantage of the extraordinary opportunities that abound. The easiest and most damaging thing to do is to take the action today that should have been employed three years ago, instead of positioning yourself for what will in retrospect be highly profitable three years hence.

The crux of this biscuit centers around the financial world's most startling anomaly and reverse opportunity: the asset commonly referred to as the world's risk free asset – US Treasury Bills – is earning zero. Trillions of dollars have or are fleeing to the drumbeat of misery pounded in our ears everyday by the financial press, the ominous slope of nearly every global economic indicator, monstrous volatility, and the serial realization of financial "unthinkables" like Bear Stearns, Lehman Brothers and AIG, and have moved into the world's largest mattress. You can really rake it in by moving out to three year Treasuries at 1% or lock in 2.3% for 10 years.

You have to sit and think about this state of affairs for a moment to appreciate the implication – what is the probability of the United States falling into a multi-year deflationary depression that will continue to tank leading financial institutions, materially destroy the cashflow and dividend paying capacity of our leading businesses, and make fixed income assets earning 1% or less a winning bet? Impossible, no, but in our opinion highly unlikely given the simply enormous current and future desire of publicly elected officials to enthusiastically spend money they do not have. To bet on zero percent Treasuries is to ignore an awful lot of economic history that suggests throwing money out of Independence Day-sized galactic spaceships (to update Mr. Bernanke's famous throwing money out of helicopters quip) combined with massive Federal Reserve laxity eventually does work with a lag. And dare we ask, what is the margin of safety at zero percent?

This will not last, as we see this as a classic example of how financial markets lose efficiency the minute they walk out the door of our leading Universities. In eighteen months, investors en masse have gone from zero appreciation of risk to a womb-like embrace of safety that defies rationality. At some point, whether it was yesterday or in x months, the mystery marginal investor will wake up and wonder what the heck he was thinking at zero percent and contemplate the currently unimaginable - "what if I buy an FDIC insured bond issued by Goldman Sachs and earn 1% more?" A few more weeks go by and our mystery investor ponders buying a government guaranteed agency bond with 2 percentage points more yield. What about real investment grade bonds issued by leading corporations with bullet-proof balance sheets yielding 600 basis points over Treasuries, the highest spread since 1962? And then stocks? But we get ahead of ourselves with that crazy notion.

This brings us to our first big thought for 2009 – US Treasury bonds of all shapes and sizes should be avoided like the plague as there is a magnificent opportunity in investment grade bonds. There is an even larger opportunity in more severely distressed fixed income, but that requires a more specialized legal and credit strategy than we presently offer and thus we leave it to other more focused players. If you do not know who the patsy is in the poker or financial markets - it's you. We are actively offering an investment grade fixed income strategy as an opportunistic strategy and you should not be shy about calling us about it.

The math is simple. There is no margin of safety in Treasury yields and no matter how cute you want to be about it, the combined efforts of our Federal issues can only be termed as highly inflationary. Putting an estimated $3 trillion dollars into a myriad of backstop, guarantee or direct investment programs, which appear to be merely a down payment on an announced capacity of $8 trillion, is a financial adventure that on an inflation-adjusted basis is only comparable in size to the gross outlay for WWII. Seriously. It will undoubtedly support economic activity with the usual historical lag and should utterly disabuse Japanese/1930s deflation chatter. Practically speaking, numerous Federal entities are likely to be in the market almost EVERY day in 2009 selling some form of Federal bonds in order to support these programs and finance our deficits.

Any of these statements on their own suggests a complete debacle in Treasury bonds sooner rather than later. The counter argument of course, is that our elected and appointed officials will adeptly handle the outpouring of capital and simply pull back on the reins as things stabilize by adroitly closing down these programs. Sure. The alternative is simple: investment grade corporate bonds well within our sphere of competence in perfectly reasonable quality companies can be purchased at yields of 6.5% to 14%. We have seen different estimates given the issues around historical data, but the yield spreads for nearly any bond are the highest they have ever been in recorded history. The yields are likely to be more than high enough for inflation protection and in many cases grossly overestimate likely credit problems. Just as it was unlikely (though not outside the realm of popular chatter) in June 2007 that the entire S&P 500 would be taken over by private equity funds, it is equally unlikely that the entire S&P 500 will go bankrupt.

We are focusing on liquidity and credit issues as these have been the grease behind the economic and stock market slide and until they stabilize, it will be difficult for the economy and the stock market to find footing. Stocks have historically returned 10% annually over time, so when you can achieve that in investment grade fixed income, it is difficult to attract marginal dollars into stocks.

But as noted above, it will turn. It might have turned more quickly if the Paulson team had been able to grasp more quickly that the correct way to inject stability into the financial world was and remains simple - act like a giant hedge fund and invest in (not BAILOUT) reasonable to high quality mortgage and corporate securities. This would have injected a glimpse of rationality into markets and private money would have poured forth in the belief that a highly educated, highly experienced and highly paid (former) investment professional is not tanking his career by trying to make the bottom. In a tremendously ironic turn, Paulson's apparent lack of market savvy is noted in Charlie Ellis' new book, The Partnership: The Making of Goldman Sachs. In discussing the decision to pair Fixed Income head Jon Corzine with banker Hank Paulson as co-CEOs, Ellis notes that Paulson "worked hard to control or eliminate risk and didn't understand or enjoy markets with all their uncertainties." Ouch.

With the advent and ridiculous application of mark-to-market accounting, a dismal secondary market for credit means that it is nearly impossible for lending institutions to extend credit. Why would a large bank make jumbo mortgage loans with a traditional loan to value of 80% to employed and stable people if that loan is going to trade and be marked down 20% the second they make the loan, producing a regulatory requirement for even more capital? The same principles are present in corporate lending, and thus surprise, we have a mess on our hands. As a more current example, the credit market, and stocks with it, rallied tremendously upon the passage of the TARP and then tumbled upon the announcement that that TARP was going to manhandle leading financial institutions into forcibly accepting Federal money in lieu of asset purchases. Then with another announcement that the Feds were going to start buying mortgage backed securities, there was another rally in both mortgage bonds and financial stocks along with a huge mortgage re-fi boom. It has been noted that there are few bad bonds, there are merely bad prices. (Insert housing here too.) And as hard as it is to believe in many circles, the financial world will turn on this simple notion – low prices will slowly attract money, and prices will stabilize.

But we are not there yet and we do not have an answer for "when." Much of the "normalcy" that is being noted here is the result of markets highly medicated by Federal intervention. The government has stuck its nose so far into the financial markets that historic "tells" have become obsolete. As an example, look at the LIBOR market. Why the heck would any rational financial institution lend to another at LIBOR in this environment when you can get money from the US government at lower prices and zero credit risk?

With the FDIC now guaranteeing the issuance of short-term debt by our largest financial institutions, it appears to us that the "liquidity crisis" is nearing an end, leaving us merely with big fat credit problems. The latter is analyzable and should be well within the normal course of business by the investment management community. The former is frightening, un-analyzable and the true bane of an investor as it involves monstrous leaps of faith in uncertainty based decision-making. The shift from liquidity fears to credit fears is the start of a bottom in prices.

While government intervention will cure the issues of liquidity, it is also the biggest obstacle to longer-term economic growth and a resumption of equity investing as a profitable avenue for wealth generation. Without going into a political discussion, the biggest and most obvious issue with government is the utter scope for arbitrary behavior that is backed by the punitive weights of bureaucracy, size and sheer incompetence, examples of which cross any party line. To wit, might not investors be reluctant to buy the bonds or stocks of financial services companies when on different days of the week the Feds put Fannie Mae and Freddie Mac into receivership killing stock and preferred holders, allowed Lehman to die across the board, effectively wiped out WaMu and Bear Stearns stockholders by giving the firms to JP Morgan, tried to give Wachovia to Citibank only to find that Citibank was so questionable that it had to be bailed out itself, and last but not least, forcibly and coercively diluted our largest banks with the TARP?

Shouldn't overseas investors sell bonds guaranteed by Fannie Mae and Freddie Mac when the government plays word games that would embarrass even Bill Clinton as to whether or not the agencies have the explicit full faith and credit of the US government?

Are the animal spirits of the economic man stoked when the financial executives of our country have to effectively go to Washington to discuss compensation structures with The World's Largest Deliberative Body, a process that in the words of respected BB&T bank CEO John Allison, would constitute "a massive subsidy for incompetence?"

And while you have to cringe at over thirty years of gross incompetence from US auto industry management, isn't there something really wrong with large public corporations owned and governed by long negotiated legal structures, privately pitching business plans on PowerPoint to people who are unlikely to have the skills to effectively run a Taco Bell franchise (and we truly mean no insult to the fine men and women at Taco Bell)?

And now we get to the mortgage market which conceptually has been the root of our current predicament and thus its improvement the source of financial salvation. All homeowners and bank shareholders are united in wishing housing prices would stop going down. The solutions out of Washington to try to "stop" housing prices from falling have proven difficult to enact, which is a correct assessment of the obvious. We have noted in the past that we simply have no idea why anyone who put little or nothing down on a house wouldn't rather mail the keys to the bank rather than continue to pay interest on an asset whose value is down

30%. Every emerging statistic about the process and outcome of mortgage modification shows that over 40% of these homeowners go back into delinquency and default again. Also ignored is the fact that most banks still own less than 25% of the mortgages they have originated, and thus the scope for a legitimate and wholesale refinancing of problem mortgages, however dubious in theory or legality, is extraordinarily unlikely. The investors in mortgages are rightfully gearing up for the fight of their lives against the daily trial balloons of inanity out of Washington to modify loans. There are blizzards of legal contracts between banks, trustees of loan pools, servicers hired to manage the pools and investors, all of who have different interests. Waving a wand in Washington to "fix" our national headlines is an attempt to abrogate a few hundred years of legal precedent in contract law, and to suggest that a practicable plan can be enacted now to have a material impact on our economy is incredibly far-fetched.

To conclude on this theme, we remain extraordinarily wary of the capacity of government intervention in financial markets by any political party as it invariably is too late to be effective, it fights the last war, and is predicated on a prescience of future events that has eluded the world's smartest men since the dawn of time. It is mind-boggling that we are re-employing the exact policies of easy money, artificially low interest rates, and giant fiscal stimulus that produced the bubble that is now bursting. The lesson of the 1930s and the last six months is that massive changes in government activity will produce only hand sitting by the private sector. What is needed are permanent, predictable rules and policies that will reverse the flow of trillions of dollars that are currently fleeing to the world's largest mattress feathered with zero percent Treasury Bills. Good luck to us all.

So if we can survive the attempts to help us help ourselves, which markets have sporadically dealt with for hundreds of years, we can get back to the day-to-day analysis of trying to buy bargains from distressed sellers, which has a lovely ring to it. We once again pose the question, why is it that stores are full of people in the worst recession in post-war America looking to stretch their holiday dollar with lures of "50% to 80% off," yet the same offer in stocks produces more fear and loathing?

We have employed our time honored process in periods of market stress - admit mistakes, do not be afraid to add to existing positions where nothing is fundamentally wrong for the long run but the price of our initial purchase, and add new ideas that seem to be regularly falling from the skies. We are not in anyway predicting a V-shaped turn in the economy and we are being heavy handed in the assumptions we use to assess economic value. But with great businesses possessing reasonable to superb balance sheets and excellent long-term prospects, we see truly stunning valuations. Might these ideas continue to get cheaper as they have for the better part of the last year? Yes, but the only people who consistently sell at the top and buy at the bottom are either liars or were employed to sell Madoff's investment vehicle. You are being paid extraordinarily well today to accept timing risk.

As far as the new Administration and how "change" will effect investment decision making, there is clearly going to be a giant increase in the noise to reality ratio, and we will look to take advantage of truly silly enthusiasm or depression in certain sectors as we can point out currently exists in energy/ green initiatives and healthcare. As Will Rogers said about FDR in the 1930s, "The whole country is with him…if he burned down the capital, we would cheer and say, 'well at least we got a fire started.'"

We would like to wish everyone a truly wonderful new year in 2009 and we are reasonably confident it will be a lot more profitable than 2008. We appreciate the partnership we have with our clients, and recognize the habitual difficulty of sticking to a disciplined, long-term, value-oriented investment strategy in times of distress. But this discipline has proved itself well past our own fifty year history and we look forward to our patience being rewarded. (Sooner is preferred.)

We at RCB have developed the habit of going back to the basics when traditional tactics seem to be temporarily devoid of success and thus we close with this excerpt from the Berkshire Hathaway 1994 Annual Letter to Shareholders:

"We will continue to ignore political and economic forecasts, which are an expensive distraction for many investors and businessmen. Thirty years ago, no one could have foreseen the huge expansion of the Vietnam war, wage and price controls, two oil shocks, the resignation of a President, the dissolution of the Soviet Union, a one day drop in the Dow of 508 points, or Treasury bills yielding between 2.8 and 17.4%. But surprise, not one of these blockbuster events made the slightest dent in Ben Graham's investment principles. Nor did they render unsound the negotiated purchases of fine businesses at sensible prices. Imagine the cost to us then, if we had let the fear of unknowns cause us to defer or alter the deployment of capital. Indeed, we have usually made our best purchases when apprehensions about some macro event were at a peak. Fear is the foe of the faddist, but the friend of the fundamentalist."

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