

Market Commentary
Period Ending September 30, 2008

The events of the third quarter clearly approached historic standards and it was truly difficult to find bright spots in which to make money across nearly any global asset class, much less individual equity sectors.

Our Small Cap portfolio continued to struggle during the quarter while our Large Cap strategy outperformed the market. While we agree with the statement that in general small cap stocks have been under tremendous pressure this year from index and hedge fund liquidations and are negatively correlated to credit conditions, the fact is that we have executed poorly on timing decisions in a market that is punishing poor timing.

We have done a decent job in financial stocks as we developed and stayed with a strategy that sought to minimize our exposure to global credit markets. While continuing to look for financial companies with balance sheets that made them survivors, we focused on management teams whose history suggested an ability to take advantage of cyclically difficult times and come out on the other end much stronger and more valuable. This has worked well with Berkshire Hathaway, JP Morgan Chase, Annaly Mortgage, White Mountains Insurance and Allegheny Corp. We continue to think the survivors in this area represent compelling value for the long run.

While the multitude of headlines associated with today's financial environment make it difficult to get a clear understanding of recent events, the basic theme remains that the world is grappling with a global retrenchment from what was practically speaking the easiest credit environment in the post-WWII era. As the pendulum swings from greed to fear, we are working our way through a myriad of economic players who are cutting spending, hoarding cash and focusing on return *of* capital rather than return *on* capital. Nothing highlights this more than a three month Treasury bill rate of 0.35% (annually) as of this writing.

The "Rescue Plan" – to use its politically safe name - is laden with the usual and expensive nonsense that Washington is always happy to supply in great quantity. The practical effect is that there will be a well-funded buyer in the market for distressed assets, which is likely to support the asset values of otherwise reasonably funded financial institutions. This helps to remove a portion of the true fear and loathing in the global markets as any sense of thawing in this otherwise frozen credit environment is good news and will eliminate existential fears for a number of financial players. We welcome the opportunity to focus on the garden variety problems of an economic global slowdown, which in our experience is easier to handicap than the whims of the Washington political class.

So we are clearly stuck today between attempting to recognize the true tectonic changes occurring in the world financial markets that will seem blatantly obvious in retrospect and the age old problem that the future is uncertain and cannot be predicted with any reasonable and



consistent accuracy on which to base a long-term investment process. There are many inexpensive stocks that with the benefit of a long-term time horizon should and are being prudently purchased. The pain, however, is tangible when we start to buy a stock at \$60 that has fallen from \$100 and we determine to be worth \$90, but is merely on its way to \$40 first. We are judiciously evaluating new ideas as well as our current portfolio in our continuing effort to improve the risk/reward of the portfolio. As we have noted many times in the past, the stock market is a voting machine in the short run and weighing machine in the long run.

We feel it is apt to end with the Horace quote found on the opening pages of Ben Graham's *Security Analysis*: "Many shall be restored that now are fallen and many shall fall that are now in honor."

We welcome your comments as we navigate these extraordinary times in the financial markets.

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