



Market Commentary

October 1, 2007

It is quite an understatement to say that things look a little bit different today than at the time we penned our last letter three months ago.

Our foremost thought is the disappointment in our short-term performance in the midst of the recent chaos in the market. For the better part of the last eighteen months, we have talked about our perception that the best values seemed to be in the higher quality companies. We were convinced that concentrating the portfolios in these types of names would not only provide a high probability of solid absolute returns, but also would produce good relative performance if the market should succumb to a variety of potential problems. Annoyingly, the first round did not go to us, which is even more surprising given a near zero exposure to the usual suspects – homebuilding, mortgage related finance companies and the like.

In our Large Cap and All Cap portfolios we did have some self-inflicted wounds, such as the decision to overweight Tyco International prior to its dissolution into three publicly traded companies. We liked the long-term fundamentals of all three businesses and their respective valuations, and felt it appropriate to position ourselves so that we would own full positions in the subsequent companies when the break-up took place in late June. After a good start, this investment approach was hobbled during the summer by the disruptions in the market and cost us in the short-run. We remain confident in the long-term potential of all the former Tyco businesses and have subsequently added to the positions.

In our Small Cap portfolio, we have waded into the headlines and added to our position in Annaly Capital, a mortgage REIT that is the *only* one of its kind that is showing a gain for the year. We also purchased Capital Trust, a commercial mortgage REIT that fell 50% this summer. Both were purchased near or at book value with normalized double digit yields, solid liquidity and are run by “grown-ups” who have the experience to profit from the chaos in the mortgage markets. Liquidity fears and volatility affect small cap stocks to a greater degree than their larger brethren and thus we are beginning to see some tremendous opportunities.

On the fixed income front, for the first time in nearly three years, we are beginning to see opportunities in non-government bonds and agencies. Yield spreads ballooned out in a number of corporate issues, but in many cases, it was a return to their long term averages. After a very long drought we would expect to see more opportunities in this area. However, we remain wary of complex asset-backed securities for all the reasons you can think of, and then some.



Remaining focused on the perverse randomness of stock market performance over short periods of time, we could pull statistics revealing the recent underperformance of the “cheapest” segments of the stock market relative to the overall market, which is again a historically unusual event. As we noted at length in our recent Strategy Letter, “value” investing in early 2007 had become a bit too popular, as evidenced by the number of value-oriented long-short quantitative hedge funds, activist investment strategies and passive index vehicles. So when people panicked or had to sell for margin reasons, liquidity became the driver and led to strong selling amongst many of the quality companies we own.

As annoying and sometimes painful as it is to go through, long-term value investors need periods like this in order to restock the performance cupboard. Newspaper headlines using words like “fear” and “crisis” tend to be fertile points in time for those with a long investment horizon to steel up the discipline and buy companies with solid fundamentals. That is what we have done, as all of our investment strategies are now fully invested.

This by no means suggests we will not have further economic problems or financial panics, as there are always plenty of things that can go wrong in the future. But is this another case of a classic mass behavioral finance disorder in which fear outweighs the facts? Abusing the “sub-prime” issue as an example, let’s say you take \$1 trillion in sub-prime mortgages and assume that 25% of them default. Let us further assume a 25% decline in real estate prices producing a 25% loss ratio on this trillion dollars. That means someone, somewhere, will have to absorb \$62.5 billion in losses over time. Now, a billion here or a billion there can add up, but frankly a \$62.5 billion loss in a mortgage market of \$11 trillion, a US economy of \$13.2 trillion and a stock market of approximately \$15.5 trillion should not produce earth shattering tremors of loathing and despair.

We welcome any questions you have on your portfolio or our investment strategy. Finally, we would suggest for the first time in quite awhile, this is an excellent time to consider adding to your account at Reed, Conner & Birdwell – we’ve got things to do.