

---

**August 14, 2007****INVESTMENT POLICY MEMO**

In January 2000, Steve Case the Internet entrepreneur who founded and owned a large part of AOL, persuaded the management of Time Warner to a merger between the two firms. AOL was much smaller than Time Warner: a one service (Internet access) company versus a venerable titan of publishing, movies and cable TV. Nevertheless, in a negotiating coup that ranks close to Bill Gates' famous outfoxing of IBM, Case and other AOL shareholders ended up owning well over half of the combined company. In effect Case sold AOL for the more pedestrian and durable values of Time Warner's businesses. His timing was superb. Two months later the Internet bubble burst. After seven and a half years, almost all of the leading bubble stocks remain far below their prices in early 2000.

In late June of this year, Steven Schwarzman, the founder of Blackstone Group, a leader in private equity and hedge funds, may have shown even better timing by offering shares in his company to the public. Schwarzman solidified the five billion dollar fortune he earned over the past twenty years, often by dubious means. Meanwhile, the purchasers of his stock experienced declines starting the day after the offering and the stock market peaked only one month later.

The broad stock market high in late July was just about equal to its peak in March 2000. Since then stocks and bonds all over the world have been jumping around much more vigorously than they had for the previous four years. Actually, jumping off a cliff (small so far) would be more accurate for most stocks. And you can make that a big cliff for many low-quality bonds backed by mortgages or by businesses purchased with too much debt, and for many of the commercial banks, mortgage originators, hedge funds and Wall Street investment banks deeply involved in these excesses of greed.

This may not be the perfect storm, but we do see a similar confluence of numerous, independent factors, each of which is negative for stock prices. At their peak level on July 19, we calculated that the expected total return for U.S. stocks over the next year was about zero. So, unless we were and are way off the mark, stocks were due for a correction. The correction began with a sharp decline the day after the new high. An immediate catalyst was news about defaults in some safer categories of mortgages than the "sub prime" group, coupled with a string of statements from Bear Stearns, the large Wall Street broker and investment bank, announcing that two of its hedge funds that invested in mortgages, and borrowed heavily to do so, had lost all or nearly all of their multi- billion dollar values.

An unusually high degree of uncertainty has also contributed to volatility and price declines. Uncertainty and volatility are of course the norm for stock markets. As John Maynard Keynes pointed out long ago, the future, on which correct stock values depend, can never be seen clearly. Accordingly every relevant small fact that becomes known today has a disproportionate influence on a market always feeling its way in the dark. Currently, the relevant facts are not so small, consisting as they do of announcements of multi-billion dollar losses by large institutions invested in mortgage funds and a number of bankruptcies. Since most of these announcements

were generally unexpected, the uncertainty is now even greater about how many more such announcements might still be forthcoming, how large the losses might be and who the losers might be. No wonder stock prices have been volatile. Greater uncertainty leads to greater divergence of opinion among investors, which is probably why New York Stock Exchange volume has set big new all time records in each of the past three weeks. If everyone thought the news was going to get better, prices would rise on little or no volume until everyone thought the better news to come was already in the price and vice-versa if everyone was pessimistic.

Added to this is the potential for a declining housing market to veer into a collapse as lenders foreclose on property and re-offer it for whatever they can get in a market already burdened by large inventories of unsold houses. In the 1930's this phenomenon was an important part of the Great Depression. The structure of banking and mortgage lending has changed so much in recent years that there is also uncertainty about whether the Fed or other government agencies could forestall another such episode.

Coming back to Mr. Schwartzman and Blackstone, yet another strand of bad news for the stock market is the unraveling of the private equity buyout boom. The essential ingredient in a successful privatization is a ton of borrowed money. This is traditionally raised by selling what Wall Street, with uncharacteristic frankness, has long called junk bonds. In recent years junk bonds with a very high probability of default have been sold to state pension funds, college endowments and others at very modest interest rate premiums to safe U.S. government bonds and without most of the traditional covenants that protect bondholders. In the current environment these investors have suddenly become fearful, as well they should. As a result the investment banks are stuck with hundreds of billions of dollars in junk bonds that they expected to unload on their previously unresisting customers. Consequently, investment banks are now extremely reluctant to create more leveraged-buyout debt that they might be stuck with.

The acquisition of publicly traded companies by private equity firms has been one of the drivers of the stock market boom. However, the more important reasons for rising stock prices have been benign inflation, low interest rates and rapidly rising profits in a growing economy. Each of these has been diluted or made less certain in recent weeks. Rising food prices around the world and especially in developing economies, added to the continued prospect for high and rising oil prices, cast at least modest doubt on the continuation of benign inflation. Some categories of interest rates are now higher, or credit is unobtainable (i.e. jumbo mortgages, junk bonds, loans to hedge funds, etc.). And the evidence continues to accumulate that U.S. corporate profits, while still growing, are doing so at a steadily decelerating pace.

We think the chances of a recession have been increased by recent events, but by only a small amount. Sales of autos, light trucks, houses and household goods have each been declining for one to two years. This slowdown in consumer spending has been partly offset by a declining foreign trade deficit related to faster growth in the rest of the world, partly by modest growth in local government spending; and primarily by the growth of business investment. The growth of business investment has recently been erratic and is now at risk. Capacity utilization has fallen modestly in the last nine months for the first time in this economic expansion. Coupled with weak consumer spending, this might remove the motivation for many investments in new

capacity. In addition, as mentioned above, the housing decline could turn into a recession-causing rout.

However, the vigor with which central banks have poured money into the banking system encourages us to think that they are very alert to the possibility of a liquidity crisis going out of control. Moreover, the pain already being felt by wealthy home buyers and sellers, not to mention wealthy Wall Street moguls, suggests that both the Bush White House and the Democratic Congress will be eager to provide relief to the housing and mortgage markets by authorizing expanded purchases of mortgages by various federal agencies. Indeed this is something the Fed has already been doing by encouraging banks to offer it mortgage backed securities for the repurchase agreements it has used to add money to the system. All in all, we think there is between one chance in ten and one chance in five, that a U.S. recession will begin in the next twelve months.

As indicated in our last Investment Memo, the portfolios we manage were reasonably well prepared for the market decline over the past month and for the increase in volatility. We continue to hold substantial amounts in cash and high quality bonds. We have held a smaller than average amount in financial sector stocks for at least the last three years. Our portfolios have large exposures to faster growing overseas economies and are designed to benefit on balance when the dollar declines. So far this year most of our accounts have done as well or better than the market when it has advanced and usually better when it has declined. They have held up quite well since the market peak a month ago.

At the moment we see little reason to make substantial changes in our investment posture. Since the recent turmoil is unlikely to significantly increase the chances of a recession, it is probably too late to increase cash and bond reserves. But, since the confluence of events depressing the stock market has yet to run its course and prospective returns from current levels are still rather small, it is probably also too early to buy more stocks.