

THE SYSTEM IS WORKING

Background

The U. S. economy has always been cyclical in nature - having ups and downs exacerbated by fear, greed and a host of other factors. Eventually the long-term trend reasserts itself in the growth of gross domestic product, productivity and corporate profits.

During the good times, corporations, the government and investors become complacent, which leads to less discipline and potential trouble. This trouble often manifests itself in a speculative bubble or some form of overvaluation in a particular area of the market. The system eventually corrects itself and the excess is purged. The cycle then begins anew, only to be repeated as time passes.

What Has Changed This Time?

Not much. Two pillars of the human psyche, fear and greed, continue to drive these cycles. Within this context, we have found that there are at least eight generalities common to the typical boom and bust. Each of the generalities contributes to ensuring the economic system works efficiently.

First, there is always a trigger that begins the corrective process of purging the excess of the last cycle. In 2000, it was technology stocks that reached unsound valuation levels. This time around, it is the real estate market that has experienced unsustainable price increases and has led us to the ongoing sub-prime fiasco. This trigger is the first step to purging the excess.

Second, the unwinding process takes on a life of its own depending on the areas that have been most exploited. In the last bear market, it was technology and large cap stocks that suffered the most, creating pain and discomfort in their own way. Currently, it is the real estate and mortgage markets, along with construction and other related industries that are undergoing their own agonizing purging process.

For example, it will take a number of years to move houses and properties from those who cannot afford them to new owners at lower prices. Some of the "flippers" - those buying houses with the expectation of turning around and easily selling them at higher prices - have been caught with properties that must be carried with all the costs (interest, insurance, maintenance, utilities, etc.). Eventually, they will have to lower the prices far enough to attract buyers. As this happens, buyers will eventually come to the table. We are already hearing stories of buyers going to auctions to find bargains from those who have to sell. The system is working and the excess from the housing bubble is being cleansed.

Third, a correction or bear market typically comes along to correct the excess of the last bull cycle. The current correction has been underway since July, 2007, when most stocks reached their highs, as measured by the advance/decline line (a net cumulative daily total of stocks moving up or down). Typically, the corrective process lasts long enough to sufficiently flush the excess from the market and eventually creates opportunities. It is important to realize that the correction in stock prices may take less time than it actually takes to cure the "bloated" part of the economy.

Fourth, as the economy starts to falter the Federal Reserve Board becomes more active by typically lowering interest rates and making credit readily available to the banking system. So far the FED has initiated a number of interest rate cuts starting on September 18, 2007. These interest rate cuts have put short and long-term interest rates once again into their lower ranges of the last 25 years. Thus, consumers and businesses have seen a general lowering of borrowing costs.

In addition, the FED has taken aggressive and creative action in bailing out Bear Stearns, a brokerage house with large exposure to the highly leveraged, riskiest portion of the mortgage market. Some observers are concerned about the extension of the FED's role into the corporate arena as opposed to being banker of last resort to just the banking system.

Fifth, the government takes center stage - especially in an election year - with many political proposals to bolster the economy (spend and elect). Congress will be supporting, proposing and debating various vehicles over the coming months to stimulate the economic environment.

Additionally, a new wave of regulation designed to help us avoid the dangers of future excess, will likely be debated and possibly implemented. The last such regulation, the Sarbanes-Oxley Act of 2002, was enacted to combat the kind of accounting woes we experienced with WorldCom, Tyco and Enron, among others.

Sixth, companies, spurred by their directors and managements, become cost-conscious and cut jobs. Jobs are currently being cut in various industries from mortgage and construction companies, to investment banks and other financial institutions. While painful, such action puts companies in a position to curtail profit erosion, and to capitalize on increased sales as consumer spending picks up again in the future.

Seventh, all the worms don't crawl out at the same time. We suspect that a number of hedge funds own assets that have doubtful value, or substantially diminished value, as a result of speculation in highly leveraged mortgage vehicles. Once again the creative geniuses of the financial institutions have left many participants with highly leveraged (some as high as \$30 debt to \$1 equity ratios), so that a small drop in the underlying value wipes out the speculative instrument. Las Vegas may have better money-making odds in some cases.

One hedge fund, the \$2 billion Pardus Capital Management LP, halted investor redemptions on April 1, 2008, at a time when many of its assets were plummeting in price. Pardus has lost approximately 40% since its 2007 peak without the use of leverage. Earlier, a couple of hedge funds lost all, or most of their investors' capital with highly leveraged mortgage products.

Eighth, the people who should have known better – didn't. Simply put, the banks should have known better. They have been willing participants in the careless lending that has defined the last few years, and have been instrumental in creating new, speculative instruments and hiding them off their balance sheets. So far, some of the biggest individual bank losses and write-downs have been:

UBS	\$ 38.3 Billion
Citigroup	\$ 21.7 Billion
Bank of America	\$ 7.7 Billion
Deutsch Bank	\$ 7.3 Billion

The impact of these write-downs is deteriorating debt to equity ratios, which leaves these firms needing to raise more equity capital at expensive prices. Again, the system is wringing out the excess.

In the context of the eight generalities illustrated above, we are constantly going through the same old cyclical pattern. The only caveat is that there are always a few new quirks and

twists to make things look different from what we have gone through in the past. While inflection points such as these can be unsettling, it is important to realize that the system is working and will continue to work through this crisis and the next.

What Should We Do Now?

(1) It is important to realize that we have been preparing for the current environment for some time. Beginning in 2006, we started selling some of our more cyclical stock holdings that had done extremely well coming out of the bear market following the tech bubble collapse. Our reasoning was that economic momentum was waning and we were entering a slow growth period.

Whenever economic momentum stalls, you have the possibility of a recession. Recessions are almost impossible to forecast in advance, but it is sometimes necessary to prepare before the conditions are fully known and prices have declined. We did not realize what "mass stupidity" was about to be revealed with the sub-prime debacle, but we prepared for the possibility of declining prices and it has paid off.

(2) To replace those cyclical stocks, we bought positions that have the ability to make progress in the face of a slower growing, or faltering economy. Hence, our emphasis on medical companies, drug retailers and wholesalers (thus avoiding the problems with specific drug company products), food companies, household products essential for daily living, etc.

(3) *These selections have significantly cushioned our clients' portfolios over the last number of months of market volatility and correction. Stock selectivity, while not being perfect, has made a tremendous difference.*

(4) At some point the worst of the bad investments, bad loans, highly leveraged vehicles, etc. will be known (we have seen a lot already), and it will be appropriate to consider some of the stronger "fallen angels" again. With great turmoil frequently comes great opportunity.

(5) But when, and what to buy? We look for the economy to wobble along for the coming months with disappointing sales and earnings as this slowdown further defines itself. As always, we are continually reviewing our existing stock holdings to make sure their fundamentals and stock values remain favorable. When they reach their sell targets, we will sell them and purchase other attractively valued stocks. Capital gains tend to disappear when you hold overpriced stocks hoping that they will continue to appreciate over the long-term. The low capital gains tax rate makes such a strategy exceptionally easy at this time.

(6) We are combing through attractive new purchase ideas for consideration when the timing is right. This type of market often offers opportunities and this is certainly true now.

In Summary

Since the outlook is not dynamically upward, we expect the markets to remain volatile as investors sort out the positives and negatives of what is happening in the economy and in the financial markets.

Most important, we believe our clients' portfolios are in an excellent position for capital appreciation over the next several years. As is evident, the system is working.

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