



## Third Quarter 2008 Performance Review

So this is what a twenty-first century financial crisis looks like! It's worldwide. Money moves seamlessly around the world and so does panic. Our banks and brokers pulled off the covers on their assets to show less than they were supposed to have and now foreign firms are being forced to show us theirs. We try to calm investors' fears by buying assets from troubled banks and fears spread to Europe about what their banks are hiding. Ireland guarantees their banks and money flows out of the other European banks to what is perceived as a small island of safety.

A minor downturn in our economy causes a worldwide dive in commodity prices and a crash in emerging markets' stocks. Morgan Stanley is bailed out by a Japanese bank. Hartford Insurance is bailed out by a German Insurer, a French bank is bailed out by the Belgium government and Iceland asks for help from Russia.

Every night, trillions of dollars moves around the world to find a safe place to get the best yield. Sometimes, the emphasis is on yield, now it's on safety. But safety is in the eye of the beholder. At best, a bank has one dollar for every ten dollars it loans. So are banks safe? Only if you trust them or there is a government guarantee.

That's why we have the FDIC; otherwise you'd have to look at the balance sheet of your bank before you made a deposit. But the trillions of dollars that moves around the globe doesn't have FDIC insurance, so they need to know that their money won't go into a black hole like the one that was created when Lehman defaulted on their debt.

The fear of losing money can cause a panic. Actually seeing billions disintegrate can cause hysteria. We have hysteria! There is a run on the world's banks and they only have a buck for every ten bucks they lent. So, now what?

George Bailey could magically appear as he did in "It's a Wonderful Life" and stop the run on the savings and loan, or the world's central banks could come to the rescue. I think it's likely that the world's central banks lead the rescue. That's what they were created to do. That's the difference between now and 1929 when they didn't exist and why we have a fighting chance of getting through this crisis alive.

Once we get through this financial crisis, and we probably will, the question is; will the recession be worse than the stock market has already anticipated? The stock market is down about 40% from its high a year ago, which would indicate earnings could drop about 40-50%, unemployment could go to 10% from about 6% today and we could have a full year of negative GDP. That's what the market is

assuming based on the fact that it's selling at about 11x forward earnings, the lowest level in about 25 years. If the recession will be worse than what the market has already assumed, worse than 2001-02, worse than 1990-1, and worse than 1980-82; the market will probably fall further but the chances of that happening seem pretty small.

The world's central banks have now pledged something like two trillion dollars to support the financial system. The world's major banks are now effectively government insured. The world is lowering interest rates now, before the apparent recession has officially begun. We don't know how bad the disease will be but we are already putting the patient on antibiotics. This is quite different than the delayed response from central banks in past recessions.

Commodity prices have already fallen giving a boost to the consumer and allowing central banks to ignore inflation and concentrate on stimulating their economies. From heating oil to plastic toys, the consumer is benefitting from lower prices now, before having to potentially suffer through two or three quarters of negative growth and high unemployment, which is the way it has happened in a past recession.

The greatest growth engines in the world, the emerging economies of China, Latin America and Southeast Asia are not apparently taking the brunt of this crisis as they have in the past crashes. After a period of tepid growth, they should be able to return to their role as a primary growth engine for the world's economy because thus far they have been able to suffer only minor damage. Years of running trade surpluses have left them with massive reserves and relatively clean balance sheets, which they can put to work to get their economies moving again. Once you start eating three meals a day instead of one and have a scooter instead of a bike, it's hard to go back.

There are real strengths in the world's economies that transcend today's financial crisis and make the likelihood of a deep, dark recession unlikely. More importantly, the basic assumptions that have guided our investment policy for many years remain in tact. US corporations remain highly competitive, capitalism is on the ascent and our markets remain open to expanding world trade. As long as these things are true, any setbacks in growth should be temporary and the best course for equity investors would be to remain fully invested.

That is easy to say, but when markets crash, account values plummet, all the news is bad and anybody with half a brain would take what is left of his money and hide it under the bed...how can we do what we know is right despite the storm raging around us? You can't listen to the pundits and market timers. Those were the same guys who told you the tech bubble would never burst, the 2001 recession would never end, you couldn't own enough real estate, and oil was going to \$200 a barrel.

I find shelter in what I wrote about in my last letter, "Investment Policy." If you wrote a policy for managing your money you could not possibly say that you would have a policy of selling in the middle of a panic: buy, but not sell. Looking at the problem of how to manage the enviable downturns that happen in markets you might say that you would try to anticipate them. Good luck trying to be smarter than the market but you could certainly try. Once in the middle of a storm, when most if not all of the damage has been done, is not the time to panic.

It was wrong to sell in 1981, 1987, 1991, 1998 and in 2001. “But this time is different,” the most dangerous phrase in investing. It’s always different, no two panics are ever the same, if they were, they wouldn’t be nearly as scary, we’d just say, “Oh, that again” and get on with business.

The plain truth is, here are times when markets just don’t work. Over the past few months, Municipalities have had to pay 7-8% for short-term loans, the commercial paper market has shut down and good mortgages with little risk of default have been unsellable. In markets like that, it shouldn’t be surprising that the stock market would suffer irrational pricing. Yes, we keep the stock market open, but that liquidity comes at a price, because when cash has to be raised it’s the only place to go. Markets are open but they probably don’t reflect anything like the true value of the companies’ equity or the credit worthiness of their debt. Markets have moved from euphoria to panic and back ever since cave men exchanged rocks for deer hides but every panic is unexpected. In every state of euphoria it is assumed the good times will last forever and in every panic we will all be poor forever.

When this panic is over, markets should return to more normal valuation and you will have plenty of time to decide what your asset allocation should be and what kind of income you can expect from your investments. You shouldn’t have done that in 2000 at the height of the market’s mania and you shouldn’t do it now when markets are irrationally low.

Markets have been chaotic and we have been anything but passive. In this market, as in past downturns, we are focused on putting cash to work, rebalancing accounts, improving equity portfolios by buying depressed industry groups, taking tax losses in taxable accounts and trading up in quality. In panics, leading companies come down to valuations typically only seem in lesser companies allowing us to buy Cadillac’s for Ford prices. Historically, this process has allowed us to benefit from bear markets. Yes, benefit! Bear markets create opportunities for the huge gains that have followed past bear markets.

We always have time to talk to our clients. If you have any questions about how we are managing your money, the state of the world or any good jokes please call us. We’d love to hear from you.

Bill Matthes

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