Client Letter

First Quarter, 2009

The world equity markets have declined for six straight quarters now, although we had some recovery in the last month. 2008 was one of the biggest calendar year drops ever, and the carnage continued in January and February of this year.

I think it fair to say that few foresaw events unfolding as they did, and the market decline that followed each new issue came suddenly and took almost all by surprise. The future has been and remains unforecastable - it is only in hindsight that things seem as clear as they do today. One good example: many of the best minds and money managers on Wall Street (e.g., Dodge & Cox, Bernstein, Bill Miller of Legg Mason Value, and many others) were recommending and buying the big banks and brokerage firms all the way down. Their best analysis was that Wachovia and Citi were screaming bargains. Ken Fisher picked AIG as his single best stock in the S&P 500 for 2008.

As of now, Nouriel Roubini, the NYU economics professor who has come to be called "Dr. Doom," is still forecasting further declines and a long recession. Mr. Bernanke has a more sanguine view.[1] Even allowing for the Fed Chairman's sensitive position, I think he is brilliant, and I also think his credibility is his most precious commodity. So my take is that he is giving us his honest opinion and being as candid as we can expect someone in his position to be. Bottom line is that great minds, as always, are not thinking alike, and we will not know who is correct until events unfold. In any case, new developments, not accounted for in any of the current analyses, will likely also affect outcomes, for better or worse.

I am not saying this to justify any past strategy or results. I am saying it because of the almost overwhelming compulsion we can experience at times like this to change course, to reduce risk, to look for a smarter strategy, a better way. Right now investors have to contemplate the world of investment opportunities before them, assess their need for investment return (defined as income, capital gain, etc. – in the end it is what you gain and have to spend, any way you define it) and their willingness and ability to take risk and suffer losses (and encounter other problems such as illiquidity). And they need to decide what to do going forward. This is always the case; we believe a periodic reassessment of investment policy and strategy is a good thing.

I would make a process suggestion for investors. Consider the needs of your asset pools, their missions and purpose, how long they will last, what they are meant to achieve. I would suggest that ought to be the driving force behind the rest of your decisions. What

[1] Blackstone, Brian. "Bernanke is 'Fundamentally Optimistic' About Economy." 14 April 2009. *The Wall Street Journal Online.* 12 May 2009 < http://online.wsj.com/article/SB123970868586316759.html#>.

are your time horizons and risk tolerance, needs for return/income? Are these assets meant to be put at risk to earn a larger return, or preserved for more immediate purposes?

In the absence of the expectation that you can time the markets and add return/reduce risk by tactically moving in and out of asset classes, you are always faced with the need to adopt a long-term strategy and have a stable commitment to the investments you choose. We strongly believe that, and a big part of our struggle over the last year in particular was trying to address the perceived need on the part of some clients for lower risk without a reduction in return. The Holy Grail of investing, if you will.

I have seen many financial firms trying to take advantage of this bad time in the market to get new business by promising new strategies to somehow generate returns without risk, or with little risk. I see brokerage firms pushing "structured product" on people, essentially offering an illiquid black box with equity, bonds and options, bundled with huge fees, offering various patterns of limited upside and downside. But I have not seen anything of value that represents a genuine opportunity in the market for publicly traded securities beyond well-managed investments in bonds and stocks.[2]

I recently watched the latest series of short presentations by Wes Wellington of DFA on the current state of the market. There are six short segments, PowerPoint presentations with Wes narrating over the slides. The last segment addresses the "what to do now" question, and is right on point for this discussion. I would encourage you, in light of the importance of the decisions being contemplated, to watch them all. Less than an hour all told. In terms of academic research and quality of presentation in a useful form, I think DFA's work is as good as it gets. You can view the presentations by copying and pasting this link into your browser: http://www.dfaus.com/share/whatshou/.

The last segment provides a straightforward framework for the discussion. What can you choose to invest in, and what do different investments offer you? Bottom line is that cash and to some degree bonds offer you relative safety and income. Cash, in fact, offers you an effective inflation hedge as well (bonds do not).

Beyond that, they look at gold and eliminate it for some very good reasons. They eliminate market timing as well. Good (brief) discussions. That leaves the investor with the main risk assets: real estate and equities, public and private. It is the choices you make about the allocation to these broad asset classes that matters most, of course.

As for our recent market experiences, I can say with some confidence that we have experienced a "Black Swan." [3] With less confidence but some real concern, I would also say that we may have moved into an era of increased volatility and risk, where once-in-a-lifetime events happen every ten years or so. Maybe. I think Taleb would quite reasonably say that we won't know until it happens, but we do not know that it won't, and we do know that it can. So in assessing risk tolerance, we may need to go beyond the

[2] I will leave alternative asset classes out of this discussion for the moment.
[3] A Black Swan is an event well beyond our expectations in both frequency and magnitude, which no one expected but which appears obvious in hindsight. Taleb, Nassim Nicholas. *The Black Swan: The Impact of the Highly Improbable.* New York: Random House, 2007.

traditional models and simply ask how well we will handle events of this size (e.g., -50% peak to trough) or worse, if they happen again. If that is what the market is like in the future, still offering long-term positive returns but with major downturns, how much of that can you stand?

In short, I would focus your thoughts on the number, the percentage of equity. Consider the risk you have in all your assets, consider the risk the world presents right now and perhaps ongoing, and consider what your needs for return are. There is no easy answer, but I believe it is critical to find the right answer for you and the assets you hold, in light of the purposes for which they are intended.

Best Regards,

Roger C. Hewins III
President

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