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TO: VALUED CLIENTS
FROM: PAUL REMACK
HAL PORTER
RE: Q3 SUMMARY & COMMENTARY

In an earlier summary this year we suggested that everyone knew what was happening and that there was no need to re-hash the known. This quarter, with all of its upheaval, is a different story. We think that it is essential for everyone, investors and non-investors, to understand how this economic turmoil came to pass. The impact this time around is fair greater than what we have experienced in prior troubled times.

In the last several weeks, the US government nationalized Freddie Mac and Fannie Mae; Lehman Brothers collapsed; Merrill Lynch was acquired by Bank of America; AIG is now owned effectively by the US taxpayer; and we are looking down the barrel of an enormous economic and financial bailout which has its own set of undefined dangers and costs. As much as we thought that 2008 was going to be a challenging year, we never could have anticipated this degree of damage and change. These circumstances have created a new landscape which everyone is exploring.

While there is no question that institutional greed and governmental lack of regulatory oversight deserve much of the blame, the issues behind the market disarray go further and merit exploration.

What went wrong? So much went wrong that it is impossible to attribute our problems to a single source. However, when we look at our circumstances we come to one large conclusion – the root causes of this financial meltdown are government related.

- The Fed acted too late Rather than increasing the money supply, the Fed has fought against the illusion of inflation for too long. There is no question that headline inflation has been high, but the economic machine was screaming for liquidity which was slow in coming.

- Freddie and Fannie dominated residential mortgage securitization These Government Sponsored Enterprises (GSE) artificially increased capital available to the housing market at the same time that they artificially lowered the cost of the same capital. Because of their implied governmental backing, Freddie and Fannie were able to raise funds at below market rates when they actually held little in the way of capital. In other words, this was a shell game. However, what made matters worse was Freddie and Fannie's entrance into the higher risk markets – by the end of 2007 subprime and impaired debt instruments represented 13.5% of the their assets. Another less-known factor was the impact of the Community Reinvestment Act, which passed in 1977. This well-intentioned act forced banks to make home loans to borrowers who lacked credit-worthiness.

- Lenders had no underwriting standards Many people who applied for subprime loans lied about their income. Whether influenced by rogue loan brokers or aggressive real estate agents or acting on their own, too many borrowers misrepresented their financial wherewithal. What made matters worse was the underlying assumption that property values would continue to increase.

- Investment banks faced asset/liquidity issues There can be no excuse for the unregulated financial innovation that led to the current credit crunch and subsequent financial disarray. But the problems impacting investment banks went far beyond their irresponsible actions. Mark-to-market rules forced banks, particularly investment banks, to value their assets to current market prices. Unfortunately, values were not determinable for many assets. As a result, some assets were overvalued and others undervalued, but the impact was significant. In addition, investment banks had the luxury of leveraging assets well beyond levels available to commercial banks. At the investment bank level, this meant that every dollar could be levered 30-40 times. In a downward market, this led to quick erosion of asset values. When investment banks began to fail, they had no direct access to Fed liquidity and had to rely on the financial commercial market. When that source of funds dried up, investment banks faced an immediate credit crunch (Bear Stearns) and subsequent demise. Even when the Fed liberalized access for the investment banks, its definition of acceptable assets was still too narrow; this led to the collapse of Lehman Brothers. While Lehman had good assets, they didn't have the 'right' assets. In the end, all these factors served to burden economy and turn a credit crunch into a credit crisis.

- Rating services dropped the ball In another example of bad underwriting, the various rating agencies failed to adequately assign risk to new financial instruments. In fairness, neither did the investment banks since they held so many of these assets within their own accounts. Too little time was spent on evaluation and too much credit was given to packaging.

With this dysfunction as a backdrop, we are now in the midst of chaos. Before Congress is a bailout proposal which offers some promise of help and hope. The purpose of the bailout is bring calm and order to the market and to free the financial logjam that has encumbered financial activity for weeks. However, there are still issues that need to be recognized. First, no one really knows the extent of the problem – while the bailout requests $700 billion, the actual requirements could be more or less. However, it is essential to note that the funds will not be needed all at once. Second, consumer and investor confidence has plunged. However, while it is critical that domestic investors be propped up, it is equally important that foreign confidence be supported since at least half of the required funding will be raised from non-domestic money. Third, it is essential to stop the domestic 'bleeding'. While real estate values and personal wealth has been impacted, we need orderly handling of credit cards, auto loans, and commercial real estate.

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Why should we believe that circumstances are going to improve? We think that genuine efforts are being made to restore investor confidence. The Fed has cut interest rates and seems willing to reduce them further. In our opinion, however, they are still moving slowly. Mortgage rates should become more affordable with the de facto nationalization of Freddie and Fannie. Assuming that the bailout is passed, the Treasury has earmarked $50 billion to support both taxable and tax-free money market funds for amounts deposited as of September 19, 2008. These are all positive moves that should ease financial concerns.

There are also efforts being made to increase liquidity and encourage market stability. Through various combined initiatives both the Fed and foreign banks have coordinated efforts to stabilize short-term rates and to bring more order to financial markets. In both the US and the United Kingdom restraints have been placed on short sales which crippled weak companies and in some cases led to their bankruptcy. Finally, and most importantly, a new model of the Resolution Trust Corporation could be taking shape as a result of the Treasury bailout proposal.

However, the most important factor is the rebuilding of confidence. We need confidence at every level. We must believe that markets are dependable, reliable, and orderly. We must believe that credit is available and that funds are safe. We must believe that assets are protected and respected. When faced by declining income and net worth, falling home prices, high debt, and tightening credit, we need more than lip service. This is why we think that we need a legitimate legislative effort to quarantine troubled assets and work them out over time. What has been ignored in criticisms of the proposed bail-out is discussion of potential cost recovery and possibly even profitability.

Conclusion This is a most serious economic time. It deserves serious attention. We strongly encourage you to contact us with questions and comments. As stated above, we are in a changing landscape. It is likely that other, unanticipated events will occur between the time this is written and the time that you read it. It is our intent to give you our clearest thoughts whenever we speak. However, in this case, the issues are so volatile that we may fall short. Despite that risk, we stand ready to help and advise you in good times and bad. Thank you for your support and interest.

This summary and commentary has been prepared in advance of quarter end. As a result, we will not include market results. We will include those with your portfolio results.

Best Wishes!