

2007 Retrospective

Without a doubt, investors will remember 2007 as the year that the housing market collapsed and triggered a credit crunch. The earnings of just about any company that was involved in homebuilding or lending were crushed, and resulting economic worries triggered stock declines for many consumer goods companies. While all this was going on, U.S. exports were booming and reached an all-time high of 12.1% of GDP (as of 9/30/07). Not surprisingly, companies with significant foreign-based earnings did well. Overseas stocks also delivered great returns. Related to the overseas story was the continuation of demand for energy and raw materials commodities from China and other high-growth developing countries—a trend reflected in the strong performance of the energy and materials-related sectors.

There was action in the bond market as well. Investors first worried about inflation and then recession. At times they worried about both. The 10-year Treasury yield ranged from a high of 5.25% in June to a low of 3.85% in November. The best action was overseas as the dollar's drop gave U.S. investors currency gains that enhanced their returns. But outside of the government bond market, perceived credit risk rose, leading to underperformance.

Remaining Focused Amidst Information Overload

"Everybody gets so much information all day long that they lose their common sense."— Gertrude Stein

In the trenches of the money management business it is a constant struggle to avoid information overload while staying on top of the right information. The amount of analysis and data and the breadth of information available amounts to a tsunami compared to what we had access to when we started our firm almost 29 years ago. But, it takes discipline to stay focused on the right information and not get distracted by the (sometimes interesting) less relevant information. Sometimes it takes creativity and persistence to find the data or research that we need to get to the right conclusions. Even with the challenges that we face with an information explosion, one thing hasn't changed, and that is the critical importance of a common sense overlay that brings us back to what really matters and helps us resist the temptation to either overanalyze or make decisions based on knee-jerk reactions. We think this common sense is one of our strengths.

So what matters most right now? Two things:

- The underlying economic and investment fundamentals

- Understanding what is reflected in current security prices

There are other things that matter when it comes to portfolio construction, but with respect to assessing competing investment opportunities—which is what investing is all about—these two areas are where we focus our attention. In each of these the challenge is the same: to sift through a seemingly limitless supply of information and determine what is most important. An additional challenge is to stay intellectually honest about what we can confidently know or assess and what we can't. (A variable may be very important but unpredictable or unknowable, like, say, next month's inflation rate.) One of the common failings of amateur and professional investors alike is thinking that they are smarter than they really are, i.e., overconfidence. All it takes is a few right calls to start believing you're Nostradamus.

2008: Big Worries ... Any Opportunities?

Our investment decisions are always made based on a multi-year outlook. This allows us to focus on underlying fundamentals and valuations—the factors that ultimately drive returns—and distance ourselves emotionally from the day-to-day "noise" of the markets and the financial media. Over shorter time periods these relationships—between fundamentals, valuations, and returns—don't always hold. This is the point made in the legendary Benjamin Graham saying "In the short-term the market is a voting machine but in the long-term it is a weighing machine."

The question most investors are asking at this point is: will the troubled housing and mortgage industries take down the economy? The underlying key is consumer spending, which makes up 70% of the economy. The contraction in the housing-related industries has a direct impact on employment and spending, but it is the related credit crunch and its impact on spending that could cause the most damage. The impact of hundreds of billions of dollars in loan losses to banks, hedge funds, and other investors means less capital available to lend, and less willingness to lend because of uncertainty about the borrowers (and because of the need to keep cash on their balance sheets to cover their own potential losses). Moreover, capital has increasingly come from outside the banking system (structured notes are an example), making it tougher for the Fed to restore confidence and liquidity.

The problem is that it is difficult to quantify the losses and impossible to confidently forecast how restrictive credit will be and for how long. There is also fear that credit problems will

spread to other areas, with credit cards being one area of concern because of permissive underwriting standards. At this point it seems pretty clear that banks will have more write-offs over the next few months or quarters and that structured investments (pools of debt that have been turned into securities), which are often highly leveraged, will suffer through more ratings downgrades as collateral values decline further. Certain types of hedge funds, which have exposure to these vehicles, are likely to suffer sizable losses in coming months. Moreover, it is very likely that lending practices will be generally more conservative, suggesting slower growth in credit for a sustained time period. A predisposition to conservative lending will make the Fed's job harder. This suggests that the current trend of less credit and higher costs probably has a way to go. This is true not just in the mortgage market (subprime and prime) but in the consumer and small-business loan market as well.

It is easy to dwell on the negatives and this is a common investment mistake that we've seen (and sometimes made) over many years. It is not a foregone conclusion that the negatives will drag the economy into recession—though some slowdown seems quite likely. Although the employment market is showing some signs of slowing (unemployment claims are starting to rise), it remains healthy. Corporate earnings outside of the financial sector are still growing. Emerging markets continue to thrive and are a positive for the global economy. A weaker dollar has helped support a boom in U.S. exports. The Fed and other central banks are aware of the economic risks and are using interest-rate policy and other measures to improve liquidity. They will not stop until they have an impact, though how quickly this will happen and how successful they will be is not yet clear. Overall, global liquidity remains strong.

Conclusion

Looking ahead, the impact of the housing slump and lack of liquidity in the credit markets has increased the level of economic risk, and recession is a clear possibility, though not necessarily a high probability. The ultimate economic outcome is not something that can be predicted with high confidence. Fear and uncertainty, while unnerving, oftentimes provide long term investors with attractive investment opportunities. If the current turmoil in the credit markets and/or an economic downturn triggers a further sell-off in equity markets, it will be important to maintain this long term perspective and take advantage of those opportunities where prudent, appropriate and consistent with your portfolio objectives.

We appreciate your confidence and trust.

Best Regards,

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