



November 21, 2008

Once again, political intransigence has helped send the market lower.

The Treasury, the Fed and Congress face a 'crisis of confidence' following changes in the Troubled Assets Relief Program (TARP) in recent weeks, as Treasury Secretary Henry Paulson decided arbitrarily to shift the program from one of surgically removing a cancer (troubled mortgages and other bad loans) to prescribing an aspirin (tossing some cash to the banks.) The announcement that the TARP has morphed into an equity infusion with a 'wait and see' component versus its original mandate to actually purchase troubled assets concerns us, as does Congress' seeming inability to creatively address the automotive industry's woes. With auto company debt trading at probable recovery levels, a pre-packaged bankruptcy seems the likely outcome, with broadly negative implications for other industrial companies and for the nation's unemployment rate.

Adding fuel to the fire is the SEC's obstinate refusal to reinstate the investor safety measures put in place in the wake of the 1987 market crash, and which were removed in recent years based on flawed academic assumptions. More than anything, the removal of the "uptick rule" for short selling, coupled with the creation of leveraged index funds – nothing more than risky derivatives for the masses – has led to unprecedented volatility. The SEC/FASB's inane "mark to market" accounting rules forced upon the banking industry should also be suspended. As the investment firm in charge of liquidating Bear Stearns' portfolio recently stated, recovery values are well in excess of the "marked" values, suggesting to us that mark-to-market accounting has failed its goal of showing the true state of a company's balance sheet.

Hedge funds continue to face massive redemptions and outright liquidation as that industry shrinks. We believe the disintermediation of hedge funds is the proximate cause of much of the ongoing selling pressure. Even those funds with above-average returns are facing redemption requests and are forced to sell assets, just as mutual funds are selling against their will to cover their own redemptions. One hope here is that we're closer to the 7th inning stretch on this than we are to the early innings.

Interestingly, as quickly as oil has dropped from \$147/barrel in July to \$52/barrel as of this writing, so too have inflationary concerns. In fact, expectations have done a complete about-face, with deflation now the primary near-term concern. As an example, in May the 2008 Social Security COLA was set at 5.8% - the highest increase since 1982. Yet the most recent consumer and producer inflation readings showed stunning declines. As commodity prices have plunged in the past few months, inflation concerns are almost non-existent today (outside of the backward-focused European Central Bank.) And while the amount of money the Fed is pumping into the system today may indeed cause inflationary pressures down the road as economic activity recovers, the Fed must continue to provide liquidity to the system in the near term.

Where does that leave us? In intraday trading on Thursday, November 20th, we hit levels of 776 on the S&P 500, down 50.5% from the intraday high of 1576 reached just over a year ago on October 11, 2007, and at the same time tested the intraday low of 775 reached six years ago on October 9, 2002. This may provide some psychological support at these levels.

We are somewhat heartened to see the 2009 consensus earnings estimates for the S&P 500 make a slight bump higher in the past week, for the first time in many months. We also know that a number

of stocks have gone from compelling long-term values to outright fire-sale inexpensive – for example, a major computer manufacturer now trades at only two times the net cash on their balance sheet, suggesting that the company’s operations are virtually worthless. As they reported positive earnings recently, a zero value seems unlikely to us. The problem, as we have noted, is that just because a stock looks “cheap” doesn’t mean it has finished going down, so there is still risk stemming from the issues cited above. However, as frequent CNBC commentator Art Cashin pointed out this morning:

"We're at a point where the viability of enterprises is being overlooked ..."

Though the recession may be long and deep, it appears to us that prices may have already discounted the worst of the economic downturn. We are not calling a “bottom,” but as a firm we intend to selectively equitize a portion of the cash balances we have held on the sidelines, where the cash is not needed for distributions and for those clients who have not expressed a concern for buying. Most likely we will add a small position in the S&P 500 index via an exchange-traded fund. This will give us broad participation in any rally from this point. Also, as we find what we believe to be undervalued individual securities with a measurable margin of safety we will add these to the portfolios as well, and in time swap the index holdings for individual positions where appropriate. As we have said in recent communications, we expect value opportunities will persist for an extended time.

We are also reviewing the gain/loss status of taxable accounts and may be eliminating some positions, even at depressed prices, to harvest losses for tax purposes. (Some of these may be repurchased again in the future.) Even if losses are not needed this year to offset gains, it may still make sense to realize them now for use against future gains as they can be “carried forward” to subsequent tax years.

As we head into the holidays we are very aware that the economy, the stock market, and the impact they have had on you and your families will be very much on your minds and part of your conversations at the dinner table. While we have not come out of this unscathed, we believe our investment philosophy and our diversification has helped shelter us from the worst of the storm. This Thanksgiving we at FBB Capital Partners are thankful for the confidence that you have entrusted us with and we look forward to continuing to serve you.

Best regards,

Susan Fulton & Mitch Schlesinger