Ponderosa Investment Group LLC
INVESTMENT LETTER

First Quarter 2008 • V8

The problems facing the financial sector and potentially the overall economy are more complex and more severe than anything I've seen in a long time.

However, there are some positives, including strong exports among domestic companies, and the Fed's commitment to formulating a strong policy response that addresses the underlying issues plaguing the financial system.

Stocks aren't pricing in a severe recession, but further declines could lead to attractive valuation levels. I've identified points at which I will increase the equity weightings.

Quarterly Investment Commentary

Stocks were down sharply in the first quarter. A few strong days at the end of March were not enough to offset the pain of the roughest quarter I've seen in a number of years. Large-cap stocks were off by 9.4% for the first three months of the year, with growth modestly underperforming value. Mid- and small-caps were down by roughly equivalent levels of around 10%, and growth's underperformance of value was more significant as market-cap dropped. International stocks also had a rough quarter with the MSCI EAFE Index losing 8.9% for the first three months. Commodity futures, as represented by the Dow Jones –AIG commodity index, did very well, gaining 9.6%. REITs managed a decent quarter, with a 2.2% gain, while high-yield bonds were off by 3% as bond investors shunned risk.

2008 Index Performance	1st Qtr.
Citigroup 3 Month T-bill Index	0.71%
Lehman Municipal Bond Index	-0.61%
Lehman US Aggregate Bond Index	2.17%
M.L. US High Yield Master II Index	-3.04%
S&P 500 Index	-9.44%
Russell 2000 Index	-9.90%
MSCI EAFE N$ Index	-8.91%
Dow Jones – AIG Commodity Index	9.60%

Investment Views

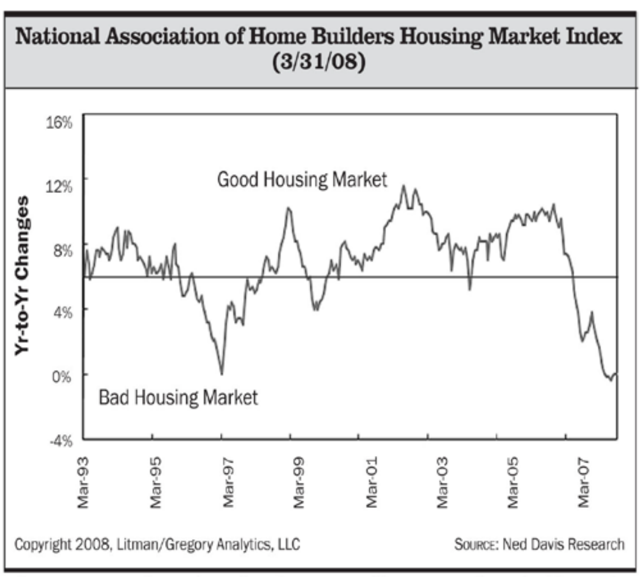
In the 2001 Berkshire Hathaway Annual Shareholder Report, Warren Buffet wrote, "You only find out who is swimming naked when the tide goes out." Well the tide has gone out and it's not a pretty sight. Though I wore my swimsuit, I did not fully appreciate the economic risks that have become apparent. I've often said that accurate economic forecasting is difficult and therefore I rely on valuation work and scenario analysis as the basis for investment decisions. That approach has been helpful to me in this environment but it's likely that we are not yet out of the woods. In terms of stock market prices, it is likely but not certain that we are now closer to the end than the beginning of the bear market, though more downside remains very possible.

This quarter I've chosen to communicate with you in a Q&A format because I believe it is the most reader friendly and efficient way to explain my thinking on a range of sometimes complex topics, not all of which will be interesting to all readers.

What is your view of the U.S. economy?

It's probable that we are already in a recession. It's clear that the severely troubled housing and credit markets are beginning to have an impact on the health of the overall economy. The worst phase of the credit market problems could last for several more months, and the housing problems could continue into 2009. High energy costs definitely don't help but are not the primary problem. The problems facing the economy are clear:

- **Housing:** The housing market is in the worst downturn since the 1930s and the evidence strongly suggests there is still a ways to go. With a massive backlog of unsold homes and waves of foreclosed properties continuing to hit the market, it could take a year or longer to get inventory levels back to normal. The weakness in the housing market reduces wealth and spending, increases unemployment, and continues to contribute to dysfunctional credit markets.



The Housing Market Index is based on a monthly survey of home builders and is composed of: traffic of prospective buyers, current single family home sales, and expected single family home sales in the next six months.

- **Dysfunctional Credit Markets:** The bottom line is that credit markets are not functioning properly at present. There is an adverse feedback loop in play with losses from leveraged entities forcing them to sell assets (deleverage), which triggers more losses, and so on. The ability to borrow money at a reasonable cost to support consumer spending and conduct business is essential for a healthy economy. Perhaps even more important to a stable economy is the ability to refinance maturing debt. The longer the problem lasts, the more damage there will be to the economy.
- **Labor Market and Consumer Spending:** Not surprisingly, we are now beginning to see a clear weakening in employment and consumer spending. A weak labor market could feed back to trigger more defaults as people have a harder time servicing their debts. This could delay recovery in the housing and credit markets and become a self-reinforcing cycle. Meanwhile, declining consumer spending will impact corporate profits.

It is also worth noting that while most of the rest of the world is doing better than the U.S., Japan's economy is also struggling and Europe's is slowing. It seems likely that most of the developed world will continue to weaken. The emerging markets are in better shape; however, I don't expect them to be fully immune from economic weakness in the developed world.

What are the positives?

The biggest positive for the economy in the near term is the aggressive, and in some respects, unprecedented action of the Federal Reserve. Though the Fed's moves have not been as effective as they would like, they have made it clear that they will do what it takes to stop a major downturn and they still have weapons in their arsenal, such as directly buying mortgage securities in the public market.

The dollar's weakness has also significantly improved the competitiveness of U.S. businesses versus foreign competitors. Export strength is already happening with exports contributing a significant one percentage point to economic growth over the last six quarters (annual rate). This almost offsets the economic impact thus far of the housing downturn. This benefit could diminish if the global economy weakens significantly, however.

Finally, outside of the financial sector, companies are generally flush with cash, especially relative to debt-service needs. Balance-sheet strength is surprisingly healthy for this late in an economic cycle—the result of strong profit growth and below-average capital investment in recent years.

Do today's economic stresses have any longer-term economic ramifications?

There are two potential long-term ramifications. First, as the Fed and policy makers attempt to break the adverse feedback loop, the amount of stimulus that is being required increases the potential for higher inflation down the road—not 1970s style inflation, but more than we've been accustomed to. Inflation is unlikely to be a near-term problem because a deleveraging (debt reduction) and recessionary environment is deflationary not inflationary. But longer-term, the increased supply of dollars has to go somewhere and that raises the risk of inflation. It also undermines the dollar's value relative to other currencies. That's also inflationary as imported goods cost more. The second ramification is the likelihood of continued deleveraging on the part of households for several years, resulting in slower credit growth (less borrowing) in the next recovery. If consumers borrow less and spend less, economic growth and corporate earnings growth will be slower than they would otherwise be. All this raises the risk of some stagflation in the next economic cycle.

How would you summarize Ponderosa's current investment posture?

Currently, there are few compelling asset class level opportunities; however I do have two noteworthy tactical moves in play.

- I continue to have an underweight level of equity exposure; this was achieved with an exchanged traded fund(ETF) that returns two-times the inverse (opposite) of the S&P 500 index. The U.S. equity exposure is overweighted to larger companies and underweighted to smaller companies based on relative valuations and economic-cycle factors.
- I continue to hold a portion of the fixed-income exposure and equity expose in cash.

What investment moves is Ponderosa considering?

Currently I plan to overweight exposure to large-cap stocks by 5% if the market drops about 10% below its current level (I continue to view large-caps as offering better value than small-caps). The plan is to buy an S&P 500 ETF or index fund with proceeds from cash and the sale of the inverse S&P 500 ETF currently held in most accounts. In the event that stocks continue declining beyond that point, I have identified the market levels at which I would make additional tactical purchases of equities. This is an important part of my investment discipline that helps to ensure that I not hesitate when presented with good long-term opportunities in the face of what would be a very negative immediate stock market environment. It is also possible that I will have tactical opportunities in areas such as REITs, high-yield bonds, and emerging-markets equities. If this happens, I expect to adjust the strategy to allow for exposure to multiple opportunities.

Closing Comments

As I write this, market volatility continues—but in the last week or two it has been on the upside. However, I suspect this will continue to be one of the most challenging investment environments I've faced, at least for a while. I believe investors may still be underestimating the losses yet to be written off by the financial sector and the resulting economic ripple effects. If stocks fall further, it will represent an attractive buying opportunity for long-term investors. And while I believe it is important for me to discuss the more negative possibilities, I reiterate that it is possible that we are close to a bottom, or that we have already reached a bottom. I can't know what the near-term is going to bring, but at times like this when economic uncertainty is high, the discipline and research process keeps me grounded and gives me confidence in the ability to make sound long-term decisions.

I appreciate your confidence and trust.

Best Regards,

Jim Cheadle
Ponderosa Investment Group, LLC

Contact Information

4888 NW Bethany Blvd. Suite K5, #154
Portland, OR 97229

Phone # (503) 286-0005
Fax# (503) 286-1050
Cell # (971) 227-0097
E-mail jcheadle@ponderosaig.com

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