

# Ponderosa Investment Group LLC

# INVESTMENT LETTER

Third Quarter 2008 • V10

September saw an unprecedented reshaping of our financial industry amidst major turmoil in the credit markets. I address the impact of these changes in a Q&A.

The credit problems will contribute to further economic weakness. Additionally, despite the government's rescue package, significant risks remain.

Longer term, the size of the rescue package will have implications for interest rates, the dollar, and the regulatory environment. These issues being assessed and I will likely make portfolio adjustments in coming months that factor in this new environment.

The longer-term return expectations for equities have improved a great deal with the recent sharp market declines. I also think significant opportunities are being created in other areas, and from current levels I'm confident in the ability to identify them and earn good returns in coming years.

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## Quarterly Investment Commentary

Things have been changing so rapidly it is hard to write, produce, and mail a newsletter without it being outdated before even the first step is completed. So I will preface this by pointing out that there are two views expressed that

may seem at odds, and both are connected by market valuations. The first is the view of the credit crisis and its impact on the overall economy. This is a decidedly negative view. The other view is about the return outlook going forward, which has gotten increasing-

ly positive, because the worse the markets get, the better the return outlook gets. It is important to balance these as you assess this environment.

2008 Index Performance	3rd Qtr.	YTD
Citigroup 3 Month T-bill Index	0.43%	1.54%
Lehman US Aggregate Bond Index	-0.49%	0.63%
M.L. US High Yield Master II Index	-9.48%	-10.64%
S&P 500 Index	-8.37%	-19.29%
Russell 2000 Index	-1.12%	-10.39%
MSCI EAFE N\$ Index	-20.56%	-29.26
Dow Jones – AIG Commodity Index	-27.70%	-8.01%

The credit freeze that chilled the financial markets in early and mid-September this year was more alarming than anything I've experienced in my investment career. I've heard the same said from professionals that have been in this industry much longer than I. The credit (lending) markets have been dysfunctional for months, but the risks to the broader economy significantly increased in September as credit markets came close to a standstill. The inability for businesses to access the short-term capital they've relied on for decades to fund their normal business operations threatens to severely damage the economy.

The problems resulting from years of growth in the amount of debt relative to the size of the overall economy has now infected the global financial system. Financial institutions, hedge funds, and households are being forced to reduce debt (deleverage) at the same time, which is not only resulting in forced sales of investment assets, but is also reducing the amount of capital to the credit markets. Governments worldwide have taken numerous actions to help bring confidence back to the credit markets—which lie at the heart of the problem. But the problems won't be fixed quickly and confidence will likely come back only gradually.

**But though the underlying economic problems are severe, the return expectations have gotten more positive.** Remember, equity returns are not simply a function of the economy and its impact on corporate earnings;



they are a function of the prices at which you can buy those securities. The steep declines in stocks have been very painful, but recent declines have taken us to levels where it is clear that fear and pessimism are taking over. Fear and pessimism are the driver of good longer-term opportunities. I want to note that I have been careful in previous communications to lay out the negative scenarios. I believed that the stock market was behind the curve in recognizing the severity of the problem in the credit markets and that it was not sufficiently discounting economic weakness stemming from the credit crisis. But I can now say that at current levels I finally have confidence that longer-term returns going forward are very likely to be decent. I'm considering the possibility of going back at least to a neutral weighting in equities. There are also other compelling opportunities at an asset class level that I'm considering taking advantage of.

### **Question and Answer Format**

The following Q&A talks more broadly about the economic impact of the very problems we face. Some were written before the very sharp recent declines but still applies.

#### **Is the risk to the economy really that serious?**

Warren Buffett told CNBC the following in response to questions about the Paulson plan (this was on September 24, while the plan was still being debated):

“Last week we were at the brink of something that would have made anything that’s happened in financial history look pale. We were very, very close to a system that was totally dysfunctional and would have not only gummed up the financial markets, but gummed up the economy in a way that would take us years and years to repair.”

I have great respect for Buffett. He is not only smart and overflowing with common sense, but he is also a highly ethical person. His opinions are highly credible and in line with several others I respect. Those views are also in line with my view of what was developing beginning the week of September 15 as activity in the credit markets moved alarmingly

close to a frozen state (by “frozen” I mean that the willingness to invest in debt securities or lend stops). That state continues as I write this and presents a great risk to both the U.S. and global economy.

The credit (lending) markets have been dysfunctional for months and I have been writing about this in past letters. However, during the last couple of weeks the risks significantly increased. Regardless of what one may believe about the greed and poor judgment that got us to this point, there is no question that the world needs a financial system that facilitates the workings of the economy. Businesses and banks rely on their ability to borrow so they can invest and grow and create new jobs, so they can bridge seasonal fluctuations in their revenues, and so they can support their day-to-day operations, including making payroll. And Main Street relies on its ability to borrow as well. Demand for a home, a car, or other long-term assets are dependent on borrowing ability. Without that, consumer demand and thus the global economy would be much smaller. A sudden and significant reduction in the availability of credit is happening, and if it continues it will result in significantly reduced demand for goods and services and a simultaneous loss of confidence on the part of businesses that would lead to waves of layoffs and less capital investment. This could create a significant shrinkage in the economy, which would have major negative fallout to businesses and individuals. Moreover, there is a risk that it could develop into a self-reinforcing cycle that would be hard to break.

#### **What is needed to help return the markets to normal?**

A capital infusion into the banking system is needed so that financial institutions can take their losses (there are many more loan losses to come) and re-capitalize. It is important that it be a system-wide solution, not a string of piecemeal reactions as was the case prior to the recent Treasury proposal. Action is needed both to address the underlying fundamental problem and to help bring confidence back to the market. A continuation of the extreme dysfunction in the credit markets has damaged the economy and will further damage the economy as long as it continues, with potentially long-lasting effects, includ-



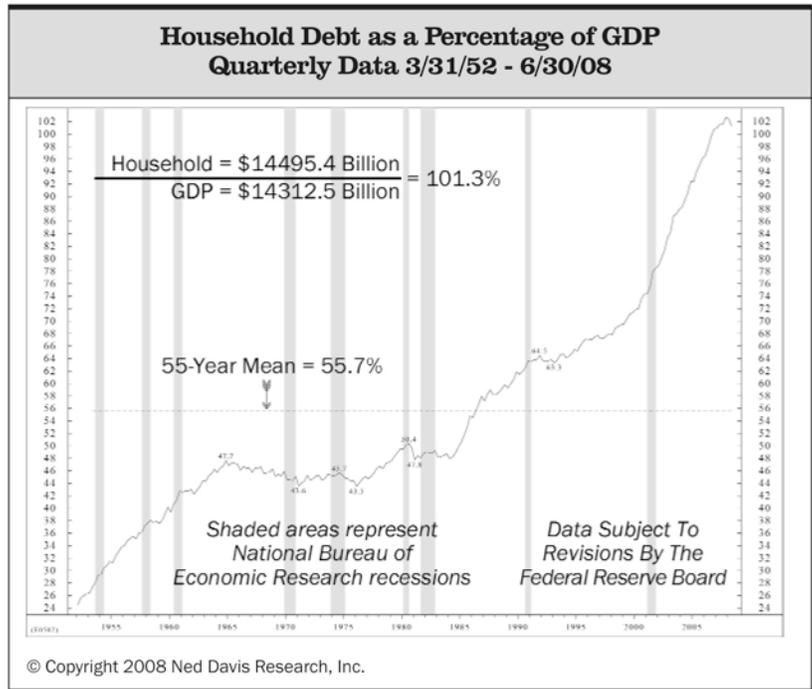
ing more financial institution failures and a deep economic downturn. In my view, governmental action (along the lines of the Paulson proposal, though there could be other variations) is the best chance to begin to bring confidence back to the credit markets. Risk would still remain, but that risk would be significantly reduced. It is the credit market not the stock market that is the economic linchpin.

Credit default swaps (CDS) remain a wild card that will not be easily addressed in the short-term. This is an unregulated market where financial institutions and hedge funds sell insurance against credit defaults. The market is huge—estimated at roughly \$60 trillion—and because it is unregulated it is hard for anyone to really understand the risks. The government bailouts of Bear Stearns and AIG occurred because they were a major CDS counterparty and their failure would have negatively impacted many financial institutions—potentially putting the entire financial system at risk. The CDS market is headed for regulation but how we get from here to there remains unknown. My understanding is that the CDS market is shrinking as contracts are unwound. That is good, but it is still a large market that is already contributing to market volatility and risk aversion and it represents an unknown financial system risk.

**What is behind this deterioration in the economic environment?**

As I wrote in April, I had become concerned that there would be “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.” Developments since that time suggest that this scenario is playing out with a vengeance. There is now no question that years of debt growth relative to the size of the economy are in the process of reversing, a process that will last for quite a while. Lending institutions, in aggregate, will be smaller with less ability to lend.

And households, with fewer assets, will have reduced ability to borrow. The debt tailwind of previous years will become a headwind to economic growth as the consumer sector shrinks. This outlook



*Household debt has been growing faster than the economy for over 30 years. This couldn't continue forever but the level at which debt growth would hit a wall has been unclear for many years. We've hit that wall now and debt relative to the size of the economy will have to shrink.*

is consistent with the experience of other credit busts in Japan, Sweden, and several other countries. Economic growth in those cases was subpar for eight to nine years. The U.S. is different but there are also many similarities.

There is also uncertainty about inflation. In the short run I'm not concerned about a big inflation spike. The bigger inflation concern comes into play as I look out into the next cycle. The government stimulus that will be necessary to manage through the downturn does risk some inflationary pressure years out.

**Why are bonds performing so poorly?**

There is an extreme flight to quality with huge demand for U.S. Treasury securities—especially Treasury bills. The demand has been so great that investors are willing to accept near 0% returns on short-



term Treasury bills. This demand is at the expense of virtually anything else.

Some portions of the credit markets, such as tax-exempt bonds, have been hurt by the lack of buyers. This has meant higher borrowing costs for tax-exempt bond issuers. There may also be some worry about reduced tax and other revenues in an economic downturn harming the credits and triggering increased defaults. I believe that default losses could be higher than in a typical recession but that the market has more than priced that risk. However, with such poor liquidity it is hard to know how tax-exempt bonds will perform over the short term. Longer term I believe they are now priced somewhat attractively with yields over 4%.

The corporate bond market is also extremely stressed with liquidity drying up in favor of Treasuries. Investment-grade corporate bonds had their worst month ever in September and their worst quarter ever. With the possibility of a worse-than-normal recession, defaults could be higher than in a normal down cycle. So some shift down in pricing makes sense. However, once again, the flight to Treasuries has sucked demand out of the corporate bond market and this has led to an imbalance of buyers and sellers, which has driven prices sharply lower (for example an ETF that tracks an intermediate, investment-grade corporate bond index was down 6.8%). I believe this will pass and that corporate bonds will perform well if we look out past this crisis period. The lowest-quality portion of the investment-grade bond universe is yielding close to 8%. Longer-term return potential looks reasonably attractive and could result in capturing the yield or perhaps better, but some short-term risk remains.

Mortgage securities are also suffering. But despite the housing market turmoil, there are residential mortgage-backed securities (RMBS) that are selling at prices that will generate attractive returns, even under very, very negative scenarios (in terms of foreclosures and losses on the foreclosed property). One highly regarded bond manager I talked to believes that his high-quality mortgage portfolio can return 7% annually over five years, even under pessimistic assumptions including an assumption that

U.S. Treasury note yields will rise significantly over that time.

Looking forward, while near-term risk remains high I'm becoming more enthusiastic about potential future returns. The painful selloff in equities in recent weeks initially reflected investors' revised expectations about the level of economic weakness we will experience. But more recently the selloff has shown signs of increasing fear and pessimism, and this is where longer-term opportunities are created for disciplined, valuation-driven investors. I'm already seeing several asset classes getting close to levels where I believe we can earn good long-term returns going forward, even under conservative assumptions. I'm also encouraged that the managers are enthusiastic at the stock-picking level—one value manager with more than 30 years of experience reports that their portfolio is at its biggest-ever discount to their appraisal of business values. These asset class and stock-picking opportunities are a reminder that the returns I can capture for your portfolio in coming years are not limited to just the baseline of what the stock and bond markets give us.

I have my own capital at risk in the same investments as you do, and my overall incentives are totally aligned with yours.

As always, I appreciate your trust and confidence.

Best Regards

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