REVIEW & COMMENTARY
1ST QUARTER 2008

Bearometer

Predicting the future is never easy and while many people make quite a nice living from it, it is hard to imagine that those prognosticators who work on Wall Street or Bay Street could have accurately predicted the turmoil in which we presently find ourselves. Credit problems and weakening real estate values are something we referred to in the past, however, it is difficult to explain how the financial system and so many great companies lost sight of something that is quite basic- risk. It is evident that even many seasoned investors bought securities that were far riskier than they thought- in some cases it wasn't their fault. In some cases it was. During financial turmoil, those who lose money always point the finger at others, rarely accepting responsibility. Some retail investors were misled. Professionals are pointing their finger at rating agencies, investment banks and brokers but, judging from the brutal decline in the valuations of many of these financial companies, they were equally victimized; either that or foolish. Today's capital markets can probably be best summarized by the quote attributed to John Maynard Keynes and one we have used many times before- " The market can stay irrational longer than you can stay solvent".

When capital markets turmoil appears, stock markets turn down and few investors escape unscathed. During the "tech bust", less than a decade ago, even conservative non tech investors were affected; thankfully, not as much as those who were heavily weighted in all those amazing new growth stories that were priced for perfection and not even close to making any money. It is hard to explain these market "corrections" but they happen with some regularity and it is only after considerable time and some distance that it tends to make sense. Market corrections often occur when valuations become extreme or greed takes over from common sense. It is always easy to look back and make sense of it but now we must remember that markets will recover, and it is usually well after a certain point or event that it can be looked upon as a turning point.

…/2

Malcolm Gladwell in his book ***The Tipping Point*** expands on how sometimes a single event can be shown to have been an inflection point that starts a trend, reverses one or simply diverts one. Successfully identifying these points in a timely fashion can be fortuitous. Often in the capital markets, these same turning points exist and while they are equally difficult to identify, it is often well after the fact that investors can look back with any assurance and identify this important inflection point. Indeed, the bid by JP Morgan for Bear Stearns, with the Federal Reserve's financial blessings intertwined, may just have been the Tipping Point that rebalanced the fears of the markets. It may take some time before we know, but there is one important thing that did happen that fateful weekend; 14,000 employees of a venerable, 85 year old investment bank watched their firm vanish before their eyes. This is the kind of devastation a crisis of confidence in the capital markets creates. This crisis, where financially strong lenders have trouble issuing debt and sound borrowers looking for financing are faced with suspicion, increased scrutiny and higher interest rates, is what the market must work its way through. Unfortunately, it will continue to be painful and will take some time. The big question is whether we have seen the worst?

It is important to remember that many of these write-offs, splattered regularly across the headlines, are really ***write- downs.*** In many cases, these loans will be re-paid in full but recent changes to accounting standards require companies to mark to market the loans thereby reducing them to the level they could be sold to an arms length third party that day. When confidence in the capital markets returns to more normal levels, these ***write-downs*** may well become ***write-ups.*** What happened to Bear Stearns was not that they were overexposed to sub prime loans, instead they tempted a rule of finance and got caught- they borrowed short term and invested their money in long term investments. When lenders retreat, if you can't liquidate your longer term holdings quickly enough you can not finance your daily operations even though your assets may outweigh your liabilities- this is what happened to Bear Stearns. It has sunk many firms in the past and will sink many more in the future.

As we often say, we aren't sure that our abilities to predict the future are getting any better with experience but history has proven a valuable lesson. There is usually some event during financial turmoil that somehow resuscitates winded markets. It may well be the JP Morgan/ Bear Stearns deal, if not, we should feel somewhat reassured that the US Federal Reserve has stepped in with their vast resources in order to back stop the markets. Many US financial institutions are trying to repair their balance sheets by either selling assets or selling equity to new investors such as sovereign funds. Washington Mutual, and Citigroup have done so and many more will do the same or possibly be taken over. Of course, times remain uncertain and there may be more pain to come but the markets look forward not back. And those of us who have been through this before, know now is not the time to retreat but to stand firm.

Stodgell Investment Management Ltd.