SAYBROOK CAPITAL
INVESTMENT OUTLOOK

December 31, 2008

"*This great Nation will endure as it has endured, will revive and will prosper. So, first of all, let me assert my firm belief that the only thing we have to fear is fear itself…*"

Seventy-six years ago at a time that echoes our own, Franklin Delano Roosevelt, in his first Inaugural Address, boldly stated these now-famous words. We cite these lines, in part, because the Inauguration of our new President this month has been accompanied by historical references to the period in which FDR governed. But there are two more specific reasons for our quotation. First, over the past year, and particularly over the last four months, the global financial system has been gripped by outright fear. Second, at this uncertain moment in our history, we believe it is essential to share our strong conviction that our financial system will again be reformed and our economy revitalized. In the first section of this letter we attempt to offer some perspective on the current state of financial markets and the economy. In the second section, we make the case for long-term investing in stocks, which we believe is as sound today as ever.

I. "Fear Itself"

On October 2, Warren Buffett declared: "This really is an economic Pearl Harbor, that sounds melodramatic, but I've never used that phrase before. And this really is one…In my adult lifetime I don't think I've ever seen people as fearful economically as they are now."

Despite our defensive positioning - both in terms of stock selection and our lower overall equity allocation - 2008 was our most challenging year, and only the second time in Saybrook's 32-year history in which we are reporting negative returns to our clients. 2008 was the single worst year for U.S. stocks since the 1930s. It was a year in which *all* global stock markets were down significantly, numerous famous investors performed even *worse than the market*, and *all* asset classes declined, except gold, U.S. Treasuries, and cash equivalents denominated in dollars or yen.

The following table illustrates how wide-spread the damage was:

2008 Returns

Stock Market Indices		Other Investments	
S&P 500 (includes dividends)	-37%	Average Large Growth Fund	-41%
Dow Jones Industrial Average	-34%	Fidelity Magellan Fund	-49%
NASDAQ	-41%	Legg Mason Value Trust (Bill Miller)	-55%
MSCI Emerging Market	-54%	Dow Jones Commodity Index	-37%
MSCI Europe	-48%	Crude Oil	-54%
Dow Jones World Index	-43%	S&P Municipal Bond Index	-2%
Bombay SE 30 (India)	-52%	S&P Real Estate Investment Trust Index	-42%
Shanghai A Shares (China)	-65%	HFR Hedge Fund Index (all strategies)	-23%

Excessive Leverage & Incompetent Oversight:

The overt causes of this crisis, as detailed in our past letters, stem from the severe downturn in housing prices and the massive issuance and securitization of sub-prime mortgages. This led to a widening credit squeeze that has severely impacted all aspects of the global economy. While housing and credit triggered the crisis, the systemic causes were excessive leverage and irresponsible oversight. The overuse of leverage (incurring debt to magnify profit or consumption) became endemic throughout the system. Investment banks leveraged their balance sheets 30-to-1, while hedge funds made extremely aggressive bets, and even CEOs borrowed money to buy their company's stock on margin. Property buyers gambled on the real estate market using adjustable-rate mortgages, and consumers used home equity loans and credit cards to live beyond their means.

Compounding these excesses was the abdication of responsibility for prudent risk-management by those charged with running our major financial institutions and regulating our banking system. Those who failed to perform their fiduciary duties are collectively guilty of poor decision-making driven by short-term expediency, excessive risk-taking, and in many cases, greed. In short, we have been in an *era of incompetence*, and there is plenty of blame to go around from business leaders on Wall Street to regulators in Washington. These sentiments were reflected in a statement at the last Merrill Lynch shareholder meeting by Winthrop Smith, Jr. (former Director and the son of a founding partner): "Today is not the result of the sub-prime mess or synthetic collateralized debt obligations. They are the symptoms. This is the story of unprincipled leadership and the failure of a Board of Directors to understand what was happening to this great company, and its failure to take action." Smith's remarks about the fate of Merrill Lynch could just as easily have been made about Bear Stearns, Fannie Mae, Lehman Brothers, AIG, Citigroup, et al.

This period of excessive debt and ineptitude gave way, in the last four months of 2008, to a massive burst of *deleveraging* as it became increasingly clear that the global banking system was at risk of collapse. Institutions and individuals attempted to unwind risky investments, as lenders slashed credit exposure, and even the best managed banks resorted to emergency government assistance to reduce their debt ratios. The crisis intensified in early October with delays in the passage of the $700 billion Troubled Asset Relief Program (TARP) and Treasury Secretary Paulson's inconsistent statements on the use of the program's funds (from buying troubled assets only, then to recapitalizing banks, then to backstopping consumer debt). As this process unfolded, a huge amount of 'forced selling' (caused by fund redemptions, margin calls, and endowments seeking liquidity for required expenditures) drove the markets down further in November. Amid this crash in global markets, even the highest quality stocks fell dramatically.

Recession and Historical Context:

By early December, the National Bureau of Economic Research officially declared what markets had suspected for quite a while: the current recession began twelve months ago, at the end of 2007. This downturn accelerated in the second half of 2008, as manufacturers rushed to hoard cash by cutting costs across the board: labor, marketing, and capital expenditures. Simultaneously, consumers - recognizing the decreased wealth effect from falling home values and declining stocks, and anticipating a prolonged recession accompanied by substantial job losses - cut their expenditures and began to rebuild savings. Indeed, the year-end unemployment rate of 7.2% will undoubtedly climb higher in 2009. Many economists now predict that joblessness in this cycle may reach the post-World War II highs of 9% in 1975 and 10.8% in 1982. And, as we all see in the press, comparisons are even being made to the 1930s.

As we have with this letter's opening quotation, many economists and policy-makers have turned to the Great Depression era for insight. While it is quite possible that the duration of the current recession may be the longest since World War II, for many structural and systemic reasons (diversified economy, Social Security and unemployment benefits, etc.), the depth of this recession is *not* likely to approximate the 1930s which saw 25% unemployment and a nearly 30% total decline in Gross Domestic Product.

One advantage we have now is the knowledge of which fiscal and monetary policies worked in the 1930s and which did not. For example, in 1932, Treasury and Federal Reserve Board officials established the Reconstruction Finance Corporation which was successfully used to rescue the national banking system, in part, by purchasing preferred stock in many banks – just as the TARP plan is currently doing. In a recent speech demonstrating the Fed's willingness to learn from history, Fed Chairman Bernanke cited the inappropriate monetary policy (rates were kept too high) and the weak, counterproductive government actions in the first three years after the 1929 crash, as key reasons for the emergence of the Great Depression. "Today," he stated, "we are doing just the opposite."

Monetary and Fiscal Response:

Although the government's policy response has been gravely inconsistent, the size and speed of both monetary and fiscal stimulus have been unprecedented. The Fed began cutting its key interest rate in 2007, and is now targeting a rate of between zero and 0.25%. The Fed is also taking other very aggressive actions, such as the direct purchase of mortgage-backed securities and other assets from banks, in order to prompt more lending and investment. With regard to fiscal policy, we are now hearing the initial outlines of President-elect Obama's "American Recovery and Reinvestment Plan." This massive economic stimulus plan is expected to exceed $800 billion over the next two years and include: tax relief, aid to states and the unemployed, immediate spending on traditional infrastructure, and longer-term structural "investments" in such things as a national power grid.

Deteriorating global economic conditions certainly warrant bold and swift government action. At the same time, we hope that fiscal policies are implemented carefully in order to reduce *unintended consequences* that will surely result from current government actions. The combination of U.S. and international fiscal and monetary stimulus programs, the possibility of deferred federal tax increases, along with the market effects of significantly lower gas prices and mortgage rates, should lessen the severity of the downturn.

II. The Case for Long-Term Investing in Stocks

Over recent months, some of our clients have asked us a reasonable question: why own *any* stocks in the midst of a difficult period that may last for an extended time? Indeed, we have just lived through a 'lost' decade for the stock market (from the end of 1998 to the end of 2008), in which the S&P 500 lost a cumulative -13%. While Saybrook Capital has managed to generate better returns during this same period (+16% cumulatively), our results were well below our longer-term average. History shows that there have been other extended periods of stagnation for equities, most memorably 1929-47 and 1966-82. So, why own stocks during these periods? Why not "just go into cash" and then "get back into stocks" when things get better? To these questions we offer five important reasons why investors should continue to own high-quality stocks through this challenging period.

1. Superior Compounded Returns:

Long-term investors with the fortitude to stay invested through the bad as well as good times have realized superior average annual returns. Since 1925, the broad U.S. stock market has generated annualized compounded returns of about 10%, above the annualized returns for U.S. Treasury bonds of about 5%, and far exceeding the 3% average rate of inflation. In other words, investors who could afford to hold onto a broad portfolio of stocks ended up doing very well, despite the Great Depression, World War II, ten post-War recessions, the Cold War, the oil shocks and stagflation of the 1970s, the crash of the late 1990s tech bubble, and terrorist attacks at the beginning of this decade.

2. The Risk of Market-Timing:

Generating superior returns requires the discipline of committing a portion of one's savings (that is not required for near-term expenditures) to investment for a long-time horizon. To get completely out of the stock market and then get back in successfully requires *two prognostic and well-coordinated decisions*, both of which are virtually impossible to consistently accomplish. First, the decision to sell has to be a correct one, and it has to be exquisitely timed (before the fall). Second, re-entry into the stock market is typically fraught with indecision due to the uncertain and tenuous nature of a recovery. In fact, this second decision is an even more difficult feat to accomplish than the first. We do not have confidence in our – or, indeed, anyone else's – ability to make both of these critical decisions accurately and consistently.

To realize the full appreciation potential of stocks, one must remain committed to owning them, as most gains occur in brief, unexpected periods. History shows that stocks can – and often do – rise just as suddenly as they have fallen in recent months, and that it is extremely difficult to 'time the market.' A performance study of a broad index of American stocks during a 40-year period (1963-2004), shows that the long-term investor who stayed 'in the market' the entire period realized a 10.8% average annual return. But the investor who was 'in and out of the market' and missed the *90 biggest-gaining days* over that long period would have had an average annual return of only 3.2%. This research clearly illustrates the perils of market-timing.

3. Current Valuations:

By a wide array of measurements, stocks are currently selling at attractive long-term valuations. The S&P 500's P/E (price/earnings) ratio is now 14x much-reduced estimates for 2008. Even Robert Shiller's more conservative 10-year trailing, inflation-adjusted P/E (inspired by the work of famed value investor Benjamin Graham), shows that valuations have fallen back to the long-term average of 15x (down from 24x in January 2007). Comparing the stock market's aggregate price to its level of revenue or book-value, reveals low valuations not seen in over two decades. And, the current dividend yield (dividend payments/stock price) on the S&P 500 is 3.2%, double the rate in 2004 and above the 10-Year U.S. Treasury bond yield of 2.3%, at year-end. Even during this difficult period, many sound companies have maintained and even increased their dividend payouts, which is encouraging from a total-return and valuation perspective.

While we believe stocks are now reasonably valued, asset prices have a long history of swinging to extremes, as demonstrated by the single-digit P/E valuations experienced during the high inflationary period of the late 1970s and early 1980s. While that risk cannot be ignored, as fundamental analysts, we believe that stock prices are ultimately rational and eventually reflect the long-term growth in real earnings.

4. Cash Does Not Hedge the Risk of Long-Term Inflation:

Holding cash certainly feels safe now, but it currently generates almost no return, even before considering the impact of future inflation. In fact, short-term U.S. Treasury Bills have recently paid slightly *negative* returns because the current demand for safety-of-principal is so great. History shows that owning shares of quality companies does provide some protection against the ravages of inflation, as corporations can pass along higher costs to their customers. We think it is sensible to use cash equivalents as a safe default when we cannot find enough attractively-priced investment opportunities, and, in extremely volatile periods such as this, we also believe it is prudent to hold *a portion* of our portfolios in cash as a hedge against stock price declines. However, we do not believe it is prudent to avoid owning quality stocks for the long-term. This view is supported in an October 17th *New York Times* Op-Ed written by Warren Buffett (and excerpted below):

> I've been buying American stocks [in] my personal account…[because] fears regarding the long-term prosperity of the nation's many sound companies make no sense. These businesses will indeed suffer earnings hiccups, as they always have. But most major companies will be setting new profit records 5, 10 and 20 years from now…I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be higher or lower a month – or a year – from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up…Today people who hold cash equivalents feel comfortable. They shouldn't. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value. Indeed, the policies that government will follow in its efforts to alleviate the current crisis will probably prove inflationary and therefore accelerate declines in the real value of cash accounts. Equities will almost certainly outperform cash over the next decade, probably by a substantial degree. Those investors who cling now to cash are betting they can efficiently time their move away from it later.

5. Confidence in the Underlying Strengths of the American System:

Ultimately, the case for long-term investing in stocks rests on an underlying faith in America – in the ability of our people, our system of government, and our businesses to ensure that our nation "will endure" and "will prosper." As a nation we have faced many consequential challenges in our history and emerged stronger each time, drawing upon our core strengths (credit is due to economist David Rosenberg for helping with this list):

- The Constitution including 'checks-and-balances' and federalism
- Private property rights and the 'rule of law'
- Top universities and excellence in science and technology
- A workforce that is productive, highly-skilled, mobile, and flexible
- A diverse and still-growing population
- A military that can defend our interests and those of our allies
- A business and political system that can adjust to meet difficult challenges

Because of these strengths and history of perseverance, our nation has reason to be confident about our future – to embrace hope over fear. Today, with the upcoming Inauguration, there is a renewed spirit of bi-partisanship. There is hope that our new President and his economic team will demonstrate competent and pragmatic leadership and will work together with both parties in Congress to enact the policies necessary to address our serious economic challenges. If so, there may be a broader national sense of optimism – even as conditions get worse before getting better. Although intangible, the importance of confidence cannot be underestimated; indeed, it is the key factor necessary for any lasting stabilization of our economic system.