

September 18, 2008

Dear Valued Investor:

As I noted at the beginning of the week, the bad news and financial instability would likely continue to plague markets and it has. As you know, AIG – one of the world’s largest insurance companies has fallen, with the Federal Reserve stepping in to take control of the company to prevent bankruptcy. Once again we are seeing a large financial institution suffer huge losses associated with the toxic combination of high leverage and very poor investment and insurance decisions. It is important to note that, in AIG’s case, it is the parent company that is in trouble, the U.S. insurance subsidiaries are separate entities that are considered to be in decent shape. Also thank goodness, it appears that the problems AIG encountered are not widespread in the insurance industry.

While the AIG problem has been resolved, fears over other very large financial institutions viability continue to circulate with published reports of additional mergers in the offing. There are also published reports that the Federal government is considering the creation of a new agency to lift a large chunk of troubled debt (subprime related securities and the like) off of these troubled companies’ balance sheets at current prices in order to bring resolution and clarity to the balance sheet concerns. All of this is, at this time, speculation, but I do think the Treasury and the Federal Reserve will continue to act to contain these problems and prevent a spreading of financial difficulties.


And, as I noted earlier, credit market instability does not appear to be widespread, rather it is heavily concentrated at some very prominent financial institutions with high leverage and poor investment decision making. For example, the S&P Regional Bank stock price index is up more than 50% from its mid July low. This bank group is still well below its peak, but not crashing lately. Banks that stuck to their knitting, maintaining reasonable lending standards, reasonable loan terms, avoiding the lure of high leverage are the norm, not the exception. In my view, the problems are mostly at some of the Wall Street banks, not Main Street banks. I think that the vast majority of local and regional banks will do just fine. They have lower borrowing costs and more profitable lending rates today, a lot less competition from some high risk non bank mortgage originators, and do not require capital from Wall Street banks. Of course, in the main, the media does not print headlines saying “Local Bank XYZ Doing Just Fine”.

And local banks are doing business. Over the last four weeks, what the Federal Reserve labels as “Small Banks” increased lending by \$6.7 billion while “Large Banks” cut lending by \$5.2 billion. And, over the last year small banks have increased lending by \$164 billion, nearly as much as the \$209 billion increase in large bank lending. Previously large banks had pretty much muscled out small bank lending. A year ago the annual increase in large bank lending was \$499 billion vs. an increase in small bank lending of only

\$86 billion. Thank goodness we have all these small banks to step in and pick up the slack when some of the large banks stumble.

So, while total bank lending is slowing, it is not screeching to a halt. And, while the economy will likely experience a credit market shock from these severe problems at some of our largest financial institutions, I do not think it will be devastating. This is not a replay of the 1930's and I continue to think that we are not heading into a major recession. A recession is possible, but so too is recovery. In the main, I think policy makers are now doing the right things and we will work our way through this financial crisis. As always, please call your advisor with any questions or concerns.

Sincerely,



Lincoln Anderson  
Managing Director, Chief Investment Officer

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