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Fall Commentary 2008

Overview

Given the tumultuous market activity of late, this issue will be formatted into three sections: Philosophic Issues, Practical Implications and Personnel/Events. Our firm recently underwent a Securities and Exchange Commission examination which went quite well. One of their directives was that we no longer publish portfolio performance data in this commentary. Anyone interested in seeing our performance results, both year-to-date and for the past ten years is welcome to email or call us to request this data. As a firm, our overall strategic asset allocation is as follows: 42% in bonds, 18% in cash, 25% in traditional stocks and 15% in non-traditional growth. The non–traditional growth category includes real estate, preferred stock, energy, hedges and metals in approximately equal parts. Remember that 94% of a portfolio's return is due to strategic asset growth allocation and only 6% to individual security selection.

Philosophic Issues

How did we get into such a mess? With a barrage of rapidly unfolding events, most investors are aghast at the precipitous declines in the stock, bond and commodities markets. I will try to explain the reasons why the current crisis came to exist, the formidable barriers that stand in the way of dealing with it successfully and give a prognosis for the long-term changes which I believe are required to deal with the current turmoil.

At the very heart of the matter is the U.S. economy's extraordinary reliance on credit. Credit is another word for the lending of money. Lenders expect the borrowers to repay their debts. Borrowers have to believe they will do well enough in the future so that they will not only be able to repay their debts, but will also accumulate enough profit or capital for themselves to make their efforts worthwhile. This concept is at the heart of the American free enterprise system.

Historically, excess capital was held in the form of gold, land or other types of natural resources. In modern times, financial capital has replaced real assets and herein lies the problem.

Financial capital can, for better or worse, be created out of thin air by governments, as well as, businesses that are smarter and quicker than government officials. The administration of financial capital, was traditionally carried out by cautious bankers. Since financial capital is a man-made resource and its use has primarily been in the hands of unfettered companies, confidence in capital now depends on belief in “the markets”.

The modern financial markets took shape in the early 1980’s, when Reaganomics deregulated the banking system along with many other industries, such as energy trading (i.e. Enron).

The 1990’s saw vast amounts of new types of capital created. Ingenious and hard-working financiers on the East Coast seized the opportunity to create forms of capital in ways that mere mortal bankers and regulators could not, and still do not, understand.

The current deterioration of the world’s capital markets, banks, real estate and stock markets has to do with a fundamental flaw of financial capital. In the face of widespread fear, confidence in capital markets can dissipate. Although the current market collapse is based partially on declining real estate markets, one could, in fact, trace the roots of the real estate bubble to Congress and the Federal Reserve Bank. Both urged for the extension of credit to American individuals and businesses through tax breaks, easy money and policies. This was the political band aid used to get the American public over the shocks of the high tech stock market collapse, 9/11, and the initiation of two unpopular foreign wars.

In normal times, when there are a small percentage of people struggling to repay their debts, there are ways to work things out. They can turn to loved ones for assistance, sell assets or negotiate new terms with lenders. Today, we are experiencing a loss of confidence to such a degree that there is little room or time available to revise loans. Today, reservoirs of financial capital exist mostly inside China, Japan and the oil exporting nations. The United States is on the other side of the equation.

We are addicted to credit on a government, company and often times, personal level. Americans believe that we have a right to consume beyond what we produce. U.S. regulators and government officials have pandered to the public’s fear and in the face of a declining stock market, continue to look in the wrong places for the wrong solution. Our Government is trying to revive borrowing as if we could go back to Reagonomics while reducing our debt is the only sane action that will work long-term.

The philosophy that individuals and corporations, left to their own devices, will act in ways that promote a long-term sustainable economy is flawed. This philosophy was first outlined in 1776 by Adam Smith’s <u>Wealth of a Nation</u>, and was repackaged by Reagonomics and subsequently promoted by every president, Democrat and Republican, since then. The current bailout “rescue” package hopes to reinstate confidence and to turn back the clock so business will go back to normal. This will be accomplished through exporting our new debt which gives foreigners more say in our future.

Unfortunately, it was structured so that a few insiders will receive most of the benefits while the costs will be spread out amongst the uninformed populace.

Some good news is that selling another trillion or two of our government bonds to foreign banks and investors will tie the world's financial markets more closely together. There is a global confidence crisis driven by the structural dependence on credit. U.S. housing prices are only a small part of the problem.

Individual countries are showing their national character through their response to the financial crisis. France has committed to buying up 30,000 unsold spec homes built by developers in order to provide price supports for their housing market. They are also planning to roll out new nuclear power plant projects to provide jobs. Does this sound familiar? The Netherlands and Belgium had to step in to arrange for the salvage of a large bank, Fortis. Spain's real estate market is imploding. Germany, after criticizing Ireland and Spain for promising to insure all bank deposits, turned around and did the same thing. So much for free markets! England has rescued its largest real estate lender. Worldwide, governments are leaning towards a "social" solution of insuring all bank depositors so that investors don't panic. They really have no alternative solution.

When the Federal Reserve creates a trillion new dollars by selling bonds, China, Japan and the OPEC nations are the only big players capable of buying such a large quantity of bonds. They have capital and we need it to bolster confidence. Our enemies have become our allies and partners so we must hang together or separated, be hanged!

This will lead us to a new world financial order. Here in the United Sates, we will have to submit to fiscal discipline through cuts in social programs. Foreigners will come to own our infrastructure. Private financial corporations, who have maximized returns first and foremost for their own executives and then their friends, will adapt to government supervision and become instruments of the state. The excesses of American style financial capitalism will give way to a more socialistic form of regulated competition. Taxes will go up.

Other outcomes of the current financial crisis are: the potential for the European Union to fragment and dissolve; China's economy will contract, due to the loss of exports to the western world; oil prices will go down temporarily and oil exporting nations will see some of their grand, environmentally crazed construction projects affected. A worldwide recession will affect our response to the political issues of the 21st century. Global warming, healthcare and the use of our military to police the world will all take on new meaning in an era of shrinking debt.

Practical Implications

What can investors do in the current crisis climate? Traditionally, we have looked to Washington for help and Congress has obligingly served up one form or another of financial assistance. While this makes markets and people feel better in the short-term, the Feds cannot make banks lend money nor force consumers to borrow and spend. Until companies disclose all their problems and new policies are in place to prevent future abuses in financial capital markets, investors have little reason to ante up with renewed confidence. Below this section of the commentary, I have listed some concrete examples of policies and market mechanism that could serve to set our financial and real estate markets back on firm footings.

During the first 9 months of 2008 the S&P 500 was down 20% and international stocks were down 31.1%. Many bonds are not pricing and consequently cannot be bought or sold. This is creating a financial crunch for some individual companies, banks and countries around the world. Bankers are under extreme duress from regulators to conserve capital because they don't know the extent of their losses on complex financial securities. At the moment, they are unwilling to lend to almost anyone.

If the untrammeled use of credit has allowed individuals to live beyond their means for the last 30 years, it also encouraged companies to grow faster than they would or should have. Investors with excess capital—people not in debt and who hold extra cash—stand to gain handsomely if they can understand the current crisis. Buying opportunities can be created when the crowd is panicking, so tough negotiating on great long-term assets is advised.

Outlined here are the practical steps our firm uses. First, we try to tie down client living expenses and really understand what it costs someone to live. No one enjoys confessing how much money goes out the door, but you must know and account for your real spending. Second, we try to secure an income that matches or exceeds expenses. It is essential to look carefully at the sources of your investment income. How secure are they? How liquid are the investments? Are your funds invested in things you understand? Third, market turmoil has created tremendous opportunity to buy top quality bonds from firms who are being forced to pay high rates of interest to investors because banks are not lending, but caveat emptor…know your borrower.

Once we have ascertained how much cash is needed to live and we are reasonably sure that your flow of cash is adequately provided by secure investment vehicles, we encourage clients to think about deploying the rest of their assets between high earning short bonds, cash for future investing and traditional and non-traditional growth vehicles. This takes a fair amount of research, especially non-traditional growth areas such as land, collectibles, rentals or direct investing.

To conclude, investors need to decide on their own if they believe the financial world is coming to an end or not. We do not think that the stock market is about to disappear nor will the housing market be blown to dust. For long-term investors, creative thinking outside the box, a willingness to buy when everything feels awful, and great patience will all be eventually rewarded in this investment cycle.

Steps to help end the Real Estate Market Debacle

- Put qualified realtors and appraisers to work establishing current fair market values on all properties in all markets.
- Give <u>all</u> homeowners the opportunity to refinance to 30 year fixed-rate mortgages at a uniformly low reasonable rate once the current fair market values are established as above.
- Require all future borrowers to make uniform down payments and pledge personal guarantees.
- Prohibit floating rate mortgages.
- Standardize and regulate the mortgage brokerage industry.
- Establish a procedure for lenders to recoup their losses on principal and interest rate reductions incurred in the refinancing described above, by having them participate in any appreciation realized at the time of future property sales.
- Require all property owners to vacate premises without legal recourse if they miss 3 mortgage payments.
- Create one nationwide electronic databank on the Internet listing all vacated, foreclosed and available properties.
- Reduce real estate transfer fees and commissions on Internet electronic market transactions.
- Put idled homebuilders and construction workers to work refurbishing abandoned and foreclosed homes, apartment buildings, and commercial properties, paid for by their eventual sale back to private owners.

Steps to help make the Wall Street Bailout Plan work and end the Global Liquidity Crisis

- Get an independent party who is free of conflicts of interest to establish a current fair market value on all financial paper worldwide.
- If and when the U.S. Government buys toxic securities from private firms at prices higher than fair market value, those companies must agree to the following conditions until the U.S. government and people are paid back in full.

- Suspend all dividends to stock holders.
- Revise pay rates of all employees to equal that of the U.S. government employee scale.
- Prohibit bonuses to executives.

- In addition, we should require all holders of financial paper globally to make full disclosure of:
  - What they have traded and at what prices on a daily basis
  - How much debt they owe and to whom
  - What they currently own

- It is especially important that these disclosure information rules apply to the following investment entities that are now completely hidden from the public view:
  - Sovereign Nation Funds
  - Hedge Funds
  - Private Banks
  - Offshore Trusts

- Insofar as future financial security creation and loan production, we should require all future credit creation to:
  - Conform to uniform documentation standards
  - Be carried out only by regulated entities
  - Contain sufficient collateral provisions that are backed by general business and personal guarantees

- To prevent overly complex and off balance sheet items from ever again clouding the markets ability to know how bad things are, we should make certain that financial companies disclose all information noted above to the public via the Internet and then create an electronic exchange for efficient trading of financial paper. In addition, all of this data needs to be available for continuous regulatory scrutiny .

Personal News/Upcoming Events

2008 has been a very eventful year. My daughter Robyn, 22, is in her first Actor's Equity Association (Union) theater production at the Guthrie Theater in Minneapolis. She is playing Catherine in Arthur Miller's, "A View From The Bridge" and she will be returning to Brooklyn, NY when the production is over. Hanna, 19, is adjusting to life at college in Rhinebeck, NY. Deb is settling into her house in Asheville and running the family farm while I now reside primarily in New Mexico. In July, I participated in the Hard Rock 100 endurance event. If you have an interest in hearing more about that 48 hour race, you can read about it on their website hardrock100.com. Besides working in and around the office this fall, I am beginning work anew on my longstanding chapel painting project in egg tempera. My mother Helen Rikoon passed away on October 7th in New Rochelle, NY. She was 84 years old.

Our upcoming tea will held on Thursday, November 6 at the Ghost Ranch Conference Center in the Rendon Room at 3:30 and 6:00pm. The following Monday will be out-of-towners' turn to have a telephone conference call where people around the country are given the opportunity to call in and submit questions. Questions can be submitted via email either before or during the telephone tea. These calls will take place on November 10 at the following two times: 3 p.m. and 6 p.m. Mountain time.

Dana: I had an enjoyable summer visiting family and friends in Idaho and California. Life at home was busy tending beehives and garden. My son spent the summer in Aspen as an intern at Jones Trading. He has taken up road biking and did his first 100 mile ride before heading back to Denver University where he will graduate this year. My daughter, Alice, is in her senior year at Santa Fe High with the college application process looming. She continues to perform with Moving People Dance Company and is beginning a year long internship program at the Lensic Theater to learn about lighting, sound and stage management. One afternoon a week she assists her aunt who teaches art in the public elementary schools here in town.

Patricia: I spent time this summer helping my son look for land outside of Santa Fe. He grew up in New Mexico and wanted something in a rural area. He invested in some property outside of Rowe near Cow Creek. I am happy knowing I will get to see a lot more of him during this project. He is talking with the folks at Clever Homes (you can check them out online) about building from a green house kit. I hope you all have enjoyed our new office. I am particularly fond of the green house and plan to keep things growing in there this winter. Come by anytime to check out the progress except Nov 8th through Nov 17th when I will be in North Carolina.

Jeff: My oldest step-son and his family spent part of the summer with us in Santa Fe. He is a commercial contractor in Phoenix, and at my request, he came and did a lot of projects at our new office location and at my house too. One of the projects at my house was to add on to the block fence in our back yard. The "little" puppy that we got earlier in the year is now about 8 months old and weighs 55 pounds. When people would walk their dogs in the arroyo behind our property she would run to the back wall, stand up on her back legs and put her paws and head over the wall. Then she would bark at those that she didn't know or whine and cry at those that she did know because she wanted to join them on their walk. She could have easily jumped over the fence, so we thought it was best to raise the fence before she figured that out. The morning after we raised the fence height, she ran to the wall after spotting someone in the arroyo. She sat down, looked up at the higher wall, turned back and looked at me, and did this several more times until she finally wandered back to the yard to lie down. I think that the new fence is a success.

Emily: This summer I got back into playing tennis on a competitive level. My dad and I played mixed-doubles in a few tournaments and recently, we both won our singles brackets at a tournament here in Santa Fe. I am hoping to getting a little more playing in before the weather turns. In September I attended the Schwab Impact Conference in Atlanta. The conference was a great opportunity to network with other investment advisors and attend educational sessions. I am looking forward to visiting the Pacific Northwest this fall for two weddings and to see friends and family.

Juliana: My constant desire to roam got the better of me this fall. Earlier in the year, I read an article in the NYT about a rush weaving workshop in England and I was able to convince a friend of mine who lives in London to sign us both up. So in September I attended my first arts and craft workshop with Felicity Irons of Grange Farm, Bedfordshire. It was a blast to spend 2 days being totally immersed in something that I knew nothing about plus I actually did make a basket. I am very proud of my creation and would love to show it to any one who ventures into my office. Besides the workshop, and spending time in London, I took a train up to Taunton, Somerset to visit another friend from high school days. The last time we saw each other was 24 years ago so it was great fun catching up after all this time. You can check out the basket workshop at www.rushmatters.info . I think I might have to go back and make some placemats.