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Spring Commentary 2008

Overview

The financial markets have justifiably taken center stage in the news recently due to unprecedented events. This has impacted economies worldwide, and we stand poised on the brink of coordinating government intervention on a global scale.

In the following pages, I will present a simplified explanation of what difficulties we face, why the current crisis exists, and outline the most likely ways that these challenges will be met, along with a few brief descriptions of the potential investment opportunities thereby presented.

The Markets

During the first three months of 2008, the Dow Jones Industrial Average was down 7.6%, making it the worst first quarter in history. The Standard & Poor's 500 lost 9.4% while international markets fared worse. Stock markets in Germany and Japan dropped over 15% in local currency terms, while India declined 20%. China, formerly the highest-flying market, tumbled 32%. Reviewing these results clearly shows that we live in a global economy!

The Rikoon Group's U.S. stock portfolios declined 7.02%* less than any of our benchmark indexes. We were helped by our strong emphasis on energy and natural resources. Our international portfolios of stocks declined 9.75%.* We removed fair amounts of money from stock markets overall during the fourth quarter of 2007 and have the highest cash positions in our firm's history.

While the stock markets experienced increased downside movement, the bond markets have been where the really scary action has taken place. The consistent stream of bad news about real estate and financial institutions has contributed to a deep feeling of malaise among investors. The actual performance of the bond index has not been that terrible. The U.S. broad-based Lehman Brothers Corporate Market Bond Index declined only one-tenth of 1% during the first quarter of 2008, while the Vanguard Short-Term Taxable Index actually gained 2.68%. Investors are now anathematic to any kind of risk and are piling into short-term bonds wholeheartedly. Some portions of the normally staid municipal bond market have been absolutely insane. Many state and local agencies that provide public services have been unable, in the short haul, to obtain funding for their normal operations. While short-term municipal market floating rate levels usually return 2 – 3%, many investors who desire immediate liquidity and complete safety have been put on edge by the failure of auctions—weekly sales which normally provide an opportunity for investors to turn bonds in for cash.

The Rikoon Group's taxable bond portfolios gained 0.57%* during the first three months while our tax-free bonds gained 1.47%.* These figures point to one of the fascinating anomalies in the markets today which is the opportunity to earn more in tax-free bonds than U.S. government or corporate securities. It is a brave new world out there!

*These numbers represent the core direction of our management strategies. Individual portfolios are managed in accordance with the client's specific investment objectives and constraints.

The Economy: Crisis/Opportunity

As 2008 has unfolded, investors have found extremely disappointing and disillusioning news on many fronts. Let's begin with the decline in real estate values. With the number of properties selling across the nation shrinking, U.S. consumers are now wondering what their primary asset, their homes, are actually worth. After five years of continuous increases, most people expected real estate value to rise indefinitely. The sad fact is that people who assume that prices of an asset will always rise and who borrow money based on that assumption, are now facing difficult choices.

Many experts predict that home prices will fall 16% nationally across all residential markets. The number of home sales will likely drop to 1995 levels which means that construction, a major source of employment, will slow down even more than it already has. A large majority of U.S. markets have likely not yet seen their fortunes fall even half as far as they are expected to over the next two years. Reality has not yet kicked in for many homeowners and builders who are likely to be forced into foreclosures as market conditions continue to deteriorate. In some markets, it currently costs almost twice as much to buy a home as to rent, so the incentive for buyers to step up to the plate does not exist at the present time.

The fundamental excesses of the real estate market from 2002 to 2007 mirror the equally meteoric rise in values and expectations of the stock market during the late 1990's. Hopefully, we have learned some lessons from that experience. Let's put the current real estate and credit situation in perspective. Fear is the dominant emotion today in the markets for real estate, bonds and even some stocks. It seems natural to reason that if the news is bad, it is going to get worse. While this may happen, do not believe that this is a meltdown situation. It is a good time to pause and consider buying property at deep discounts for cash. Rental property can be especially attractive in these circumstances.
No doubt, the markets are scary for some people. Entire nations have taken on unsupported debt levels in much the same spirit as real estate borrowers did in the U.S. Countries such as Iceland and Croatia have national debts resembling that of real estate speculators, in that they borrowed more than they could afford and did it in such a way

that it may now come home to roost. Iceland may have to directly intervene in international currency and stock markets to restore its financial houses to order and to re-establish global confidence in their country's economy. Can they go bankrupt? Could Washington Mutual, the largest U.S. savings bank, go bankrupt? Theoretically, yes. Practically speaking, no. Coordinated and concerted efforts by central banks will fill in the gaps and normalcy will return.

Let's look for a minute at the whole issue of speculation, be it in real estate, business or nations, and try to understand it in context of today's turmoil. People borrow money because in good times it will make them more money than just working with cash or savings. Borrowing money is encouraged in our culture, be it for home ownership or business expansion. Over the last twenty-five years, people have come to believe that the market will deliver safe returns to investors. We have grown complacent and assumed that we are due stability and prosperity. Ronald Reagan and every U.S. leader since 1980 have encouraged us to believe that deregulation—less government and more business—will inevitably lead to a higher standard of living. This has essentially held true. The mutual fund, investment banking, investment advisory, commercial banking, mortgage, student and credit card financing, energy, transportation, production, and automobile industries have all benefited from the belief that growth is always good, and because more growth comes from more borrowing, then inherently borrowing is good. These premises have held true for a longer time span than most people can remember. How can seemingly solid institutions get into trouble? Basically, the answer is greed.

The complexity of financial instruments, created by modern borrowing techniques, is so great and the size of them so vast that no government or regulatory agency is able to track what is happening. The originators of these financial arrangements are not going to be held accountable because the problems' sources are virtually untraceable. Let me use an illustration to explain.

Let's begin with your typical home loan of $300,000, although we could just as well be talking about your business, student, credit card or car loans.

Your loan is not held locally but is sold to someone who, in turn, sells it to someone else who, in turn, sells it yet again. Each time your loan changes hands, the buyer borrows money to acquire a portion of your mortgage. So, if you borrow $300,000 after putting up a down payment of $30,000, and the next four buyers of your loan do the same, there is now $1,500,000 of loans created based on your $30,000 down payment, or a 50:1 ratio of debt (borrowings) to equity (cash put up as collateral).

This is well and good if you make all your payments, if interest rates on any of the five loans don't go up too much, and if the value of the house doesn't go down drastically. Everyone is happy because no one imagines or worries that your loan could go bad.

Now, the geniuses on Wall Street have taken your loan and the $1.5 million of borrowed money based on your loan and cut them up into interest and principal payments. Furthermore, some of the buyers and sellers after your bank have cut up the loan into smaller parts, for example, into the next three, next six, next twelve, next twenty-four payments and so on, resulting in 50 sub-loans instead of five full loans, again, all based on your payments and loan terms. If you have an adjustable rate mortgage, there could be more than 100 smaller loan pieces created.

Now, none of the investors who bought one of your potentially 100 mini-loans knows you, and you don't know them. The buyers of your loan would have to spend a lot of money to find you or talk to you. This is not a problem as long as they all believe you will pay on time. But, if the real estate market is tanking, or their economist thinks you won't pay when your adjustable mortgage rate resets, everyone becomes a little edgy. Maybe a nervous bank or investor wants their money back sooner than your mortgage is scheduled to be paid off, so they try to sell one of these 100 mini-mortgage pieces. But, lo and behold, no one wants to buy it because they are nervous too due to rumors of bad debts flying around. Welcome to a credit crisis. When you read about bank write-offs, capital infusions into savings and loans companies, failed municipal bond auctions, companies threatening bankruptcy, hedge funds liquidating, it all pretty much boils down to the fact that there are loans that can't find a happy home.

Of course, no one really knows if you are going to stop paying on your mortgage, but few investors are willing to sit around with a wait and see attitude, especially because it is impossible to know who you are and therefore, to ascertain the true risks.

Lack of confidence in a company's ability to pay off its very short term loans recently took Bear Stearns, one of five primary U.S. government bond dealers, to its knees. It had 30 billion dollars on hand one week, and by the next week, the threat of having almost no cash on hand due to people calling in their loans forced the company to be sold to J.P.Morgan at 20 cents on the dollar. It was purely a crisis in confidence that brought down the mighty Bear. J.P.Morgan came in and bought what was, and still is, a great firm, all because the Fed did not want to see panic take hold.

We may see this situation occur in some real estate markets, as people realize their homes may be worth less than their mortgage. This is why the Federal Reserve Bank, the U.S. Treasury Department, the European Central Bank, and governments worldwide are intent on restoring investor confidence. I believe they will succeed at some cost but with potentially large gains as well.

U.S. government intervention in the real estate markets, on a massive scale is becoming a likely reality. The U.S. Congress has passed a multi-billion dollar measure that they hope will bring relief to real estate markets by providing increased government financing for mortgages, tax credits to people buying homes in foreclosures, and bailing out homebuilders through tax breaks.

Ever since Ronald Reagan and his team deregulated the banking industry, the cost of papering over financial trouble spots, starting with the savings an loan industry, has always eventually been thrust into taxpayers' laps. We can expect to see substantially higher tax rates on all kinds of income by 2010. This will greatly affect our firm's investment strategy as 2008 progresses. Our children and their children will pay for the bailout of financial institutions that is now unfolding by footing the bill for the current financial debacle through higher inflation. The size of this kind of debt is estimated at 45 trillion dollars. This is so great an amount of money that the resources needed to allay investor concerns will likely outstrip the monetary reserves of Western banks. I believe that cash reserves of Middle Eastern governments will be required in order to stabilize the financial system and that they will be forthcoming as it is in their best interests to keep us afloat.

If and when this happens, we will be rewriting the rule books about how financial markets operate. This means that the stock and bond markets will not head on an endless downward spiral because the big money players on the planet will buttress up the system in exchange for a bigger piece of the pie.

We expect to see some local companies possibly declare some form of bankruptcy, yet emerge able to carry on their functions within the financial system under new ownership. This will essentially wipeout current shareholders and, in some cases, bondholders as well.

The public will generally be unaware of the pain inflicted until we look back at the change in what our paychecks can buy. This means that we have to invest for growth more than ever, but what kind of safe growth is possible? One such possibility is bonds from the states and counties that need to borrow money and who have substantial collateral.

In the real estate markets, there are certain parts of the country and certain kinds of buildings which are experiencing continued robust demand. The investment field is not for the faint-hearted. The time to buy is when there is “blood running in the streets.” Government regulators, generally years behind the wiz kids in New York, London and Geneva, are talking about re-regulating financial institutions in “new and better ways.” Coordinated moves by global banks will help result in lower interest rates, looser standards for collateral and a greater regulatory burden on everyone involved. As the regulations increase, investor returns will decline. Low taxes on the very wealthy, with favorable capital gains treatment, and near exemptions of interest and dividends from income taxes, will likely go away.

How can you take advantage of this switch? We believe the use of high yield bonds in times of inflation works out. Companies who are not highly leveraged will be able to pay back their debts and thrive. The areas of energy, health and medical services, and tax-free bonds are ones which we believe do well, credit crunch or not.

Personnel News

Juliana Henderson went to Canyon Ranch in February for a lovely pampered spa and exercise weekend. She was joined by an old friend from Raleigh, NC, and they both enjoyed every aspect of the Ranch! In April, Juliana will be spending time in North Carolina visiting her mother and working with Rob in the Asheville office.

Jeff and his daughter enjoyed the recent ski season as they went to Ski Santa Fe most Sundays. This was Stephanie's second year on snowboard and she is improving but still not as agile as she is on skis.

Patricia bought a new car this winter. Something to be more gas conscious for the commute to Santa Fe. It is a little red Scion xD that gets great mileage and is very fun to drive (and park).

Emily Zinn joined The Rikoon Group in January. Emily, a Santa Fe native, recently moved back after 7 years in Oregon. She has a degree in Economics from Willamette University and worked for an investment advisor in Salem before joining The Rikoon Group. In her spare time, Emily enjoys working on crafty projects, playing tennis, hiking and taking in the Santa Fe arts scene.

Dana is happy to report that her bees wintered well and are out and about. She reports that her children are following suit; one buzzing around Denver University and the other Santa Fe High.

Upcoming Events

In part of our ongoing efforts to communicate with our friends and clients around the country, we will be holding our next quarterly gathering on May 15 at the Ghost Ranch Conference Center (Perea Room) at the corner of Paseo de Peralta and Old Taos Highway in downtown Santa Fe. We hope to be able to announce the location of our new office facility in Santa Fe. There will be two sessions, one at 3:00 p.m. and the second at 6:00 p.m. each lasting ninety minutes. Please feel free to bring a friend with you.

For our friends and clients who are not able to physically attend, we are going to set up an afternoon and evening call-in date with a party line. We will cover similar ground as that of our "teas" in Santa Fe, and encourage all of you who have not had the opportunity to join us to do so telephonically. Each caller or attendee will have a chance to ask a question of Rob about the markets, the economy, or the influence of world and political events on your portfolios. We look forward to everyone's participation.