

Margin of Safety Investing Opportunities in the Current Market Environment
10/17/2008

"In the short-run, the market is a voting machine but in the long-run, it is a weighing machine."

Benjamin Graham, 1930s

Executive Summary

Our premise is and has always been that volatility is not the same as risk of permanent loss of capital. Perhaps more importantly, volatility *has to exist* in order for investors to be afforded opportunities where they will not be exposed to permanent loss of capital risk, i.e. for bargains to exist. We have never been able to time the market, and concede our inability to do a better job picking stocks or bonds better than the seasoned professionals, who we consider to be the best managers in the world.

This may be the buying opportunity of our lifetime. While this is of little comfort to our clients already invested, it is an excellent opportunity to deploy cash and to encourage others who have been sitting on the sidelines to do so. Since 1929, when Benjamin Graham started Margin of Safety investing, long-term investors have been rewarded handsomely for staying invested according to this discipline. Other managers, including Warren Buffet, and more recently Jean-Marie Eveillard, Marty Whitman, Bruce Berkowitz, and David Winters have had similar success. Warren Buffett is buying.
Warren Buffet October 17, 2008

The purpose of this communication is for you to hear our firm beliefs of what happened, what is happening, where the best opportunities are, and what we expect to happen. We also would like to ask you to **refer** other potential clients to us so that we can represent them as an investment advisor and make sure they make the right decisions for their long-term financial health.

What happened prior to the bailout?

Recently, we have experienced unprecedented volatility. This took many years to brew, beginning with easy money for too long and ending with inappropriate regulation of investment banking (too much leverage) and insurance activities (nearly unlimited downside exposure in credit default swaps). The recent global financial crisis caused a selling spree:

- Home prices started to fall and foreclosures started to rise (something apparently not anticipated by the Huge Investment Banks), causing the value of Collateralized Debt Obligations to fall as it became obvious the AAA ratings did not represent their true risk
- As one bank became more skeptical of other banks' holdings, banks became more reluctant to lend to one another
- Institutional and individual depositors began to fear for the safety of their money markets and began running on the banks (withdrawing deposits)
- Leverage ratios were further reduced causing the financial institutions to sell more assets, any assets (including municipal bonds and even otherwise illiquid assets)

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- All bond prices except treasuries experienced downside volatility; even investment grade bonds sold at discounts of 25% or higher. Unrated paper sold for much more significant discounts even if fundamentals would warrant an investment grade rating

Bottom line: financial institutions were forced to sell assets indiscriminately causing many fundamentally sound assets to drop precipitously in price. Individuals and institutions, driven by their primitive hindbrains and its flight or fight instinct, reacted and sold too. Our managers, including our fixed income managers, have almost all been affected. The difference is that wherever possible, they are buyers instead of sellers. They are selling when they see opportunities to sell cheap securities and buy even cheaper securities.

Before the bailout, it was becoming increasingly possible that there would be widespread bank failures that would impair the lending capacity of the banking system for a very long time. Steve Levitt wrote on wonderful piece describing this crisis, see the link below.

[Steve Levitt on the Banking Crisis](#)

What is happening right now?

Liquidity and more importantly, capital, has promised to be injected into the system. However, this takes time. It will take months before the capital makes its way into the banks and back into the economy. When it does, selling pressure on assets that have historically been illiquid, but which have been sold at fire sale any price to raise cash and restore liquidity, will cease. Until the liquidity crisis ends, spreads on investment grade and high yield bonds may remain high. When it is clear the crisis is ending, we would expect those spreads to contract and for the prices of the bonds to rise. Equity prices should also rise.

None of the experts we trust (Jean Marie Eveillard, David Winters, Bruce Berkowitz, John Hussman) believe the United States faces a Great Depression nor do they believe we face malaise similar to what happened in Japan in the 1990s; we are finally hearing a chorus of "the government has done the right thing and this will pass." The global economies are working through the former crisis as capital makes its way out through the banks and back into the Global Economy. What we face instead, is a crisis of confidence. Since the turn of the century, the United States has faced such a crisis about every 20 years. While this may be a larger crisis, it is **not** the Great Depression.

In the selling frenzy that occurred, assets of all quality levels were affected. Investment-grade corporate bonds, non investment-grade bonds, equities with high margins of safety and yielding 4-5-6 times free cash flow (extraordinarily cheap valuations) all fell in price. The Margin of Safety managers generally came into this environment with high cash balances, which they have been deploying to buy cheap companies. They have also sold off some cheap companies to buy even cheaper companies. Bruce Berkowitz is buying bonds in companies where he owns the stock, because with 15% or so yields these are compelling bargains.

Where are the greatest opportunities?

The greatest opportunity in the short run is likely in the fixed income space. Both stocks and bonds of companies that have strong balance sheets and a favorable outlook even in an uncertain environment have been punished. Unrated municipal bonds, even when underlying fundamentals suggesting an investment grade rating, have been especially punished. We have managers that own all of these.

Even if assume default rates on high yield bonds that occurred during the Great depression, high yield bonds would still be expected to return 6% p.a. over the next 5 years. We believe the greatest opportunity over the next two years or so; however, is NOT in fixed income but is in our long-term return potential managers. The overall stock market (S&P 500) is trading at valuation levels not experienced in decades. Investment grade closed end municipal bond funds are trading at 20% or better discounts to net asset value, i.e. not only are the bonds likely undervalued, the fund is another 20% undervalued, with taxable equivalent yields of 10% - 11%. **THIS IS VERY COMPELLING EVEN TO INVESTORS RETICENT TO MAKE EQUITY INVESTMENTS.**

In this environment, we are excited at bounce back potential. Most of our managers are at historically high draw downs, i.e. these managers have previously never experienced losses of the current magnitude. While we can never know what the future brings, we do expect valuation disparities to be corrected over time, i.e. in the short run the market might be a voting machine, but in the long run, it is in fact a weighting machine.

What do we expect to happen going forward?

The liquidity crisis will take at least 2-3 months, maybe 6-9 months to normalize banking operations. Sometime after that, it seems clear that yield spreads will tighten and fixed income securities not truly exposed to default risk will appreciate. However, the economic recession is a reality. Consumer sensitive industries may face a prolonged recession. This will cause economies around the world to slow down. Industries that are less sensitive to consumer spending, like healthcare and defense, should fare better. At some point in the not so distant future we expect the stock market to act more like a weighing machine and for the underlying share prices of stocks owned by our Margin of Safety managers to appreciate, regardless of what happens to the broad market. Our managers are stress testing all of their assumptions to make sure the Margin of Safety still exists. We believe they know what they are doing.

Conclusions:

The broad stock market and our funds may retest lows over the coming months. However, unless you are making large withdrawals, you absolutely need to stay the course. If you have cash or if you know people who have cash, PLEASE HAVE THEM CONTACT US!

We have ideas that we feel will be compelling over various time horizons and with varying risks. Moreover, we have access to fund managers who will not *pay to play* on other platforms. For example, International Value Advisors recently chose not to pay a

major wire house to be allowed access to their platform, because they would have had to pay \$50,000 setup, 0.25% of assets, and \$16 per account. We have heard similar stories from Hussman, Fairholme, and Wintergreen, all funds that chose not to *pay to play*. Moreover, any investor that you refer to us will be placed in an investment advisory account, on which Global View Investment Advisors will be fiduciaries, will not receive commissions or any other payment except our advisory fees. Following are some instances where you might consider referring your friend or client: Please contact us you know someone who:

- **Is invested in cash**. Currently there are substantial opportunities using investment grade fixed income products that pay high yields and that may sell at substantial discounts to their true worth. For example, we have investment grade closed end municipal bond funds paying yields of over 7%, taxable equivalent yields of over 10%!
- **Is invested in an index**. For one, as there are many substantial periods of rolling 3 and 5 years where indexes have not performed well, we feel it remains prudent to have a Margin of Safety investing bias. Second, there are closed end funds that have substantially similar holdings to the indexes and that sell at discounts of 15% to 20%.
- **Is concerned about their investments**. Investors concerned about their investments and about their financial future need to know the golden rules of investing and follow the advice of someone who adheres to them. These are:
 - o Always trust your investments to people who have shown success in the past
 - o Look for honesty above all else
 - o Follow a strategy that makes sense
 - o Deal with someone who has been through difficult times in the past
 - o Deal with someone who puts his own money where his mouth is
- **Has their investments at a Wire house, with an Insurance Company, or other Financial Conglomerate**. Remember, all of these companies generally charge an admission fee, i.e. they make investment companies *pay to play*. While this is true of all custodians; the fees charged by some are excessive and cause many managers to abstain from participating in those platforms. While we are also capitalists, we do not feel the extent to which participating managers are forced to *pay to play* is sufficiently disclosed and borders on dishonesty.
- **Has stopped making 401k deferrals or is in cash in a 401k**. If you are not retired, it goes without saying that you have a long time horizon. Now is the time to be invested for your future.

For the sake of your own financial health, stay the course. For the sake of your friend's or client's financial health, please refer them to us.

Yours sincerely,

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