globalview
Professional Experience, Unbiased Perspective

Quarterly Newsletter to Public Q4 2008
Testing your Mettle

Executive Summary

These markets are testing your mettle in a way we have predicted could occur, but not knowing when it would occur, were unable to avoid for our clients. As of today, the S&P 500 is about 36% off its peak in October of 2007. We are one year into a bear market and ask our clients to give the managers 3-5 years from its start in order to work. This means we believe, based on history, these strategies will work out by October 2010, latest October 2012. That said, between now and then is uncertain. In our last communication, we showed you that the Margin of Safety strategy has largely steered clear of owning the leveraged assets that have caused this crisis, but the share prices of stocks in these funds, while generally less than indexes, have suffered along with everything else. Good, bad, and other have all fallen. We are suffering a crisis of confidence in the global financial system that will only be rectified when the financial institutions behind it are de-levered, i.e. are recapitalized.

We are convinced that our strategies will work but understand more volatility almost assuredly awaits us. There are very good reasons to continue with your current strategy especially given the history of our margin of safety managers over worst 3 year and 5 year rolling periods; however, if you have concerns, then we need to address them. The only guarantee worth the weight of its guarantee, and we hope that guarantee still holds, is the guarantee that the US government will make good on its promises. Therefore the truly risk averse investor should be invested in US treasuries. The problem with that guarantee is that it is currently expected to pay about 3% p.a. over the next five years. Taking this guarantee almost assuredly means you will sacrifice some of your freedoms, especially if you fear inflation will rise, as do experts we respect.

To quote David Winters "every other panic in history has ended and it is a huge opportunity to be a buyer of securities … now we have great companies that are cheap. … for long-term investors great wealth is created in times of stress."

If you feel distressed, we must discuss Plan B. Plan B is an alternate strategy we can develop jointly with you as a second best solution, understanding that your long-term success depends on you being able to stand interim volatility. Your health, financial and emotional, is important to us. But keep in mind, the average bear market is a decline of about 32%. Right now the S&P 500 has fallen more than that. We can stop the pain right now, but the healing process will take longer.

Your Custodian Safety and Security

Our clients have their assets at Charles Schwab Institutional and National Financial Services, two firms not directly affiliated with the Huge Investment Banks or other financial conglomerate banks directly exposed to this crisis.

These institutions are taking prudent measures to make sure money markets are not at risk. Moreover, Charles Schwab in particular is a very sound and profitable company with very low exposure to credit markets. Charles Schwab and NFS are insured by the Securities Investor Protection Corporation (SIPC) against fraud.

Furthermore, and more importantly, you should take comfort knowing that we have a fiduciary loyalty to act in your best long-term interests ahead of our own interests. All of our recommendations are made with this in mind.

Market Update

The credit experts at PIMCO and Loomis Sayles had suggested the worst of the credit crisis was behind us. However; no one expected a crisis of this type or global magnitude to occur this quickly. This crisis has affected almost every asset class, causing even corporate bonds to fall significantly in the third quarter. Last month alone, the S&P 500 fell 9.2% and EAFE index fell 14.4%. Oil prices also fell significantly. On Friday, October 3rd, commodities prices fell the worst in 50 years. As of today, the S&P 500 has lost 18 percent since the start of 2000, exceeding the 8.9 percent plunge in the 1930s, following the stock market crash of 1929.

The bottom line is this: we are not sure what will happen over the next year, but remain confident that two to four years from now our clients will be rewarded for holding the course. We are seeing hedge fund managers turn off short positions and “permanent” bears become optimistic, moreover valuations have become much more favorable. John Hussman, who manages one of our Short-term Volatility Control funds, and who made 4.5% through the end of September, in his last newsletter said, “Investors should recognize that normalized valuations are now the best they've been since 1995. That may not be saying much, since the total return on the S&P 500 since 1995 has averaged only about 7% annually, but it is what we might call "the beginning of wisdom."

Our Model Portfolios, which are the basis on which we make investing decisions for our clients (but which no client owns in an exact proportion), fell significantly through the end of the 3rd quarter 2008:

Global View Moderately Aggressive: -14.9%
Global View Moderate: -10.4%
S&P 500: -19.3%
MSCI EAFE: -31.0%
MSCI World: -25.6%

How did the crisis happen?

What is happening in the banking industry is a crisis of confidence. Banks have been afraid to lend to other banks on an overnight basis fearing overnight loans might not be repaid. Individuals and institutions were afraid to use money markets fearing principal might be at risk. Bill Gross made a good analogy to a McDonald’s drive through window: you pay $4 for your Value Meal at the first window, but are afraid you won’t get the Value

Meal when you drive up to the second window. People suffering from this “McFear” are understandably reluctant to stop at the stop at the drive through window.

How did we get here?

Republicans largely blame the Community Reinvestment Act (CRA); democrats blame corporate greed. In reality it is a little of both. Independent mortgage companies, not covered by the CRA, made high-priced loans at about twice the rate of banks and thrifts that were covered by the CRA. On the other hand, the problem was magnified when leverage at Huge Investment Banks (Bear Stearns, Lehman Brothers, Merrill Lynch, Morgan Stanley, and Goldman Sachs) was extended from 12:1 to 30:1 or even 40:1 in 2004. The final insult to this injury is the proliferation of credit default swaps— essentially insurance against the failure of a security that was inappropriately priced. In retrospect the cost of insurance was far less than the risk that was insured. This caused the failure of AIG.

Regardless, the “bail out” package had to happen and will likely make US taxpayers money. If you want to learn Warren Buffet’s perspective on this, read Warren Buffett interview on 10/1/2008. See LINK : http://www.charlierose.com/view/interview/9284

Recommendations

In this environment, it may be too late to adjust your investment strategy without sacrificing substantial bounce back potential. While we could tell you to reallocate, invest in CDs, treasury bills, or offer you the false guarantee of a variable annuity with a 6% p.a. income rider, this option should be pursued by only the most risk averse of investors. Remember, we have only one interest: to help you make the most you possibly can in a very scary environment by keeping you from losing money first.

That said, we do have a Plan B which includes that have the Margin of Safety investment orientation and focus on short-term volatility reduction. While it is always best to make such a reallocation into a rally, we cannot predict when such a rally might occur so, it is imperative to discuss this based on your concerns. We feel Plan B will reduce long-term total return, but is a better alternative to CDs, treasury bills, or other false promises.

Long-term Return Orientation

Significant historical research reinforces our belief that the Margin of Safety orientation is the best strategy for avoiding permanent loss of capital over a relevant time horizon of 3-5 years. Since we are only one year into a Bear Market, we have no reason to believe our premise is incorrect.

This orientation also applies to bonds. Loomis Sayles conducted an analysis of bond returns during the Great Depression and the Long-term Capital Management Crisis in 1998. Based on current yields, the US Treasury index can be expected to return about 3% p.a. Even accounting for default rates during the Great Depression starting in 1929, investment grade corporate bonds should be expected to make 7.2% p.a. or using default rates beginning in 1998, 7.8% p.a. Similarly, using default rates for high yield bonds during the Great Depression, high yield bonds might be expected to earn 5.8% - 7.9% p.a. We believe talented bond managers can do better than this.

We believe this bear market too shall pass. Based on the long-term history of a Global Value Manager since 1979, the worst three year compound average return ever experienced was 3.6% p.a. Assuming we are one year into that period beginning at the market peak on 10/9/2007, then the manager has fallen 19% (while the S&P 500 is down 36%). In order to make 3.6% p.a., having lost 19%, the next two year returns would need to be 17.4% p.a. Although this is hypothetical, it is sound reasoning based on the premise that the intrinsic value of the underlying securities will equate with market value over time. Thus, a bounce back is inevitable.

Choices based on this premise:

	Value 10/9/2007	Value 10/8/2008	Hypothetical Value at end of Worst 3 year period (October 2010)	Imputed Compound Annual Return from today
Global Value Manager	1,000,000	807,000	1,111,935	17.4%
S&P 500	1,000,000	645,000	590,590	-4.3%
LB US Treasury Intermediate	1,000,000	1,083,200	1,149,167	3.0%

Therefore your choices are clear:

1. Hold on and strive to get a return of 17% per year (keeping in mind we are already well into a Bear Market),
2. Reallocate to Plan B, building a bridge over the uncertain period ahead of us (with an expected return likely above 3% and lower than 17%)
3. Take no risk and invest in Treasuries or CDs.

Of course, it is possible that all of the Margin of Safety Managers are wrong— hat this truly is a new period and that we are likely to be reduced to club wielding, rock throwing Neanderthals. We feel our clients should continue to make the appropriate bet, but at the end of the day, the risk you wish to take is up to you.

Process for Manager Selection

Through Charles Schwab Institutional, Global View Investment Advisors receives no compensation from any of its mutual fund managers other than the fee we charge our clients; we will accept invitations to due diligence trips for the sole purpose of conducting due diligence on mutual funds we already use.

Our process for selecting managers is simple from one perspective. Every manager must have as its investment objective (either explicitly stated or implied in its prospective and other literature): to avoid the risk of permanent loss of capital. The other variables require more explanation. We rank funds based on two categories: long-term return and short-term volatility control

Long-term return potential:

The following criteria are considering for selecting managers for long-term return potential:

- Shareholder-first attitude: fund will close to new investors if asset size becomes an issue (fund gets too large), and will practice business practices that appear to accomplish this objective in contrast with growing larger. A manager with multiple funds that appear to have a similar objective and holdings would be disqualified from this ranking

- Asset size: smaller funds are more nimble and can make investments larger funds generally cannot

- Flexibility: the ability to invest across any market capitalizations and across broad geographic regions is favored. Restriction to a particular market capitalization or geography is grounds for disqualification

- Own-Cooking Eaten: the portfolio manager and analysts should be substantially invested alongside investors

- Managers' Track Record: the track record of the manager who will manage the fund— not of the fund itself— is given consideration here, allowing us to look at new funds that have no performance history

- Stated Return Objective: few managers will put forward their goal in absolute terms; however, we have caught most of our managers, in a moment of weakness, admit to an internal target. While having a goal is never a guarantee the goal will be attained, not having a goal makes it far more likely it will not be attained.

Short-term Volatility Control:

The following criteria are considering for selecting managers for short-term volatility control:

- Degree of Diversification: more holdings and lower concentration of any given holding should reduce volatility

- Downside Deviation: lower historical downside deviation may contribute to reduced volatility

- Ability to Hedge: ability to take anti-risk bets, i.e. to bet against an index by purchasing a put on it or to take short positions, without taking leverage (which can result in permanent loss of capital risk) may contribute to reduced volatility

- Stability of Strategy: fewer manager changes, lack of ownership changes create less stress on the management team which could result in management discontinuities

- Ownership Concentration: the lower the concentration in any given position, represented as a percentage of that asset owned, the more nimble the manager is to sell the position

Any Plan B strategy should start with investments including our short-termvolatility control managers including Hussman, Loomis Sayles, Nakoma, and others. These managers have the potential to participate in the upside potential while potentially mitigating downside risk.

Relevant Economic Commentary

Bill Gross commentary from PIMCO – Nothing to Fear but McFear Itself

See LINK:
http://www.pimco.com/EN/Insights/Pages/Investment%20Outlook%20Gross%20October%202008%20Fear.aspx

Remember, past performance is never a guarantee of future results. Please contact us if we need to address your concerns and develop a Plan B strategy. Thank you for your time and attention in this unprecedented period of volatility. We look forward to working with you for a very long time and value your emotional and financial safety.

Yours Sincerely,

Your Team at Global View