



Financial Markets Review and Outlook

October 2008

It is difficult to justly describe the deterioration of the financial markets this year, which accelerated in September with the government's takeover of Fannie Mae and Freddie Mac, the failure of Lehman Brothers, and the failure/take-over of AIG, all in rapid succession. As this Review and Outlook is written, stock markets across the globe continue to sell off, and there are few places to hide as prices for corporate and municipal bonds, commodities, and real estate are all falling. Only U.S. Treasury bills are stable, but they offer virtually no yield. This has all been very apparent to anyone watching the news or reading the newspaper.

Our general advice to you today is:

- **Be patient and don't panic!** Following investors who are forced to sell (for a variety of reasons) is usually a bad idea.
- **If your personal financial situation has changed in such a manner that suggests a re-evaluation of your overall portfolio allocation, please contact your Samoset financial advisor.** If changes are required, we would recommend a plan to reallocate your portfolio over a period of at least 3 to 6 months.
- **We continue to believe that crisis creates opportunity.** Those opportunities are best exploited through the use of experienced, independent portfolio managers. This is the core of Samoset's investment philosophy.

Please read on below for a more detailed discussion of the current environment, including responses to questions you may have, and a general review of Samoset's investment philosophy.

The freeze-up of the commercial paper market, which may not be readily apparent to people outside the financial industry, is creating significant stress in the credit markets. Commercial paper (CP) is the name for very short term debt (bonds) issued by corporations across all industries, and especially the financial sector. It is the life blood of the financial system for corporations. Revenues and earnings of most companies do not flow in exact synchronicity with expenses, so corporations issue CP (i.e., take short-term loans) in order to make payroll or purchase inventory, etc.; or in cases where they have excess cash, they purchase CP (i.e., make short-term loans) in order to park their cash somewhere and earn a modest return. Financial corporations are heavy issuers of CP as they constantly borrow in the short-term markets and use the cash to make longer term loans or other investments. This is very similar to a bank taking in savings deposits (which can be redeemed at any time), paying a certain rate for those deposits and investing or lending longer term and earning a higher rate on such investments or loans.

Closely related to CP are bank loans and certificates of deposit (CD). These are other ways for banks to lend and borrow from each other and the public. You have undoubtedly heard the term LIBOR mentioned repeatedly in the news lately. This stands for "London Interbank Offered Rate", and represents the average rate that large banks are willing to lend to each other. It also happens to be used as the basis for many loan contracts and securities. For example, many

variable rate mortgages, home equity lines of credit, auto loans and commercial loans are tied to LIBOR. Because all of these things are interchangeable, the interest rates delivered by CP are closely tied to LIBOR. Furthermore, virtually everyone, from individuals to large corporations, is directly involved in CP, bank loans and CDs, through the purchase of money market mutual funds, which generally hold all of these securities.

Up until the summer of 2007, the CP markets had been very safe, well functioning, and liquid (i.e., there were plenty of lenders and borrowers). Bill Gross of PIMCO, a noted investment strategist, recently stated that "credit markets are based on trust and when there is no trust, markets can freeze up." Last summer (2007), the CP markets froze up as buyers became unsure of the balance sheets of many of the issuers. Having not returned to normal, the situation was exacerbated in September 2008 when Lehman's default caused one very large and visible money market fund to fall below a dollar and freeze redemptions, which caused broad distrust in the stability of all money market funds. Similar to a run on the bank, there has been a run on the CP market. The clear evidence to this has been a sharp rise in LIBOR. This sharp rise in borrowing rates has been detrimental to both healthy and troubled companies, as well as consumers.

This is an important piece of the puzzle which the U.S. Federal Reserve Bank tried to remedy a few weeks ago by extending a guarantee on money market funds and, more recently, by implementing a program to purchase CP, an unprecedented move. In addition, yesterday, the U.S. Federal Reserve Bank along with the European Central Bank (ECB) and several other central banks including those of the U.K., Canada, Switzerland and Sweden coordinated to cut their interest rate targets. These recent moves, along with all of the other unprecedented actions the U.S. Government has taken, are evidence of the Government's determination to resolve the crisis. As Seth Glickenhau, a long-time Wall Street veteran who was around to witness the 1929 debacle, recently noted "[in contrast to the Depression,] this time Government is moving heaven and earth to reverse the cycle."

In our view, these are all positive influences, and there are some other good signs. We believe that the Wells Fargo announcement and fight to acquire Wachovia is evidence of a more normal market. Warren Buffet's purchase of Goldman Sachs (GS) and General Electric (GE) preferred stock is similar. Granted, he extracted a significant premium from GS and GE, but his willingness to buy is notable. In addition, we note that there is an enormous amount of cash on the sidelines that we expect will have a significant positive impact on the markets over time.

So why hasn't any of this worked to stop the overall decline yet? The virtuous cycle that we have often referred to over the last decade developed over the course of years, and kept moving into the extreme excesses of leverage that are now well documented. The vicious cycle that began in early 2007 to undo those extremes should not be expected to reverse immediately or predictably. The credit crisis has now gone long and deep enough to have affected the broad global economy, and we believe we are in a recession. Unemployment is rising, house prices are still falling and credit is still not flowing. The first earnings reports for the third quarter (i.e., Alcoa) have come in weak and retail sales figures from the likes of JC Penney and Target support the emergence of a global recession. We expect the coming holiday season sales performance to be extremely weak. Default rates on high yield bonds and investment grade bonds will rise. Deleveraging is still happening and likely has a ways to go. In summary, cycles like this are not stopped abruptly.

This naturally leads to the question, “If the cycle has a ways to run, why not sell and convert to cash and wait?” The simplest answers are well worn but true. The markets are efficient and contain a discounting mechanism comprised of informed and uninformed investors with a wide range of motivations and constraints, and as such are difficult to predict. Market timing by investors whose basic philosophy, process and expertise are not oriented to that type of approach can be dangerous and unproductive. This applies to most investors! In addition, following the forced sellers (which are currently the investors who must sell to cover certain obligations) is usually a bad idea.

This may lead to a few related questions:

How long and how deep will the solvency/liquidity crisis go? It is very difficult to know. We would reiterate the resolve and actions of the U.S. and other governments to break the gridlock and reduce the fear. Along with this, we are seeing evidence of private sector actions reflective of a return to normalcy.

Is recession priced into the market? While it is again difficult to know, after this past week’s market declines we feel more confident that the answer is yes. Among many of the equity portfolio managers we respect, most believe their portfolios to be attractively priced relative to forward earnings and cash flow expectations. This means they believe there is upside to gain by investing now. The mortgage experts we speak with note that foreclosures will continue to rise, but that many mortgage securities are being valued at prices which assume default rates and recovery rates far worse than in the Depression, and far worse than more recently experienced in other countries’ real estate declines. This does not mean that prices can’t fall further. The bottom is entirely unpredictable, and the further prices fall, the greater is the detrimental effect on the real economy. We do believe that recession, distrust and significant fear are currently priced into the markets.

Because of the distrust and fear, we expect the stock market to remain volatile. For literally decades, investors have learned to buy on the dips in the markets. More recently the market has trained investors to sell when the market improves and rallies. We believe this is what we are seeing today. Whenever there is marginally good news and the market begins to rally, sellers pile in and move the market lower. This is going to take some time, and it is how the remainder of the leverage will be worked out, and how the money on the sidelines will be worked in.

What should you do now? Our first recommendation is to be patient. Because of the huge changes in prices and valuations across securities and asset classes, before making any changes to your portfolio, it is imperative to re-evaluate your individual long-term asset allocation targets with respect to your objectives, time-horizons and liquidity needs. Given heightened uncertainty and the weak state of credit availability, investors should err on the side of ample liquidity. If, with your Samoset financial advisor, you determine that a rebalancing or reallocation of assets is in order, we would recommend defining a schedule to rebalance in regular increments over the next 3 to 6 months. If, because of liquidity needs you need to allocate away from long-term targets, we would recommend defining a plan to move back to long-term targets in regular increments over the next 3 to 6 months.

Finally, because of the U.S. Federal Reserve Bank’s newly created facility to purchase CP, we believe it is safe to move back out of the U.S. Treasury-only money market funds and into the high quality corporate money market funds that we have approved for cash investments.

A word or two about Samoset’s overall investment philosophy. We believe in the value of active portfolio managers. The best way to implement a long-term strategic asset allocation plan is to utilize portfolio managers that make active investment decisions. These managers can be accessed through separate accounts, mutual funds, limited partnerships or other pooled vehicles. Importantly, we believe that each of the managers we utilize should have the flexibility and willingness to concentrate or diversify across its opportunity set and to use cash. Especially in environments such as we are experiencing now, we can trust and rely on the portfolio managers’ judgments to manage risk and exploit opportunities.

To enhance diversification, and achieve what we call “intelligence diversification,” we believe it is beneficial to utilize multiple independent portfolio managers. In a properly constructed multi-manager portfolio, it is generally favorable to utilize managers that individually construct fairly concentrated portfolios.

Our belief in the value of active management extends to the use of alternative strategies including hedge funds and private equity managers. In the case of alternative strategies, the importance of intelligence diversification is paramount.

We also believe that there are appropriate and efficient uses of passive (index) portfolios. However, because of their static characteristics, we must be more diligent about tactically assessing their suitability and valuation.

October 9, 2008

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