

U.S. Stock Markets: 3Q08

What an investment climate this is. The current stock market is more dizzying than my eighth grade sex-ed class (and you should've seen the look on my face walking out of *those* classes). The S&P 500 Index produced a total return of -8.5% during 3Q08, resulting in a -19% loss through September 2008. The majority of the losses occurred in the final two and a half weeks. The U.S. and global economies grinded to a halt as financial institutions, incurring massive credit losses and witnessing the bankruptcies of peers, became scarred to lend to even the most creditworthy borrowers. I can personally attest to this lack of lending. My wife and I agreed to buy a house in September, only to find the process of obtaining a loan more difficult than expected (my new office address is on the footer of our letter). Our only current debt was in our existing home mortgage, plus we have a credit score exceeding 800, but were actually turned down by the first mortgage broker we contacted. Despite receiving an immediate loan via Freddie Mac from the second mortgage broker we contacted, the process definitely illustrates how lending practices have shifted. A lot has occurred this October and I want to get straight to *how* we are doing and *what* we are doing – so lets get started below.

Comments on Our Performance

The Good News: We had an excellent third quarter and first nine months of 2008. Despite the S&P 500 Index declining about 19% through the first nine months of 2008, in aggregate our accounts were up in value. This is something I'm very happy to report. Our significant out-performance was in-part due to (a) avoiding big losses in the stock market (b) picking winners such as U.S. Bank and Burlington Northern, and (c) investing in beaten-down corporate bonds offering good value and income in midst of a declining stock market (primarily KB Home, Waste Management and Echostar Communications bonds, among others).

The Bad News: As of this writing, the S&P 500 Index is down an astounding 27% in October. The October 2008 stock market crash has been thorough - EVERYTHING is down in unison. The only relatively well-known stock I can find nearing a 52-week high is Campbell's Soup. I guess investors figure if the world is truly coming to an end, we'll all sit on our kitchen floors eating chicken noodle soup until Christ returns. Most of our accounts, including the partnership fund I manage, are down with the market between -25% to -30% this month. Absolutely no company – “good” or “bad” – has been left untouched. Of course, we have our big October losers such as Sears Holdings down -38%, and we have our relative winners such as Pfizer at -10% (not including Pfizer's dividend yielding 7.5% annually). What has been truly amazing about the October 2008 market crash is businesses with solid fundamentals have fallen in equal or greater amounts compared to weaker competitors. The selling has been absolutely indiscriminant, which I believe provides us an opportunity to buy the world's leading businesses at prices I never dreamed would be available (please read “What We're Doing” section below).

Summary Comment: Through the first nine months of 2008 intelligent stock picking provided us refuge from the market's 19% fall, and made us look pretty darn good vs. our neighbors. Unfortunately, stock analysis and business valuation have been worth nothing in October, as every stock imaginable is suffering in unison. I'm sure it hasn't been a pleasant month for you, and it has been a rather helpless-feeling month for me. The good news is instead of being down over 40% for the year, I helped us save about 20% through the first nine months. If we had been down an additional 20% with the market in those first nine months – I can hardly imagine how we'd all feel.

What We're Doing – Stock Market Opportunities

The current stock market represents the best long-term investing climate I have lived through. We are investing in businesses with 7% to 15% free cash flow yields, and the investments we're making today will prove beneficial to our net worth's given time (free cash flow = cash produced by a business in a given year

after paying all expenses...think of “free cash flow yield” as a dividend). Warren Buffett stated on Wednesday, October 22nd he recently invested all his personal assets into U.S. stocks in October, after being 100% invested in U.S. Treasury bills for numerous years. Many stocks are simply too cheap, and there are times during my day that I honestly do not know where to start the research process because multiple businesses look attractively priced. If I was in college, I'd describe the current situation as walking into a swimsuit competition and being told by the judges I could date any girl I want. I would know “to begin,” but wouldn't know where to start.

Given ALL stocks dropped in the October crash, I think we're being offered a rare “trade-up” opportunity. For example, during the market crash we added Coke (KO), Pepsi (PEP), Nike (NKE) and Starbucks (SBUX) to our portfolios. Here are the recent stocks prices of these four stocks vs. their 52-week highs:

Starbucks: 52wk high = \$27; current price = \$9.50; Equals -65% below 12-month high

Coke: 52wk high = \$65.50; current price = \$41; Equals -37% below 12-month high

Pepsi: 52wk high = \$80; current price = \$51.50; Equals -36% below 12-month high

Nike: 52wk high = \$71; current price \$46.50; Equals -35% below 12-month high

If you can imagine the world in five years, I bet you still see the four above companies as (a) in existence, and (b) strong brands. Given their significant business price declines and dominant competitive positions I think we can expect a favorable return on our investments. I also like the defensive nature of Coke and Pepsi, given our economy could be in for a couple years of stagnant economic growth. Further, each business sans Starbucks is strong globally, thus offering us annuity-like returns on global beverage and athletic gear consumption at attractive prices.

What We're Doing – Bond Market Opportunities

Little reported in the general media, the corporate bond market also experienced significant devaluations in October, and we took advantage of select opportunities. For example, Mohawk Industries (MHK) and Berkshire Hathaway-owned “Shaw” are a virtual duopoly in the U.S. flooring business, similar to the relationship Home Depot and Lowe's share in the home improvement market. Before the global financial crisis, Mohawk's bonds maturing in November 2011 were yielding about 6.25%. During the market crash, these bonds fell in price to the point where they now yield 10%. In many accounts we've been selling a portion of our Mohawk stock and buying these November 2011 bonds, yielding 10%. From a risk vs. reward perspective, taking a 10% annual return isn't a terrible choice. The fundamental risk in owning the bonds is Mohawk could go bankrupt if we have a multiyear economic slump. However, I think the most pertinent risk is if the economy recovers strongly in 2009 or 2010, Mohawk stock has at least 50% upside potential vs. our 10% fixed annual return. Given the current economic outlook, I decided to error in the case of conservatism and allocate a portion of our Mohawk stock investment to the bonds.

Other corporate bonds offering value include Home Depot bonds maturing in September 2009. These bonds were yielding about 4.5% only a couple months ago, but during the global financial crisis forced sellers were offering these bonds at a price yielding 7% to maturity, and we took advantage of the fire-sale price. I do not see an outcome where Home Depot could go bankrupt by September 2009, therefore we locked-in a 7% one-year return. I think that risk vs. reward is quite favorable, especially given the serious state of our economy. Finally, we purchased Echostar Communications bonds yielding about 10.5% to October 2011 (Echostar is a satellite TV competitor alongside Direct TV). Echostar's story is the same as Mohawk and Home Depot – good company struggling in a terrible consumer economy – bonds fell in value during the October crash – I do not think Echostar is likely to go bankrupt - thus we elected to receive a 10% annualized return at our purchase price.

A Perspective on Current Business Valuations

Veteran clients are used to my discussion of “free cash flow yield.” Here's a quick tutorial for new clients and those requiring a refresher course. Free cash flow is the cash leftover at a business after paying all expenses, taxes, etc. It is cash that can be used to pay dividends, buyback stock, acquire other companies or be invested back into the business for growth. The term free cash flow yield is a hypothetical term used to express the cash flow produced in the form of a dividend yield. For example, if you and I owned the local

Albertson's grocery store, and, after paying ALL our expenses we generated a "5% free cash flow yield," that means you and I could pay ourselves a dividend equal to a 5% yield on our investment (just like a stock).

The October market crash has produced panic and forced selling, leaving some businesses at borderline crazy asking price levels. This is why I'm optimistic on stocks at today's prices for the long-term vs. cash and high-grade bonds. Here are a few examples of businesses we own and their free cash flow yields:

Starbucks (SBUX - \$10.00 price / \$7.1 billion market cap): In its most recent quarterly earnings release, Starbucks' pessimistic 2009 earnings scenario would yield owners a free cash flow yield of 6.7%. Under its realistic scenario, Starbucks should generate a yield of just under 8%. This is a business that, pre-2008 crash, would have traded for a 5% free cash flow yield, and the stock was at one time over \$40 per share.

Health insurers such as WellPoint (WLP - \$38.00 price / \$18.5 billion market cap) and UnitedHealth (\$20.00 / \$24.75 billion market cap): These are the two largest health insurance businesses in the United States, and both are priced to generate free cash flow yields of at least 10% under extremely conservative 2009 scenarios. These are two of the cheapest stocks I can find. I think the risk of radical legislation from an Obama Administration / Democratic Congress is one reason for the massive price discount. Keep in mind, in the early 1990's word spread Hillary Clinton wanted to nationalize our healthcare system, and a similar meltdown in select healthcare stocks occurred. Eventually, nothing radical happened and the stocks became huge winners.

Buffalo Wild Wings (BWLD - \$23.50 - \$420 million market cap): I think Buffalo Wild Wings can successfully double its current 550-ish restaurant base (which means over the next five years it should grow earnings off of its 2008 performance). However, if it never grows earnings from 2008, it would generate a free cash flow yield of 8%. This is an incredible buy at the current \$420 million market cap. Just because I think it's an incredible buy here doesn't mean it can't go lower in the near-term. Keep this in mind – when Buffalo Wild Wings hit \$42 per share a couple months ago, I sold half our position. Today we are aggressively buying in the low \$20's. I think it will get back in the \$40's, which means I'm predicting it to go up 70% or more in the long-term.

One more – Sears Holdings (SHLD - \$55 / \$6.5 billion market cap): Analysts expect Sears to earn around \$1.25 per share in 2009. I wanted to know what kind of free cash flow Sears would generate if it broke-even (zero net income)...so I reviewed my financial model for Sears and made some assumptions. My conclusion – if Sears breaks-even in 2009 (doesn't make or lose money on a GAAP accounting basis), Sears can still generate \$600 million in free cash flow, which is good enough to pay shareholders a dividend yield of 7.5%. We've pulled back a little on our Sears investment, simply because Sears needs a healthy credit market to survive, and the credit market along with consumer spending has fallen off a cliff in October. Specifically, Sears needs a functioning credit market in order to sell or improve its real estate holdings (Sears owns 50% of its stores). Clearly, we will buyback the portion we sold if facts change.

Final Comment – Light at the End of the Tunnel

The sharp decline in commodity prices appears not only to be a factor of poor global economies, but also a product of a speculative bubble that hit a crescendo in the Summer of 2008. Oil in the \$60's or \$70's per barrel is an extremely positive variable for U.S. consumer and business well-being. I can see oil moving back to the \$80 to \$90 per barrel range when the global economy recovers, but for now the price reduction from the \$147 top is highly supportive in times of high unemployment and rising healthcare costs. Despite oil's decline we continue to own my favorite energy company, Canadian Natural Resources (CNQ) for the same reasons we owned it when oil was \$45 per barrel...then \$140 per barrel...and now in the \$60's – I love CNQ's management team; I love CNQ's potential to double or triple production in a time when major energy countries and companies are producing fewer barrels each year; and I love the fact CNQ is in a geographically safe location.

Thank you very much for your trust and support.

Sincerely,

Bryce Peterson
President

Washington Street Investments, LLC

Quote of the Quarter: “In short, bad news is an investor’s best friend. It lets you buy a slice of America’s future at a marked-down price.”

- Warren Buffett in his October 16, 2008 Op-ed Article in the New York Times. I have included this article with our letter because I think the Oracle of Omaha communicates an excellent message in a clarity that I can only attempt to duplicate.

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