

## **U.S. Stock Markets: 1Q08**

1Q08 was a difficult quarter for the U.S. economy and stock market. Amid constant talk of U.S. recession, rising food and energy costs, mounting loan losses at financial institutions and the “worst housing market since the Great Depression,” the S&P 500 Index declined 9.4% to 1,322.70. To give you some perspective on where we are today, the S&P 500 reached a high on October 12, 2007 of 1,561.80. The market hit a low on March 10, 2008, at 1,273.37 for a -17.5% decline from the recent October peak, while the quarter ended down 14.3% from the peak.

### **Comments on Our Performance**

Our 1Q08 performance ranks as one of the best in the industry. During a period of time when the well-regarded mutual fund managers were down between -5% to -15% vs. the S&P 500 down -9.4%, our private accounts ranged from down about -3% to +3%. Good individual stock picks, an avoidance of poorly-run businesses that plummeted in value, and the discipline to hold cash when the market started looking pricey were attributable to our success. Many of our top investments out-performed the market, including Tyco International (+12%), Wal-Mart (+12%), Burlington Northern (+11%), Buffalo Wild Wings (+5%), U.S. Bank (+5%). Also, well-timed trades of J.P. Morgan, Home Depot & Lowe’s were material to our performance.

Energy stocks as a group under-performed the market, with our holdings of Canadian Natural Resources (-7%) and Diamond Offshore (-17%) negatively affecting results. Berkshire Hathaway’s -8% decline and a short but bitter relationship with eBay also detracted from performance.

The key to maintaining and adding to our market-beating performance will be to keep up with the market averages in 2Q08 or 3Q08 when they eventually rise. In Q1 many poorly-run businesses substantially declined in value as the U.S. financial system began to “de-leverage” (an industry term meaning lenders decide / are forced to lend less, thus causing economic growth to slow or contract). On the positive side, your investment manager was smart enough to identify poorly-run businesses and avoid the cost of owning them. On the negative side, in a typical stock market recovery these businesses can appreciate hard, often significantly out-performing the “higher quality” businesses that did not fall during the stock market’s malaise. Because our investments tend to be of “higher quality” and significantly out-performed in Q1, our “risk” in the short-term is that more challenged companies rise while our businesses’ stock prices take a rest. Subsequently, I’ll consider it a short-term victory if we can match the market if it rises during the next couple quarters.

### **Comments on Our Performance - Winners**

One dominate theme of our current investments is the ability grow earnings despite a lackluster U.S. economy. Most of our businesses are strong enough to grow in mild recessionary times, and are run by management teams that have positioned the companies well vs. peers. For instance, Burlington Northern’s +13% stock price gain in Q1 is a testament to its ability to grow earnings in 2008 by about 10% from 2007 levels. Common sense would tell me a railroad’s earnings growth is highly correlated with the domestic economy’s up’s and down’s. However, after losing market share to trucks for about 50 years, the railroad business is gaining share and enjoying stronger pricing vs. trucks even during a tough U.S. economy. This is due to many factors – one, rising fuel prices favor railroad transportation vs. long-haul trucks; two, the growth of the global “mass poor” is increasing demand for basic necessities such as coal for power generation (China, for the first time in its history, is now a net importer of coal) and food products which the rails transport in bulk; and three, after decades of major infrastructure investments, the railroads are becoming more efficient operators, helping increase profit margins. Burlington’s stock price has run-up to \$100 from a low in the high \$70’s in Q1, thus the market is beginning to recognize the railroad’s intrinsic

value. I continue to believe the railroads are on a multi-year path to sustainable earnings growth, and do not imagine us selling BNI despite its big move this year.

**Wal-Mart (WMT - \$57.68)** is a very interesting case in recent U.S. consumer spending history. From about late-2002 through 2007 it lost share to competitors prompting many investment analysts to predict Wal-Mart's low price competitive advantage to be diminished. Specifically during this period U.S. consumers experienced robust spending on the heels of excellent job growth and rising real estate values, often trading-up from discount stores such as Wal-Mart to retailers or product categories considered to be "affordable luxury." Today, Wal-Mart's sales and market share are rising as U.S. consumers, pressured by rising gasoline, home heating and cooling, and food costs are focused on "everyday low prices." The days of robust consumer spending have faded into the sunset, benefiting the discount retailers.

We also made money with short-term trades in Q1. Although short-term trading is not my specialty, the market's volatility in Q1 offered well-researched investors decent opportunities. Early on we sold our Home Depot and Lowe's stakes, bought each back 15% or so percent lower in January, and watched them appreciate 20%. These trades helped us make-up some lost money after I had originally bought them too early! Later in the quarter we bought J.P. Morgan Chase shares in the high \$30's after they quickly fell 15% to 20% during the market's January decline. JPM has one of the best management teams and balance sheets among U.S. lending institutions, thus when the shares fell they offered a relatively safe opportunity and compelling value. Soon after our purchase, the Federal Reserve bailed out Bear Stearns from bankruptcy, which included J.P. Morgan playing an instrumental role via buying Bear Stearns for \$10 per share (Bear shares had been as high as \$105 in 2007). The market perceived this as good news for J.P. Morgan, sending the shares from the high \$30's to the mid \$40's. We sold at about \$46 per share, pocketing a 20% gain in a matter of weeks. It wasn't a tough decision to sell JPM – I think the near-term fundamentals are challenging at best vs. a \$46 stock price, and have considerable reservations on what the Bear Stearns federal government bailout means for taxpayers and our lending system (more about this in the "Risks" section below).

### Comments on Our Performance - Losers

**Berkshire Hathaway's (BRK-B - \$4,473)** 8% price decline weighed on our results. I view the price decline as natural after Berkshire rose 30% in a matter of a few months in late 2007. We have trimmed our Berkshire exposure from a high of 20% to 30% of portfolio assets to about 4% to 5% today. There's nothing wrong with the business, except its valuation in the \$4,500 to \$5,000 per share range is not unduly cheap at 1.7x to 1.85x book value. I still think it's capable of out-performing the market, but, after appreciating 30% so quickly from our initial \$3,600 price its value is not worthy of garnering 20% or more of our assets. We would become more interested in Berkshire in the high \$3,000's to low \$4,000's price range. Berkshire's appeal is its exceptionally strong balance sheet and present management's investment acumen. Both strengths could provide advantages heading into 2009 as the U.S. consumer, financial institutions and general economy remain weak. Owning Berkshire at this point is like bringing your 6'5, 240 lb friend to that college party that could get a little rowdy – you may not need his services, but you'll be glad he's there if things get out of hand.

Both of our energy investments, **Canadian Natural Resources (CNQ - \$68.26)** and **Diamond Offshore (DO - \$116.40)** declined last quarter after fairly big 2007 appreciations. I don't see the declines as cause for concern – stock prices for commodity businesses are naturally volatile, and will continue to be. More important than price volatility is the long-term fundamentals for oil and natural gas remain appealing, with global supply being too old vs. global demand being too young (mature fields such as Saudi Arabia vs. "young" demand such as China and India).

Finally, we bought eBay in the mid-\$30's and sold in the high \$20's. It was a minor position for us at 1% to 2% of account assets, but nevertheless detracted from our Q1 performance. After we purchased it, the company announced some major pricing changes that are complicated to analyze and have the potential to change both eBay's profitability and negatively impact its seller's experience. We took our eBay proceeds and re-invested them into Burlington Northern in the \$80's, which with the stock north of \$100 today, helped mitigate the eBay loss.

## Market Outlook – Opportunities

### Fear & Discipline

Fear combined with discipline was our #1 opportunity in Q1. I positioned us conservatively to start the year with cash as a percentage of portfolio assets ranging from 15% to 50%. When losses at financial institutions reached a fever pitch, the press couldn't stop talking about a U.S. recession. At one point on CNBC you couldn't go a day without hearing that "33% of economists are predicting a recession." If you followed the recession game show, you'd have heard that percentage go up almost daily (to update the score for those following at home - right now 100% of economists say we're in a recession, and 5% are sure of that). By mid-January the S&P 500 Index had declined to the 1270's, marking a 17.5% decline from the October 2007 peak. It was during this time we started making our good buys such as Buffalo Wild Wings (\$20 then...\$30 now), Burlington Northern (\$80 then...\$100 now), and Waste Management (\$30 then...\$36 now). It was also during this time we had the opportunity to repurchase Lowe's in the low \$20's and Home Depot around \$23 - \$24. Today, the market has rebounded off its lows and the "fear" factor has gone on vacation (which is probably a "risk" – complacency).

### We're in a Holding Pattern

Searching for investment opportunities today is challenging given economic fundamentals in the U.S. are sub-par and European fundamentals, which have been a little stronger than the U.S., are starting to get worse; commodity costs are relentlessly high (however, energy businesses continue to be a favorite of mine); business prices have rebounded sharply off the bottom as extreme fear has mostly left the stock market; and yields on fixed income securities are highly unattractively (as a proxy for you to understand this, the 10 year U.S. Treasury Note yields 3.8% - awful). To top it all off, holding cash is my usual default when waiting for investment opportunities, but money market yields at 1.5% to 2.0% are yielding at or below the level of inflation. Our focus right now is not to lose money and find investments that protect us from inflation. It's certainly possible the market endures another round of fear and drops 5% or 10%. Should this happen we're in businesses that are fundamentally strong, and will use our remaining cash to increase our investments.

### Financing the Rise in Living Standards of the Global Mass Poor:

#### A Roadmap to Make Money During the Massive Transfer of Wealth

Taking a big picture look at the world helps me focus on where we're going and where the investment opportunities should be. The first conclusion I've drawn is it appears the wealthier, developed nations such as the United States and Western Europe are in a multi-year period of financing growth of the mass-poor nations such as China, India and Russia. This could take five more years, or it could take 10 or 15 more years. My second conclusion is this massive transfer of wealth to the mass poor, resource-rich countries is it will open up huge opportunities for the developed nation's businesses and spur a new round of accelerated growth for the U.S., *but*, it will take time.

The first item to understand is the wealthier, non-commodity rich nations were in "Consumer Heaven" from the early 1980's through about 2002. To further understand this, think about the circumstances the world lived in during the 1980's and 1990's – for about 20 years "real prices" (prices adjusted for inflation) declined for all types of commodities from oil, natural gas, food, steel, and copper, as did prices for "cheap" labor as the world economies synchronized. We drove our cars, transported our goods, heated our homes, built our products, homes and buildings, and consumed food at costs that didn't rise as quickly as general inflation. This means we had about two decades of an increasing amount of discretionary purchasing power to spend on non-staple items (apparel, technology, vacations & entertainment, homes, etc.) or invest. In the process we invented and /or fine-tuned the world's most important technologies and brands ranging from Microsoft's operating system, Intel's processors, the internet and its myriad of cost-saving applications, medical technologies, consumer brands such as Whirlpool or Kenmore's appliances, Starbucks and Nike, to massive entertainment products such as movies. Conversely, the "resource rich" nations stayed poor as prices for their commodities floundered. For example, we were paying about \$39 per barrel for oil *in 2004*, vs. \$38 in 1981 (both prices adjusted for inflation – Source: Forbes Online). Putting this into perspective, how would a

hypothetical Nike employee's personal net worth look today if in 2004 Nike was selling Air Jordan's for the same price it was selling shoes for in 1981?

Starting early this decade it appears the trend of falling commodity prices reversed, and the rise in living standards for the world's mass poor has begun. To me, this means we're in a multi-year period of rising commodity prices and a massive transfer of wealth from the developed nations to the mass poor nations. This sounds painful for us, and in the short-term it has been and will continue to be (fuel prices, home heating prices, food costs, falling margins at businesses reliant on commodities, etc.). But I think the natural progression of free market economics will again swing things into our favor, which I briefly touch on in the next section. Today, in my opinion this means investment opportunities can be found in the following:

- ▶ Energy-related businesses (Canadian Natural Resources & Diamond Offshore are our primary investments)
- ▶ Consumer staple businesses benefiting from the rising wealth of the mass poor (we own Wimm-Bill-Dann foods, Russia's #1 branded dairy producer and a leading Eastern European beverages and baby food producer; and Fomento Economico Mexicano, a Mexican branded beer company, Latin American Coke distributor and owner of Mexican convenience stores)
- ▶ Businesses that benefit from, or can quickly adjust to rising commodity costs (we own U.S. railroad Burlington Northern, and FMC Corp, which does business in crop fertilizing in Brazil, lithium batteries for portable electronic device & soon rechargeable vehicles, and produces soda ash for industrial development in the emerging economies)

As a hedge against falling commodity costs we also own domestic businesses that would more than not benefit from falling commodity prices. My favorites include Buffalo Wild Wings, Mohawk Industries, Lowe's, Waste Management, and U.S. Bancorp.

### Light at the end of the Tunnel

Rising energy and food costs are stretching the wallets of consumers, and, like a mouse on one of those mouse treadmills, are forcing businesses to work harder just to maintain profit margins. But I think there is light at the end of the tunnel for the wealthy nations. Right now the mass poor are in the early stages of accruing more wealth, which means they're enjoying "the basics" such as healthier diets, stable housing and electricity. For example, as I write this, I'm reading about global rice shortages and outrageous prices for corn – both due to rising wealth of the mass poor resulting in greater demand for the basics.

Soon, these mass poor nations will have accumulated enough commodity-related wealth to desire the next leg of human needs – Whirlpool or Kenmore dishwashers and clothing washers and dryers; home heating & cooling systems from United Technologies (UTX), branded clothing from Nike, food away from home or higher-quality branded food products (McDonalds' in China), basic financial savings products like a bank account or life insurance policy from Citigroup or AIG, or even technology devices such as a HP or Dell computer (which would include Microsoft Windows or Intel processors). I think when this next step in development of the global mass poor meets reality, Americans will see the next big bull stock market similar to the 1980's or 1990's. I have no idea how long this will take to develop, nor whether when it does if demand for our products will happen quickly, or be more gradual. Regardless, this is something I'm watching for in businesses' numbers. You can see some of it happening now whether you look at Coke's or Nike's earnings growth in emerging nations...but the real impact appears to be years away.

### **Market Outlook – Risks**

#### Background: The Bear Stearns Bailout

Monday, March 17<sup>th</sup>, 2008, the U.S. Federal Reserve took unprecedented steps to bailout Bear Stearns from bankruptcy, striking a weekend deal in which J.P. Morgan Chase would purchase the entire company for \$2 per share, for a total of about \$325 million (since the deal price has been renegotiated to \$10 per share). For some perspective on Bear's collapse, on December 10<sup>th</sup>, 2007 its stock was at \$105 per share, and the company was valued at about \$17 billion (that's big). The collapse of Bear Stearns was a disaster and is a

case study in management ineptitude. If you're wondering what happened, the simple and common sense answer is Bear Stearns had a terrible balance sheet. Management, seeking to goose profits, got itself into too much debt and invested in things it did not understand. As "consumers," this is similar to our friend who used an adjustable rate or interest only mortgage to buy a house that they otherwise couldn't afford, and, instead of saving money to finance the pending rise in mortgage payments, used their remaining cash to buy a 42 inch flat-panel TV and go on a nice vacation. Much like the situation our friend is facing today per declining residential real estate values, when the tide rolled out in the markets Bear Stearns served, its management team was found to be swimming naked. On the day of Bear Stearns' bailout the stock markets reacted positively, and have been higher since. Today, all you hear from media commentators regarding the Fed's bailout is "the Fed drew a line in the sand, marking the end of the credit crisis." This implies that it's OK to buy stocks because the worst for the U.S. financial system is over. I think this is crazy, and U.S. financial institutions are in for a long, hard battle that's nowhere near over. For example, for years I've studied financial businesses and have attending conference calls and analyst meetings with banking CEO's and CFO's. For about four years – roughly 2003 to 2006 – U.S. consumer and business credit conditions were pristine. In fact, good credit standing for consumers and businesses was so off-the-charts good, that banks had no idea why or how long the good times would last. J.P. Morgan CEO Jamie Dimon mentioned on a conference call about a year ago that we may have just experience the best credit conditions we will ever see "in our lifetimes." I think he's right, and it takes a lot longer than six or twelve bad months to unwind four years of off-the-charts good times. This is why we continue to own very few financial institutions despite the group's stock prices being down since 2007.

### *Risk – What We Don't Know Should Scare Us*

Two questions strike me as troublesome regarding the Bear Stearns bailout. One, why did the Federal Reserve feel obligated to bailout Bear Stearns? And two, if this bailout was such a great thing for financial institutions and the acquirer, J.P. Morgan, why didn't we hear about other financial institutions bidding for Bear Stearns?

One explanation to the first question is Bear Stearns was highly involved in "credit default swaps," which is a fancy term used to describe a contract Wall Street financiers have created to lay off credit risk. For example, if you and I owned debt issued by Burlington Northern and wanted to protect our bond's value from the remote event of bankruptcy, we could purchase a credit default swap. The person on the other end of this security would receive our money (in essence our insurance premium), and have to pay us if the unpleasant event of bankruptcy occurred at Burlington Northern (in this case the bankruptcy of Burlington would be akin to a car accident, but with a remote chance of occurring). What the Fed's bailout implies is if free market capitalism was allowed to work and Bear Stearns would have been allowed to go under, many financial institutions would have been in panic mode. This also implies there is too much complicated debt in the developed world's financial system that could someday cause a global liquidity panic. We need to return to more plain-vanilla days when borrowers borrowed from a bank that carefully scrutinized the borrower's risk, and a credit relationship was built around trust. In all likelihood, if J.P. Morgan had not bought Bear Stearns for \$300+ million dollars and worked with U.S. taxpayers to take on Bear's obligations, J.P. Morgan would have been facing millions of dollars in losses as collateral damage from Bear Stearn's failure. This pain would spread to other, innocent parties in the U.S. economy. For instance, small businesses with decent credit histories could have found it challenging to secure lines of credit, as cash-strapped banks refused to lend. This chain reaction is what Warren Buffett is referring to when he describes derivative contracts (i.e. credit default swaps) as "financial weapons of mass destruction."

My explanation as to why we haven't heard about other financial institutions bidding for Bear Stearns is no one wants to touch what's on Bear's balance sheet. Potential suitors fall into two camps – the camp that was so mismanaged this decade that they can't bid because their financial strength is threatened (this includes Citigroup, Washington Mutual, Lehman Brothers, Wachovia, Merrill Lynch, Morgan Stanley and many large Western European institutions); and the camp consisting of financial institutions that have avoided making relatively dumb decisions and have the capital to buy Bear Stearns, but are reluctant to bid (includes U.S. Bank, Goldman Sachs, Berkshire Hathaway). J.P. Morgan's CEO Jamie Dimon is one of the best, but I have to think the only reason he's willing to take on part of Bear's assets and liabilities is his firm, as a large derivatives player in North America, would have experienced large losses had Bear Stearns collapsed. In this instance, what we don't know or aren't hearing about Bear Stearns should be worrisome to investors.

The above two worries are the reasons we sold all of our J.P. Morgan stock after it rocketed higher on news of the Bear Stearns buy.

### *U.S. Taxpayers are Getting a Raw Deal*

The #1 risk associated with the bailout is the Federal Reserve has put my money and yours at risk by taking billions of dollars of Bear Stearns' obligations on the Federal Government's balance sheet. This means (a) in the good times Bear and its management team made millions of profits, and in the bad times (today), we (U.S. taxpayers) must take on the risks of footing the bill for their mistakes. This decision by the Federal Reserve should encourage intelligent investors to demand a higher rate of interest on both U.S. Treasury debt as well as anything linked to a U.S. government backing. In turn, higher long-term interest rates will act as a headwind to many businesses, including the already troubled U.S. housing market. (B), the Fed's bailout of Bear Stearns equates to a "socialization of risk." This means that in the future, all U.S. citizens will be paying higher costs for debt financing because we've set a precedent of bailing out the most fiscally irresponsible members in our society. Looking ahead, U.S. citizens who irrationally bought homes during the real estate bubble will now demand to be bailed out using the logic, "you bailed out the Wall Street financiers and investors, now bail us out." If we follow this path (and the current composition of Congress is following it – see below) we are setting ourselves up for higher future mortgage rates, which should result in lower existing home values, the prospect of higher taxes, more government control of our lives, stagnate inflation-adjusted economic growth and more collective pain for those of us who acted responsibly during the housing boom.

### *Congressional Response to U.S. Housing Is a Real Problem*

To make matters worse for the U.S. taxpayer (you and me), and compounding the likelihood of higher long-term interest rates for us, Congressman Barney Frank's housing bill recently passed the House. The Wall Street Journal reports the "Bill" (no pun intended) allows lenders to dump up to \$300 billion of their worst mortgage loans into taxpayer hands. If these loans go bad, guess whose taxes are going up to pay for it? Ours. The news gets better. The Bill also creates the "Neighborhood Reinvestment Corporation" and takes **\$230 million** of taxpayer money and disperses it however it sees fit to "counsel" housing victims. For \$230 million dollars of your money I'll council housing victims and give them a back rub. My wife might get jealous, but she'll get over it when she sees the check in the mail. The Wall Street Journal sums up the "Bill" nicely, "The Frank plan appears to take care of everyone in the housing market, except the renters and homeowners who lived within their means."

The Bill is sure to pass the Senate, which means our only hope is President Bush, who doesn't exactly have a spending record fiscally conservative people are envious of, veto's the Frank plan. I'm starting to see why some desperate English people hammered a few thousand nails into some wood and got the heck out of England.

### *Investment Implications of Bear Stearns & our Government's Actions*

- ▶ We are avoiding long-term U.S. government bonds and being very selective on all fixed income securities with durations greater than five years. Longer-duration bonds are time bombs waiting to explode. If you buy low quality, long-duration fixed income securities expect to lose money. ("duration" is the time until your bond matures and you get your money back)
- ▶ We are looking for businesses that can adjust to, or protect us via pricing power from the risk of inflation. Burlington Northern thus far has been a prime example.
- ▶ We are looking for businesses with international growth prospects for the reasons mentioned in the "Opportunities" section. We are also looking internationally because the "socialization of risk" and populist political rhetoric makes U.S. investing increasingly risky.
- ▶ Stock market return expectations adjusted for inflation should be ratcheted down. Rising tax rates on ordinary income, capital gains, and dividends (all in 2009 or 2010 if the current political momentum continues), rising interest rates, and credit markets in turmoil will be headwinds for both stock and bond investments.

- ▶ Investment returns are going to become divergent among investment managers – stock picking and avoidance of extreme losses have been, and are going to be more important in 2008 and 2009 than ever before in my career.

### Closing Comment

Overall, our Q1 was good as our private account performance ranged from -3% to +3% vs. the S&P 500 Index at -9.4%. Using the WSI Fund as a proxy for our private accounts, year-to-date through early May we're +6.4% vs. the S&P 500 Index at -4.5%. We are out-performing the S&P 500 Index by 11%... "so far, so good." The only thing I can promise you is I'll do my research; I'll try not to do anything stupid (but I inevitably will do many stupid things); try to make money and try not to lose it. This is my sophisticated plan to manage your money, and I look forward to reporting our results soon.

Thank you very much for your trust, and especially for your level-headed support during the good and bad times.

Sincerely,

Bryce Peterson

President

Washington Street Investments, LLC

**Quote of the Quarter:** "Knowledge is the only instrument of production that is not subject to diminishing returns."

– J.M. Clark

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