

## U.S. Stock Markets: 2Q08

The S&P 500 Index produced a total return of -2.7% during Q208, resulting in a -11.8% loss for the first half of 2008 (1H08). April and May started out strong, but oil's relentless move higher combined with continued bank-health fears drove stocks lower in June. The only two S&P 500 sectors producing notable gains were Energy and Materials. These businesses appreciated in unison with prices for commodities such as oil, natural gas, metals and agricultural inputs. Meanwhile, businesses tied to finance and consumer spending continued to make the L.A. Clippers jealous, sustaining their multi-year weakness.

## Comments on Our Performance

We had an excellent second quarter and first half of 2008. Our managed equity accounts performed in a range of -3% to +14.9%, vs. the S&P 500's -11.8% (most were in the -2% to +5% range...the +14.9% was that rare account where everything we owned worked out right). For those of you with email access, by now I've emailed your performance summary, so you should know exactly where you stand. It has been a really tough U.S. stock market, and, while I'm not happy "losing less money than the other guy," it has been a battle trying to eek out break-even to positive returns. What's really interesting to me is while the U.S. stock markets have dropped over 20% since October 2007 (as of early July 2008), global markets haven't done much better with China's market down 50% and India's down 33%.

Overall, it feels good that we were able to preserve capital and even inch out some gains in Q2 and the first half of 2008. I know people do not want to hear this, but the truth is we're due for an under-performing quarter. I do not want people to expect us to out-perform the S&P 500 Index each six months by at least 10%. Put it this way – if we begin to do this on a regular basis, we'll all be well-off in ten or twenty years, our returns will rank with the all-time best investors, and you'll begin reading my name in conjunction with investing articles. This is of course my professional goal, but it's important to be realistic and that should tell us to expect a few bumpy quarters vs. the S&P 500 Index at some point.

## Comments on Our Performance - Winners

Commodity-related businesses produced solid returns in Q2. In our portfolios this included **Canadian Natural Resources' +47% (CNQ - \$100.25), FMC's +40% (FMC - \$77.44), and Diamond Offshore's +22% (DO - \$137.51)**. Oil, natural gas and other commodity businesses are about the only investments appreciating in 2008 as oil approaches \$150 per barrel and other commodities are recording new price highs. I could write an essay on what is impacting the price of oil (I've studied it ferociously). The facts on the ground are (a) global oil supply is falling in key exporting countries such as Mexico, Russia, and Norway, and (b) global oil demand is still rising thanks to China and India. For example, Russia supplies over 10% of the world's oil but its latest export numbers show a -3.3% decline (*its 2008 oil production is also down vs. 2007*), indicating an extremely important global oil supplier is in trouble. This means for the first time in the world's history, fundamental global demand is about equal to global supply. In summary, we have a global energy crisis because demand is meeting and potentially exceeding supply for the first time in oil's history – most people are in denial and instead are on a witch-hunt for villains instead of offering viable solutions (and there are plenty of solutions) – oil prices are likely to remain north of \$100 until serious demand destruction is accomplished.

I also want to provide a quick note on FMC because I haven't talked about it in previous letters. FMC is a fairly small materials company with positions of global importance in lithium-carbonate production, soda ash and crop fertilizer. All three of these businesses exhibit favorable long-term growth trends, but the most interesting business is the lithium business. The majority of global lithium carbonate supply is mined in two locations – in Tibet (controlled by China) and in a tiny corner of property shared by Chile, Argentina and Bolivia. Lithium-ion is used in battery-powered devices such as portable electronic devices, which is a

growth category in itself. Further, with gasoline prices rising dramatically, lithium-ion battery technology is considered one of the best bets to power future motor vehicles, making FMC an interesting and relatively unknown investment bet on the future of hybrid / electric vehicles.

### Comments on Our Performance – Losers

It takes a lot of research time and dedication to pick losers in three different sectors, but I managed to do it this quarter. If our goal was to pick a diversified portfolio of market losing stocks, I'd be a Five-Star manager because we had them in traditional domestic banking (**U.S. Bank – USB - \$27.89**), multi-national industrial and finance companies (**General Electric – GE - \$26.69**) and in emerging market telecommunications (**Philippine Long Distance – PHI - \$53.42**). Next time you call...if I don't answer it means I'm at the dog track going for the Tri-fecta.

For the record, U.S. Bank declined about -12.5%, Philippine Long Distance was down about -22.5%, and General Electric produced a -26% return. Sorting through the rubble, we still own U.S. Bank. In fact, we've increased our position lately as the entire U.S. banking sector has succumbed to a rage of panic-selling. U.S. Bank should be commended for its disciplined approach to growth during the credit-boom years of 2003-1H07. During the boom it was an unpopular stock, but now it's one of the few banks that has not cut its dividend and is taking market share from lesser peers. In fact, at its current \$25 price the shares yield a tad under 7% - a dividend that by my analysis is sustainable short of a *massive* U.S. recession.

Philippine Long Distance was a disappointing stock. Fundamentally the company is performing very well. It's adding profitable wireless subscribers, and has trimmed its debt to practically zero, thus uses almost all its free cash flow to pay a dividend yielding 7% to 10% (varies annually). However, the Philippine economy experienced close to double-digit inflation in 1H08, thus the fear of devaluation in the Philippine Peso prompted major selling of Philippine stocks - including Philippine Long Distance Company. I remember back to 2006 / early 2007 when I got a lot of questions about investing overseas in "emerging markets." Well...this is the risk – run-away inflation and governments not intelligent or experienced enough to respond can be a real problem. Thus, in PHI's case, you can do the fundamental company research, but the macroeconomics can turn against you...quick! What's funny is I bought PHI in late 2007 thinking the U.S. economy was in real trouble, thus seeking a safe haven from pending U.S. boom & gloom. Given our portfolios ranged from -3% to +14.9% with predominately U.S. investments in 1H08, I literally should have "gone fishing" vs. fishing for growing foreign equities with large dividends. I guess that puts me at the dog track with a fishing pole.

General Electric's 26% march lower was not as bad as advertised, because we sold at about 6:31 AM for \$32.50 the morning it announced poor earnings (market opens at 6:30 AM on the West Coast). Our quarterly loss was about -11%. We bought GE at the same time we bought PHI and on the same premise – looking for non-U.S. exposed earnings with solid 2008 outlooks. GE's stock since our sale has tumbled to about \$27, and we've actually bought a tiny bit back. Despite its problems, GE's 4.5% dividend yield and valuation wipe-out provide the conservative investor a decent opportunity.

### Market Outlook – Opportunities & Risks

In preparation for writing this letter, I prepared by re-reading what I wrote one year ago in this section. It's interesting, because then I communicated a contrasting opinion detailing a bullish outlook for energy companies and a bearish outlook for financial firms. In hindsight, the energy sector has been the best performing group in the S&P 500 Index and the financial sector has been the worst. Part of our out-performance vs. the index is attributable to owning large positions in companies benefiting from higher energy prices such as Canadian Natural Resources, and owning very few financials.

I have two big-picture comments regarding my current outlook. One, the obvious bad news and something you all know is the price of oil in the \$125 to \$150 per barrel range is impeding profit margins for the majority of businesses. Because oil is affecting everything from consumer spending, business costs and inflation rates, I think the near-term fortunes of our stock market as well as most major foreign exchanges are tied to

oil prices and our long-term response. However, complicating matters is our Legislative Branch's pathetic response (none) to the fundamental supply vs. demand issue. Instead, Legislators first paraded "big oil" executives in to harass them, and then tried to blame speculators in order to make themselves look good to the average American voter (I watched both spectacles on C-SPAN...and yes, it's amazing I ever got a date). If only our elected representatives took oil supply vs. demand as seriously as they take steroids and Major League Baseball, we'd all feel more confident in our nation's future! The good news is regardless of the ding-bats in Washington, the free market is working, hinting to oil demand destruction in future years. U.S. consumers are voting their will by not purchasing gas-guzzling trucks and SUV's, and are demanding fuel-efficient vehicles – in a rare Zen-like moment, satisfying the ideals of both the global warming and trickle-down, free market capitalist crowds. It appears it will take auto companies years to offer mass-produced hybrid and electric vehicles, but the economic and free market will of the American people is a strong and efficient catalyst for change.

Two, the good news is there is ample amount of negative sentiment in the U.S. stock market. Business prices are more attractive today than in the past five years, often priced for 2008 free cash flow yields of 6% to 9%. The term "free cash flow yield" is easy to understand. For example, if you and I own the corner dry cleaning business, free cash flow refers to the cash we'd have left over after paying all expenses, including taxes, and investing enough capital to maintain our business. Therefore, if our dry cleaners generated a "6% free cash flow yield" in 2008, as owners of the business we receive a dividend equal to 6%. As of early July, there are some attractively priced common stocks with dividends that are safe barring economic collapse such as U.S. Bank (7%), Dow Chemical (5.25%), General Electric (4.5%), and Home Depot (4%). Please note the free cash flow yields on these businesses exceed the dividend yields, as each business is re-investing its free cash flow for growth purposes. When you compare these free cash flow yields of 6% to 9% vs. the current 3.9% yield on the 10-year U.S. Treasury note, investing in the stock market at today's prices, despite economic uncertainties, begins to look fairly attractive (the risk in stocks is free cash flow yields can decline, or inflation rates can spike). Further, I think if oil prices were to decline to around \$100 to \$110 per barrel, the S&P 500 Index would be good for a quick 10% to 15% rise.

In summary, the greatest investors – those with ice in their veins – will tell you it's best to buy stocks when it feels the worst. Things can definitely get worse if energy prices stay at recent highs, but I'm seeing some pretty good values today based on how much cash I expect the businesses to produce. If I were writing to a bunch of high school boys, I'd say buying stocks today is like going for that first kiss from the girl you can't get out of your mind. You're going to be nervous going in, but you might like what you end up with.

### Thank You

Thank you very much for your trust and support.

Sincerely,

Bryce Peterson  
President

Washington Street Investments, LLC

**Quote of the Quarter:** "They don't ring a bell at the bottom."

– Warren Buffett on knowing when the stock market has bottomed.

If they did, Warren Buffett would not exist, and I would not be in business. In fact, quoting the great General George Patton, I'd probably be shoveling "manure" in Louisiana.

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