The Long & Short of It

The first quarter of 2008 was extremely difficult for investors. Equities turned in the worst quarterly performance in over five years with the S&P 500 Index falling by 9.5%. Though painful, this is not as bad as the second and third quarters of 2002, when the S&P 500 Index dropped by 13.4% and 17.3%, respectively. At that time, stocks were declining from record high valuations reached during the dot-com bubble and by late 2002 were priced at some of the most attractive levels we have seen in our company-by-company research, which dates back to 1969. The drop in stock prices during the first quarter of 2008 reached levels nearly as attractive as those seen at the bottom in 2002. While we cannot even begin to predict the future, and we do not know whether a bottom in stocks has been reached, we do know that valuations are attractive and that the math today says stocks should be purchased and owned.

The drop in stocks, particularly in March, was broad based and indiscriminate, the type of drop that accompanies bear-market bottoms. It even had a failure/bailout story that often accompanies a turn in the market, i.e. Bear Stearns.

There will be a continued economic drag from the contraction in credit as financial institutions strengthen their balance sheets and tighten lending standards. However, most market bottoms accompanied by loose monetary policy and a large failure/bailout are followed by significant upside rallies. As usual, one can make an argument for the market going any direction at any time. Predicting the direction of the market is ephemeral at best. But, when the math shows a company to be attractively priced against its intrinsic value, it is evidence that should not be ignored. Again, where we go from here is anyone's guess, but based on valuations, we really like owning stocks at the beginning of the second quarter of 2008.

Contrarian Value Equity Composite Portfolio
Top 10 Holdings
as of 3-31-08

Company Name	Percent of Portfolio
ConocoPhillips Oil Company	5.8%
Intel Corporation	4.7
BB & T Corporation	4.0
Barrick Gold Corporation	4.0
American International Group, Inc.	3.4
Electronic Data Systems Corp.	3.1
Wal-Mart Stores, Inc.	3.0
Coca Cola Company	2.9
General Electric Company	2.9
Mattel, Inc.	2.8

For those who have been told that this is the worst banking and economic crisis since the Great Depression, they should consider some significant differences between then and now. Jim Grant recently pointed out in *Grant's Interest Rate Observer* what most have forgotten, or never knew, i.e. that nominal GDP in the United States dropped by 12.0% in 1930, by 16.1% in 1931, by 23.3% in 1932, and by 3.9% in 1933. The cumulative drop was almost

46% in the goods and services produced by our country. This shocking bit of history clearly has not been repeated in this cycle, thus far.

Deflationary times have come before, but not with such large amounts of leverage or comfort with leverage, so there is the potential for greater deflationary impact. Thankfully, the deflationary influences of this credit contraction are being met with accommodative (inflationary) policy responses instead of the restrictive ones that helped to cause and deepen the Great Depression. Still, our government has never been so willing to meet deflationary forces with so much accommodation. Any way you look at it, their ability to offset massive deflationary forces with massive inflationary policy in an attempt to keep them in balance is being tested at levels rarely, if ever, seen in U.S. history. Hopefully, having these tools and experience should go a long way towards averting a Great Depression type slow-down.

Contrarian Value Equity Composite Portfolio
Fundamentals
as of 3-31-08

	R&W Equity Composite	S&P 500
Number of holdings	36	500
Wtd. Avg. Mkt. Cap. ($B)	71.8	97.2
Price/Earnings Ratio	13.8	15.8
Price/Book Ratio	2.2	3.3
Price/Cash Flow	7.4	8.1
Dividend Yield	2.9%	2.1%
Return on Equity	16.9%	23.8%

While the debate will rage on about whether the inflationary and deflationary forces can be kept in balance, the predictable impact of dollar printing is being seen in the weaker dollar. As long as the dollar weakness remains contained, it should be a digestible evil. To the degree the dollar loses its status as the world's reserve currency, the pain will be greater. That pain can be softened somewhat through exposure to gold, gold mining stocks, or some other inflation hedge.

Over the long run, large companies that are worldwide leaders in their industries sustain significant value due to their ability to produce and deliver products around the world, that are paid for by any currency that has value. The average large-cap American company generates nearly 50% of its sales abroad and, at the right price, has a significant ability to create wealth for the prudent investor even in an inflationary environment.