STEPPING STONES MANAGEMENT, LLC

First Quarter 2008 Commentary

April 18, 2008

In its lead headline on March 26, The Wall Street Journal coined the term the "Lost Decade" describing the stock market of the last nine years where the S&P 500 has had a negative return. The only other examples of periods as long with negative returns were in the 1930s and 1970s. It made me think of a very famous Business Week cover from August 1978 stating "The Death of Equities". That was just before the great bull market that saw the Dow Jones Average go from 1,000 to 10,000. The 1930s also ended with a ten fold bull run from 100 to 1,000 on the Dow. You may see where I am going with this. Yes, I believe the next great bull market will see the Dow Jones Average climb to 100,000. That may sound crazy as we are sustaining what the greyest beards in finance are calling the worst financial crisis since the Great Depression. However, history can repeat itself and I think the fact that 100 million people in the world are entering the middle class every year justifies such a rise in a stock market index that represents the great multinational companies of the world which are serving all those new consumers. The prior ten fold increases were fueled by the growing American middle class in the post World War II era and the technology revolution in the post 1970s. Granted, it's difficult to see this forest through all the falling trees, of which Bear Stearns is the latest and biggest.

The Bear Stearns collapse was the story of the quarter that saw further turmoil in financial markets and devastation among financial stocks. Those financial stocks continued to decline as investors had no idea how long the seizure of the credit markets would continue and how much more dilutive capital these companies would have to raise. The Fed came to the rescue on St. Patrick's Day by making credit available to financial firms that didn't have access to the Fed before and by accepting mortgage backed securities as collateral for loans. This seems to have opened the market for mortgage backed securities that hadn't been functioning since last summer. It also alleviates some of the concerns about healthy companies being able to access credit. However, the St. Patrick's Day massacre saw Bear Stearns trade down to $2 per share (from a high of $170), Lehman Brothers trade down to $20 (from a high of $86) and Merrill Lynch trade down to $37 (from a high of $97). Since then, Bear has agreed to be bought out by JP Morgan at $10, Lehman raised $4 billion in an oversubscribed preferred stock offering and saw its stock rise to the mid $40s and Merrill Lynch's new CEO John Thane has reiterated several times that the company will not have to raise additional capital and its stock is back to the mid $40s. I don't want to say we are out of the woods yet but things seem much better today than just a month ago. Although at the end of the devastating quarter the average stock was more than 30% below its high.

I've written about the unfolding financial turmoil in prior quarterly letters and e-mails and don't want to get into too much in this letter of limited length but I would be happy to discuss it further with you at any time. If the crisis has come to and end (which we will only know for sure with the benefit of hindsight) we need to brace ourselves for the ripple effects that will be sure to follow. The Treasury Department has already made a proposal to reorganize the financial regulatory framework which has little chance of being implemented until we have a new occupant in the White House. I think the basic framework will be implemented eventually and it would in fact ease the regulatory burden on most financial firms who are already heavily regulated and would welcome some streamlining of the various agencies they report to. The mortgage industry is likely to face some increased regulation which may increase the effective costs of home purchases. The biggest threat to financial firms in my view is the capital structures that they will be forced to maintain by the investment community. If investors aren't willing to invest in firms that are leveraged 30 times (as many financials are) then what kind of earnings will these companies be able to produce? That question will make it difficult for these stocks to get back to their old highs but there is still a lot of room for them to run just to remove the panic discount. It's very important to the health of the overall economy to have a healthy financial sector. The analogy of 1990s Japan has been mentioned frequently but that country never saw the catharsis in their financial sector that ours has seen in just the last six months.

Although my bullish long term view is based on a strong world economy, our stock market will have trouble advancing as long as the US dollar is weakening (I have to eat some crow here after last quarter's letter made fun of Gisele Bundchen's dollar aversion). While the weak currency boosts our economy in the short term through increased exports, it will weaken it over time as foreign investment goes elsewhere. The world investment community has the impression that the Bush Administration really doesn't mind the weak dollar and won't do anything to strengthen it. Companies that rely on foreign investment are now finding it difficult to come by after a flurry of deals late last year when it looked like the currency had bottomed. Lack of investment inhibits our economy from reaching its growth potential, exemplified by weakening employment statistics, which inhibits the stock market from reaching new highs. Eventually however, our trading partners will begin to feel the pain of losing exports to the US and will pressure their central banks into easier monetary policies. We have seen such requests from European producers and politicians but so far the European Central Bank has resisted calls for easier money, basking in the glow of their strong currency despite the pain it is inflicting on the European economy. The hope now is that the economy will weaken enough in those countries to induce international investors to take advantage of good relative values in the US which could ignite a dollar rally that could feed on itself the way dollar weakness has over the past decade. I don't think it is coincidental that the stock market has had negative returns over a decade that the dollar has been weakening. The first quarter was no different as the broad S&P 500 index lost 9.92%, its worst quarterly loss since the third quarter of 2002 and its first back to back quarterly loss since that same period that marked the low of the post technology bubble bear market.

That financial turmoil has turned my stomach at least as much as yours and I can only say that these periods have historically been followed by the best bull markets in history. That may not provide much solace as you watch your portfolio lose value but we don't want to miss out on those potential gains after paying the price of this miserable decade. The consensus is that we are now in a recession which I'm not so sure about when I see the increased amount of government spending that may keep us from the technical definition of one. Regardless, the private economy seems to have ceased growing sometime between the end of last year and beginning of this year and I hope that the improvement we have seen in the credit markets brings the economy back to a growth trend. Even considering that slowdown, earnings are still at levels that suggest the stock market is extremely undervalued, confirmed by sentiment surveys that show historically high levels of bearishness. Amidst the poor market in the first quarter was a ray of light where, on three occasions, the declines stopped at about the level of Dow 11,700 which interestingly is the level that stood as the all time high from 2000 to 2006. That combined with the fact that bad news over the last couple of weeks has been met with a rising market suggests that the worst may be behind us, sellers are done, and buyers are beginning to reallocate some of the three trillion dollars in low yielding money market funds (an all time high) into stocks. The only guarantees in investing however are Treasury bonds which will currently get you 3.5% if you're willing to lock up your money for ten years. I still like the risk reward in stocks even though it's been a long time since we've seen any of that reward. I feel terribly about how your investments have done over this period and can only say that I am in the same boat and so is just about anyone who has invested in stocks this decade. I appreciate your perseverance through this difficult time and as always I thank you for your trust and thank you for your business.

Yours truly,

Daniel D. Hickey
STEPPING STONES MANAGEMENT, LLC
501 Madison Avenue, Suite 501
New York, NY 10022
direct: 646-723-6262
fax: 646-619-4804