STEPPING STONES MANAGEMENT, LLC

Second Quarter 2008 Commentary

July 23, 2008

Last quarter I teased you by saying that I would write about oil in this quarterly letter. Little did I know that it would in fact be the story of the quarter. I was actually hoping to write about how the decline in the price of oil is proving beneficial to the market. Unfortunately, the story is the endless run-up in that price and the reasons why. Most of the press is focusing on speculation in the market. The implication is that sophisticated financial players are manipulating the price for their own selfish gain; in fact many of the speculators take the form of pension funds and retail investors looking for exposure to one of the few assets showing price gains. The fact that you and I are now able to invest in the commodity by purchasing an ETF is attracting a huge amount of oil buying by people who will never take delivery of the oil. This, in addition to expanding demand in the developing world, has thrown off the supply demand equilibrium resulting in a shortage of oil and therefore higher prices. Also disrupting the balance are continued rebel attacks on Nigerian oil facilities and fears of an Israeli attack on Iran and the supply disruptions that that could cause.

The new equilibrium will result from lower demand and/or greater supply. We have already seen U.S. demand for oil decline in the face of higher prices and it is suspected that the Chinese are building up their own strategic petroleum reserve in front of the upcoming Olympics which should be relieved next month; it would be nice to also see supply increase. While the Saudis have pledged to increase their production, our politicians do not seem to want to increase U.S. production. Fortuitously, the Brazilians have discovered a huge oil field off of their coast which should help to establish a more favorable equilibrium in a few years when the field begins production. Anticipating this, maybe the greedy speculators will begin to place their bets on lower prices, thus driving the price of a barrel below its natural level like it has driven it above that level now. It would be a shame if legislation drove the speculators out of the market before that happened.

The oil price run-up that we are experiencing is not just a supply and demand equation. A big factor has been the decline in the value of the U.S. dollar which has made oil much more expensive in dollar terms than in Euro or Yen terms. I have written quite a bit about dollar weakness and will only add here that thankfully the dollar is off its lows, though certainly not rallying. Many people are pointing fingers at the Fed and its easy money policy as the culprit here. However I'm not so sure that the banking system that is now enjoying a positively sloped yield curve is lending that money to hedge funds buying oil futures. The easy money critics also do not address the anemic money supply growth which is inhibiting our economy from reaching its growth potential. The Fed critics also point to rising food prices as evidence of loose money and incipient inflation. However inflation is defined as a general rise in prices not a rise in certain prices. Inflationary periods have also been marked by increases in aggregate demand and increases in general spending levels which are counter to the cash hoarding we are currently seeing. While it is painful to fill up our cars and grocery carts, prices of housing and clothing and other consumer goods are actually dropping which is inconsistent with inflation. Therefore I don't see evidence of a return to a 1970s style of stagflation. It is a testament to the resiliency of the US economy that the recent financial storm has not put us into a recession although we may not be able to continue growing if oil continues its parabolic rise. We are already seeing strain on our manufacturing sector and an uptick in the unemployment rate which has been my greatest concern. It's pretty hard for an economy to be in a recession when employment is strong, but conversely, it is hard to avoid one when employment is shrinking. I think it is these employment statistics that has the stock market most concerned and the June numbers showing a modest decline in non-farm payrolls continued a troubling six month trend although the unemployment rate held steady at 5.5% which has never been considered a recessionary level. I think it will be difficult for the stock market to sustain a rally until we see some stabilization in the employment market and it will also be difficult for the financial sector to see any relief until that happens which would relieve the fears of corporate debt defaults. And you guessed it; I don't see these things occurring absent a correction in the price of oil.

The stock market has now entered an official bear market as both the Dow Jones Industrial Average and the S&P 500 have dropped more than 20% from their recent highs of last October. The weakness has spread from just the troubled financial companies into those operating in manufacturing, transportation, and consumer cyclical industries. Oil seems to be the culprit. Furthermore, housing has yet to show a bounce and health care related industries are facing the political uncertainties that usually present themselves in an election year. Consumer staple companies are hurting from the price pressures that they are finding difficult to pass on to their customers and telecommunications companies aren't finding many new buyers for their latest technologies. The winners of the quarter were led by energy companies and utilities that are able to pass along price increases. Materials companies also enjoyed higher prices for their products and their stocks, and technology companies saw good demand for their productivity enhancing products. For the quarter the Dow declined 7.4% while the S&P 500 managed to keep its decline to just over 3% and the NASDAQ actually rose a meager 0.6%. Breaking out results between growth and value saw the former rise 1.21% and the latter fall 5.82% as represented by the respective Russell indices.

Unfortunately our portfolios were most impacted by American Capital (they dropped "Strategies" from their name) which was hit with two headwinds, the aversion to financial stocks and the aversion to dividend payers. The company announced non cash writedowns on its debt portfolio of close to a billion dollars but reiterated its view that those lower valuations will not be realized as the company would not exit the positions at such prices. This goes to the heart of the financial crisis which is more an accounting issue than a cash flow one. Yes, there has been an uptick in residential mortgage defaults but most of the financial writedowns we have seen over the past year are not a result of such defaults, rather they are a result of the extremely complex accounting standards that force companies to adjust the value of their assets to some formula which may or may not be relevant to their true value. In the old days, gains and losses were not accounted for until they were realized. The standards were changed in the quest for greater transparency but the opposite has resulted. Now thinly traded assets are marked against a model distorted through derivative securities which throws off all the valuations that have to be marked against it. This has resulted not only in massive non cash writedowns across our financial sector but also huge job losses at financial firms and at companies that can't get the financing that they need because the financial companies are constrained from making loans. The latest leg down came when bond insurers such as Ambac Financial and MBIA had their credit ratings downgraded from AAA. Now any financial firms that hold any debt backed by such insurance have to mark down the value of those securities from an AAA valuation to one barely above investment grade. This is despite the terrible credibility problem that the rating agencies have; however that's how the rules are written. It has resulted in American Capital trading down to where it now has the highest yield in the S&P 500 at 18% and the dividend has been reaffirmed since the asset writedown. Furthermore, the company is not leveraged like other financial firms who are dealing with insolvency rumors, their debt to equity ratio is less than one, compared to the 30 times leverage at many other financial firms. Merrill Lynch is one of those leveraged financial firms and it too was hit again in the quarter due to expected writedowns resulting from the downgrades of the bond insurers. I can't think of many more items on their balance sheet that could face writedowns but this story just doesn't go away. The positive story on Merrill Lynch is their large private client group and the recurring revenues that it generates. Across the financial sector, we are seeing companies trade at price to book ratios and price to earnings ratios and dividend yields that have only been seen at extreme times like the early nineties and the mid seventies which both turned out to be incredible buying opportunities. This has been my rationale to hold onto these stocks throughout this storm which has admittedly been far worse than my expectations. Another weak name in the quarter was General Electric which isn't considered a financial firm but does have a large financial component. Maybe its weakness is related to its financial arm or maybe it's because it is a dividend payer or maybe it is because recent results have been lackluster. Whatever the reason, I don't want to part with such a fine company at such a low valuation. Despite the losses, I think the best strategy is to keep the hurricane door bolted shut and wait for the storm to pass, which it will.

We are living through very difficult times in the financial markets and I can't say how much longer it will last. I can say that these periods always have led to better times and when we look at the underlying strength of the US economy and world economy, I am reassured to see the growing middle class throughout the world who are hungry for the same things that drove the great US bull market of the post World War II era. Although it is painful to see our savings shrink, we haven't seen the economy shrink and the market is still not too far from its all time highs despite these terrible headwinds. I want to again reiterate that the financial losses we have seen have been accounting losses and not cash flow losses; that is what makes it so difficult to gauge because companies have a certain amount of flexibility in how they value their thinly traded assets. If it turns out that their writedowns were excessive then we will see strong earnings gains in the periods following the storm.

To end on a happy note, I would like to announce the birth of my second son, Brian, who arrived to his excited family on July 13. The best news is that he is healthy. His Mom is feeling fine after the delivery and his older brother is now feeling like a big kid. Daddy wants him to sleep less during the day and more at night. Having a healthy and growing family is truly a blessing, as is having a loyal clientele. Let's hope for some blessings in this and upcoming quarters and an end to the financial storm that has entered its second year. Until next quarter, 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