STEPPING STONES MANAGEMENT, LLC

Fourth Quarter 2008 Commentary

January 15, 2009

In decades to come we will be regaling youngsters with stories about the great crash of 2008. When our parents and grandparents told us such stories about the last time the financial markets were this bad those stories were more about the Great Depression than the Great Crash of 1929 which preceded it. Now the prevailing question is what will follow this crash? Reading John Kenneth Galbraith's "The Great Crash", considered an authoritative history of that earlier market disturbance, I have seen many corollaries to recent times. In the late 1920s the investment trusts had a huge influence in the market, similar to the hedge funds of our times. Additionally, the banking system became strained due to the excessive loans made to those trusts, similar to the losses that banks have sustained at the hands of their current hedge fund clients. The stock market didn't just crash on October 29, 1929; it had been going down steadily for weeks, similar to the weeks prior to the recent low on October 10. It then continued lower for a few more weeks, such as ours continued down until November 21. As these declines were decimating investors, financial and political leaders were assuring the public that prices were not acting rationally and the fundamentals of the economy were sound. The market even got a savior when John D. Rockefeller announced that he and his son were buying stocks after the worst day, October 29. The market lost another 25% in the next two weeks. Our corollary would be Warren Buffet buying stakes in Goldman Sachs and General Electric and writing his bullish New York Times op-ed on October 16; those stocks went on to lose another 25% by November's low. These similarities rattle our nerves but there are stark differences between these two times as well.

One difference is that the 1929 crash followed a speculative bubble in stock prices which we haven't seen in modern times except for the 1990's tech stock bubble. The problems with the banking system today stem from a real estate bubble, not a stock market one. If the 1990s tech bubble didn't result in a depression maybe the bursting real estate bubble won't either. The Federal Reserve has pulled out all the stops, so if we do go into a prolonged recession it won't be because of tight monetary policy like we saw in the 1930s. Also, the Great Depression was an economic contraction of an agricultural based economy in the face of a multiyear drought.

Remember reading about the Dust Bowl years? What could cause a similar contraction of today's service based economy? We don't know but there are reasons for concern. Consumer spending has hit a wall as those with jobs fear they might join their friends on the unemployment line. My biggest concern is that the policy prescriptions we are hearing from Washington are for a huge fiscal stimulus, some even calling it a new New Deal. I think these people need to examine the effectiveness of the original New Deal which did not revive the economy. If it did, we wouldn't speak of the Great Depression which lasted until we got into World War II. We must keep in mind that every dollar spent by the government must come from the private sector either through higher taxes, higher borrowing, or an increase in monetary creation which devalues our currency and results in inflation. If higher government spending makes for a stronger economy we wouldn't fear another depression after the last 8 years of heightened government spending. We enacted two fiscal stimulus bills in the last 8 years that both failed to revive a struggling economy (2001 and 2008). In fact, I don't know of any fiscal stimulus plan that has revived the economy which usually comes out of recession when the government takes less money from it in the form of taxes or borrowing. The incoming Obama Administration has sent signals that some of their stimulus package should include such tax cuts so there is reason for hope. His economic advisor said during the campaign that their economic plan would keep government's share of the economy at around 18.5%. If that is the case then I would predict that President Obama's plan will be successful. That number would be difficult to achieve however with the numbers being discussed for the stimulus bill.

So here we are in a state of waiting. Waiting on the new Administration and the policies it implements, waiting to see how bad the economy gets before it gets better, and of course waiting on what the stock market does. Any prediction I make would come out of thin air, so I won't bother. As I've written over the past year, the key to the economy is employment which has been nasty of late and will continue to be an important indicator that I will be watching. Also important are housing prices which have not yet stabilized. There were some signs of stability in the 4^{th} quarter but home purchases seem to have been put off as government mortgage programs have been discussed. Why buy a house now with a 5% mortgage if the government is going to be offering 4% mortgages in the spring? This is but one example of how government programs designed to stabilize the economy can do otherwise. As we wait for answers to these questions our portfolios are holding higher than usual cash balances. The risk of this stance is that we miss out on a rising market which we offset by purchasing an ETF that tracks the S&P 500 by a factor of two. This is not a long term hold due to the leverage risk and we sold it as the market has come down again it before sustaining further losses. We will now assess the investment landscape in light of the policies coming out of Washington and allocate accordingly.

A strategy we have been using more often as an alternative to outside managers is employing Exchange Traded Funds with various characteristics to provide the desired market exposure in our portfolios. Using managers with research staffs is a way to reduce company risk without giving up market exposure and I have found that ETFs can provide similar benefits. Early in the quarter, I had prepared a sell list in the event that the market broke below some key support levels. Both identified levels were breached and we sold many holdings accordingly. On the last breach, the closing low below the 2002 low on November 20 provided the sell trigger on November 21. Later that day, Barak Obama named Timothy Geithner as his Treasury Secretary and the market rallied. Not wanting to be out of the market on the potential rally back we deployed much of the proceeds from the November 21 sales into the leveraged ETF I mentioned above. While we enjoyed gains in that vehicle at year end, the quarter was still impacted by the downturn into November 21 and especially our position in American Capital. The company saw its stock decimated when it suspended its dividend in order to conserve cash. This was necessary since mark to market accounting rules forced the company to write down assets even though they were performing well. When the story of this financial crisis is written there will be a lengthy discussion of these perverse rules which even the regulators acknowledge are "pro-cyclical". Cyclicality is the last thing we should have in accounting rules as it creates downward spirals like we have witnessed with no regard to individual security quality. This issue is too big to go into in this letter but I am available to discuss it with you at length on the phone. The bottom line is that it forces good assets to be sold at fire sale prices and the selling begets more selling. Rather than be forced to sell the assets it holds that are performing well, American Capital chose to offset the capital depletion from lower marks by conserving cash rather than paying it out. Unfortunately, many of their shareholders owned the stock for its dividend and they sold when that dividend was suspended. I chose not to sell as the company stated its book value was in the mid $20s even after the marks and the stock was trading below $10 at that point. It got as low as $2.77 at year end before beginning to rebound so far this year. I expect the company will reinstitute the dividend sometime this year as they are required to pay out most of their earnings being a business development company. Another alternative for them could be a buyout of the company. Whatever comes of it, I have had confidence in management for the 10 years we have owned the stock and I believe their valuations of their portfolio are realistic. Eventually there will be a correction of the distortions that have emerged in this historic crash and I think American Capital is one of the bigger ones.

The crash of 2008 has been an incredibly painful experience which causes great anxiety for the coming months and years. Most people associate the Great Depression with the Crash of 1929 and thus expect a repeat in the decade to come, I do not. However I do have great anxiety about what awaits us largely as a result of government policies to come. Our political leaders have not shown much grasp of the modern financial system (nor have our financial leaders for that matter) and I fear remedies that worsen the disease. That being said, ours is a dynamic economy where entrepreneurs are constantly developing solutions to everyday needs. Maybe fewer of those solutions will be able to come to market in the future but I am confident that the best will and the economy's natural tendency to grow will be realized. Despite my view of government in general, the Obama Administration will be composed of experienced professionals who are certainly smart enough to recognize lessons of this historic calamity. Combining that with the lessons of the 1930s there is no reason to expect a repeat. There is however every reason to expect unintended consequences of policies that are implemented to address this crisis. One consequence that will be difficult to avoid is a resurgence of inflation when the increased money supply meets an increase in economic activity. The Fed assures us that they will be quick to remove the liquidity from the system but that is always easier said than done. A recent lesson is the increased liquidity that was provided after the September 11 attacks that wasn't removed until 2005 despite the economy coming back to health in 2003. Most people didn't recognize the healthy economy in 2003 and by 2005 inflation picked up beyond the Fed's comfort zone. I am not trying to be bullish or bearish, I just want to be positioned correctly which obviously was not the case in 2008. For the reasons expressed above, among others, I think the odds favor a stronger market over a weaker one and I plan on positioning portfolios for that but in a nimble enough way so that we can reverse course quickly if facts prove otherwise.

I'm getting tired of thanking you for your perseverance but I can't express enough how much I appreciate it. I never get tired however of thanking you for your trust and thanking 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