MARKET PERSPECTIVES

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The equity markets lost ground again during the third quarter as fears of economic recession gave way to a potential deflationary spiral, as a result of a destabilized financial sector and growing concerns about a potential credit collapse. During the third quarter our portfolios performed in line with most of the broad market declines, as investors found no safe havens in any financial instrument except cash.

A Long-awaited Global Response Relieves World Markets

At the close of the third quarter, U.S. bond and equity market selling showed no signs of abating, despite the already steep decline in stock and bond prices experienced in the prior quarters since the fall of 2007. The global markets accelerated their downward pace in September as well, once the collateral damage of the U.S. banking crisis bled into the world's major central banking system. Just as the panic selling appeared to reach a climax, not too dissimilar to the bottom experienced in the 1974 bear market, on October 10th the central bankers of the G7 nations announced a dramatic action of a coordinated rate cut and partial nationalization of the banking system. Despite the central European banks tendency, in the post war periods to fear inflation rather than deflation, this long awaited response reassured financial markets that global policy makers have finally taken decisive steps toward repairing the rapidly deteriorating banking system abroad and consistent with U.S. policy initiatives. This policy reversal appears to be the cooperative action that U.S. investors required to insure confidence and defer portfolio liquidations that has persisted unabated all year. However, the global response has been more tempered as markets outside the U.S. continued to operate under a negative cloud into the month of October with credit spreads widening and debt markets remaining clogged against a rising U.S. dollar.

During the third quarter, amid growing fears that the world economies were embarking on a protracted recession, investors continued to demonstrate little patience indiscriminately selling long duration investments. Despite any positive news associated with current fundamental earnings reports, the "risk premium" to hold stocks soared as a result of investor fear. History shows us that investments made in times of greatest distress offer the most rewarding periods to build wealth for the long term.

An Optimistic Perspective on Today's Financial Markets

In retrospect, it appears that the U.S. authorities' decision to allow Lehman Brothers to collapse was a grave mistake. As we are acutely aware, the decision profoundly shook confidence in the U.S. banking system, leading to the complete shut down of the interbank market. We would also add that allowing Fannie and Freddie Mac's preferred share prices to collapse, effectively wiping out large portions of tier one capital for many financial institutions, was yet another policy blunder. Consistent with a historical framework, we know that trust in the entire banking system can easily be broken by one or two bank failures, which inevitably lead to the immediate cessation of credit flows. Not dissimilar to the experiences of the 1930's, a major interruption of credit flow can potentially have devastating consequences.

It is unfortunate that our banking system has operated under the basic premise that these institutions are "too big to fail" and ultimately protected by government at times of financial crises. John Kenneth Galbraith, author of over 30 titles spanning five decades on economic policy issues that critiqued matters between the public and private sector policies, warned us about the continuing divergence between approved belief characterized as "conventional wisdom" and what he termed "reality". In one of his last published essays in 2004 "The Economics of Innocent Fraud", Galbraith identifies that the economic and political system in the United States cultivates its own versions of the truth with no necessary relation to reality. He concluded that in large part that which we all refer to as the ever expanding public sector is in "all practical effect in the private sector". Despite recognizing this problem that Galbraith describes, we are still faced with the dilemma of encouraging free competition in the banking system while at the same time protecting the public interest in the face of a confidence crisis. Our cautiously optimistic stance is bolstered by the fact that mark-to-market accounting rules although severe have shortened the corrective phase of this cycle. We are further encouraged by the fact that since we now understand the problems, we are closer to arriving at appropriate solutions. We would expect the end result will ultimately be an implementation of an appropriate regulatory response that promotes sounder risk management practices as well as shifting the role of the Federal Reserve Board away from the necessary monetary responses of a post-bubble clean up towards a preemptive regulatory oversight.

Positioning LCV Equity Portfolios for Long Term Growth

The world economies have now joined the U.S. commencing a period of subdued economic growth and potentially intense deflationary pressures. We would anticipate the Bureau of Economic Analysis to officially declare that we are in recession (two consecutive negative quarters of Gross Domestic Production) and that we expect this condition will persist into next year. If history is any proxy for the future, we would expect that equity prices should begin anticipating the recovery perhaps as early as the first or second quarter of 2009.

We remain steadfast in our belief that stepping out of the market can have severe consequences to long term investment programs. We are reminded of countless examples such as the deflating technology bubble, the demise of Drexel Burnham Lambert's failure after the implosion of the junk bond market, Texas and New England bank failures and the savings and loan debacle in the late 80's. All of these examples saw significant advances in stock prices in subsequent years rewarding investors handsomely that stayed the course during the market turmoil.

As we enter a period of global reflation, we believe that oil markets will continue under pressure. As long as global growth stays sluggish, policy reflation efforts will most likely be aimed at stabilizing banks and reviving growth overtime. Usually a dramatic fall in interest rates benefits banks and financials first and over time the stimulative monetary impact is transferred to the broader economy. Although banks are still in crisis mode, the beaten down share prices will ultimately reward investors who can focus their sights on the longer term and emphasize the better capitalized companies in the sector. A sharp fall in interest rates in the U.S. has already begun lifting bank shares relative to the benchmarks, a trend that may take hold for the next several quarters before broadening out into the other economic sectors.

Expecting a fourth quarter rally, we have refocused our efforts on the profit outlook of our investment holdings with a heightened sensitivity to our non-financial profit exposure as we enter a global recessionary period. Assuming that October 10th marked the bottom in equity prices for the broad market, the current drop was far more severe than the average peak-to-trough declines experienced in past crises, according to Ned Davis Research. The correction in the non-financial stocks has been more severe in the current cycle than in other banking crises as our moderate decoupling theory was held hostage by the fact that the U.S. consumer is still considered an important engine of growth for the world economies. On a positive note, the U.S. non-financial sectors' weak equity performance in the third quarter has likely discounted a deeper recession than in past global housing busts.

<u>We are Optimistic about the Financial Markets and anticipate a U.S. Economic Recovery by the second half of 2009.</u>

We are encouraged by recent declining oil prices and continued Federal Reserve monetary easing. The financial markets appear to have begun a rebuilding process, with the Fed funds rate now substantially below nominal GDP growth. We have refocused our efforts on companies that display positive free cash flow, healthy balance sheets and supportive fundamentals in a difficult operating environment. As we have reiterated in past quarterly letters, the severity of the U.S. economic slow down, turmoil in the credit markets, and potential deflationary worries, geopolitical headwinds and market volatility have all added to the bear market sentiment and substantially diminished investor enthusiasm for equities. As you might expect, periods of heightened investor anxiety are often optimum times to accumulate shares in superior companies at historically depressed prices.

During these stressful times, we want to assure our investors that we continue to review investment holdings erring on the side of conservatism, as a keystone to our investment philosophy and process. As we attempt to remain calm and steady in these turbulent markets, and distill the noise, we remember the words that Warren Buffet recently spoke on CNBC: "I do know that the American economy, over a period of time, will do very well, and people who own a piece of it will do well." We appreciate the confidence and trust that our clients have demonstrated through these most challenging times. We remain committed to providing a prudent investment discipline and a long term outlook, so that they can rely on us to help navigate this current environment and yield the best results over time.