ALTMAN INVESTMENT MANAGEMENT

MARKET PERSPECTIVES — JANUARY, 2009

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VALUE INVESTING – PRINCIPLES & TECHNIQUES IN THE "POST-BUBBLE" PERIOD

General Observations:

Over the past year we couldn't help but notice that many of our clients, although concerned about the current financial market conditions, have demonstrated a sense that we have "seen this before". Although it is true that the hedge fund community has been the hardest hit according to Hedge Fund Research, 920 of the 10,096 hedge funds have closed shop in the past year, this group tends to reflect the younger generation that seems to be the most pessimistic. Perhaps this market niche is the most terrified because the generation before them appears complacent with respect to the future. On many levels the current problems are not insurmountable. The median home price of $200,000 the government could buy 2.5 million houses for $500 billion and either rent them or take them off the market. That's no doubt a hefty sum, but less dramatic now that we have moved into the Trillions in terms of the Federal deficit. Fixing the housing supply problem is key to the recovery, in our view. Regardless of how low mortgage rates go, if one doesn't have the ability to sell their current home it is difficult to afford the down payment to move. Despite all the distractions concerning various methodologies employed to inject capital into the banking system, foreclosure relief, and executive compensation, we have been sidetracked from the original plan for TARP which was intended for - - buying bad assets. What we really need is a stimulus package for 2009 and an investment package for 2010. Infrastructure spending can help the economy but not immediately. In this cycle we are relying on the government to keep productivity growing. Despite the plunge in GDP, fourth quarter productivity reached an acceptable 3%. Since the government is actively preventing financial failure, we believe that we are presently in a reflationary process that presents us with a more bullish stance on the markets.

The Economic Outlook – Early Signs of a Silver Lining

- The economic statistics for the November-December period suggest that the momentum of the economy continues to decline. The consensus outlook among economists was that fourth quarter real GDP would decline by about 5- 6%, overly pessimistic as the real GDP report showed a decline of 3.8%. Little or no improvement is expected for the 1st quarter of 2009. Overall the majority of economists believe that the U.S. economy will decline 2% in 2009, with a possible recovery in 2010. We are somewhat more optimistic but recognize that the near term picture remains bleak. Negative November statistics based on year-over-year figures continue to decline in construction spending, durable goods orders, loss of jobs, and leading indicators. Additionally, industrial manufacturing and services remain at recessionary levels.

- There's no shortage of economic data to indicate that more needs to be done. Payroll employment in the U.S. continued to fall dramatically in January, down -598,000 m/m, hours worked showed a -0.7% m/m decline, and the employment diffusion index hit a new low as the job losses were broad-based. Despite the drop in the labor force, the unemployment rate continued to surge to 7.6%. In addition, industrial production declines of 7.8% and consumer confidence at new lows are all aggravated by the housing data that suggest a recovery will not occur until 2010. The National Bureau of Economic Research has stated that the economy has been in recession since December 2007.

- Although it is more difficult to find a silver lining in these numbers for the economy, from a political perspective at least there's a good amount of positive news that Congress is moving forward on a bad-bank/asset-guarantee plan, a housing bill, and further stimulus, almost irregardless of the cost. This helps explain why the 10 year Treasury yields are up to 3%. While the Bank of England continued to lower interest rates last week to 1%, the ECB held rates steady at 2%. The OECD leading indicators, however, suggest that more needs to be done globally to stimulate the economy, as the indices continued to plunge in synchronized fashion in December. Glimmers of hope have come recently from the China PMI, as well as the Baltic freight index (up to 1642), and China stocks. However, U.S. unemployment claims continue to rise +35,000 to 626,000 last week, showing a labor market that continues to deteriorate.

- Despite the negative news that U.S. auto sales fell again to a truly awful level of 9.6 million SAAR in January, as well as chain-store sales and construction spending were negative, not all the economic news continued to deteriorate rapidly. The U.S. manufacturing PMI ticked up slightly to 35.6% in January and the PMI moved up to 43%. Additionally, ABC's weekly measure of consumer confidence improved slightly to -52 from -54, though that's still very weak. Pending home sales were also up +6.3% month over month in December. With the Fed's Senior Loan Officer Survey showing that banks are still tightening mortgage lending standards in 1Q, but not at the same pace as previously, there's some tentative evidence that the credit markets are thawing, at least some. However, lending still remains impaired in other areas, including commercial real estate and consumer credit cards.

- There are a few positive statistics worth mentioning as well that include the fall in inflation, as measured by the producer price index (PPP), of 0.9%, which compares to an increase of 6.2% in 2007. The consumer price index (CPI) grew by only 0.1% with the core rate (ex food and energy) up 1.8%. In 2007 the CPI increased 4.1%. The fall in gasoline prices of 43% in 2008 gave the consumer a tax cut equivalent of $200 billion. Because of the fall in inflation, real hourly earnings grew at 4.5% in December versus year-ago levels. The personal savings rate measured as a percentage of disposable income was at 2.8% in November which is moving in the right direction after zero rates in late 2008. We would assume that over time U.S. consumers will be forced to save more absent the asset appreciation in equities and houses. The latter should begin to improve once the economy is put back on a growth path.

- Finally, the U.S. dollar has been rising as the trade deficit has improved. In November the trade deficit was $40.4 billion versus $56.7 billion in October. For the twelve-month period ending in November the trade deficit is $833 billion. Unfortunately, international trade is declining at a rate of approximately 7% because of the global recession and it is impacting foreign economies, such as China and Germany which depend heavily on exports. China's 4th quarter real GDP grew at 6.8% versus 9% in the 3rd quarter. In 2008, China's economy grew at a rate of 9% versus a revised 13% in 2007.

- Looking ahead, many countries have announced stimulus plans with the U.S. at $825 billion and China at $586 billion. The U.S. plan includes $275 billion in tax cuts for middle and lower income individuals as well as for small businesses. Additionally, banking bailout plans are being accelerated, particularly in the United Kingdom and the U.S. These plans amount to partial nationalization of the most troubled banks. In addition, the Federal Reserve has expanded its balance sheet to $2.2 trillion, and announced an expansion of its quantitative easing policy so that a wide range of assets will be purchased in order to maintain adequate monetary flows in different asset classes. The rate of interest on federal funds has also been lowered to a range of zero to 0.25%. While criticized by many, these policies are essential at a time when deflationary risks are growing. For 2008 the fiscal deficit will approach $1.5 trillion and there remains a growing concern that we no longer have the ability to finance it. In recent months however, there has been some improvement in the corporate and municipal bond markets as well as in commercial paper issuance.

- While in a distinct minority, we believe that given quick action by the new administration an economic turn-around is still possible by the end of 2009. As a result, we are still forecasting 1% real growth in 2009 with corporate profits gaining 5% (as measured in the national income accounts) and CPI inflation of 2%.

An Optimistic Perspective on the Financial Markets

Equities have declined over recent weeks and successfully tested their lows of November 20th, against a background of renewed worries over the capital strength of the banking sector, and significant 4th quarter earnings declines at many companies. Investors continue to be concerned about the length and magnitude of the current recession. The recurrent corruption scandals on Wall Street have taken their toll on consumer confidence levels as well. At present, the S&P 500 Stock Index (826) has fallen 8.4% over the past four weeks and is down 38.6% from year-ago levels. Foreign stocks, as measured by the MSCI EAFE Index (1115), have fallen 9.82% over the past month and are down 43.5% over the past year. Similar fears of recession plus a stronger dollar have penalized foreign securities as well. However, in terms of valuation, the S&P still sells at attractive levels of 11.8 times and 13.0 times the consensus earnings of Thomson First Call analysts of $69.19 per share and $63.01 per share for 2008 and 2009 respectively. These earnings estimates reflect declines of 19% and 8.1% for 2008 and 2009.

The current yield on the S&P is 3.4%. While there has been modest deterioration in Treasury bond prices recently, the rush to safety has made them the investment of choice over the past year. At present, 3-month Treasury bills yield 0.24% versus 0.03% a month ago and 2.3% a year ago. The 10-year Treasury bond yields 2.72% compared to 2.37% a month ago and 3.52% a year ago. In sharp contrast, corporate and municipal bonds yield significantly more than year-ago levels. Currently, high quality long term corporate bonds yield 6.44% versus 6.35% a month ago and 4.12% a year ago. Municipal bonds yield 5.28% compared to 5.56% a month ago and 4.12% a year ago. The risk in buying Treasury bonds at present would be the concern over financing a possible deficit of $1.5 trillion when interest rates on Treasury securities are at 50 year lows. High quality corporate and municipal bonds appear relatively more attractive based on yields and the belief that the economy will improve by the latter half of the year. There has been modest improvement in commodity prices in recent weeks. The CRB index of commodities (318) is up 1.01 % from levels a month ago and down 25.4% a year ago. Oil ($41 per barrel) has risen 2.1% and the Baltic Dry Index (900), a measure of bulk raw material shipping rates, has increased 10% over the past month. It is currently 86% below year-ago levels. The slight increase in Treasury yields and the modest commodity price increases could be early signs of a shift in the economic winds.

Positioning Equity Portfolios for Long Term Growth

We are not endorsing a consumer defensive hedging strategy to offset portfolio risk at this juncture. The market appetite for risk shifting more defensively in the last months of the year was more coincident with forecasts that the U.S. economy will continue in decline at an even faster pace than we are experiencing in the first and second quarter of 2009. This has encouraged analysts to drop estimates for 2008 more than current expectations of 20%. The primary reason we resisted rotating portfolios defensively, reacting to the abrupt changes in the economic landscape, is driven primarily by the realities that the average consumer defensive stock valuation already has more than discounted the fundamental deterioration of overall corporate profits. Consumer staple companies are now far too expensive in both relative and absolute terms against their cyclical counterparts in the market place. These premiums have existed for quite some time as investors bid up the consumer staples anticipating a below trend line U.S. growth rate. Our best explanation for this aberration was a growing concern among investors as early as 2006 that the U.S. capital spending cycle had matured, bolstered by the backdrop of stretched U.S. consumer balance sheets.

As early as 2005, we recognized that the real-estate bubble had driven financial institution profitability to unsustainable levels, and encouraged our investors to deemphasize the Large Cap Russell 1000 Value Index as the only style performance benchmark due to its heavy exposure to credit and banking exposure. We added the Standard and Poor's 500 Citigroup Value Index which represented a better proxy for our style bias with substantially lower credit exposure.

We made the case for our strategic shift sighting Steven Roach's, the chief economist at Morgan Stanley, conclusions that, in the aftermath of the post technology bubble experience, Federal Reserve policy was far too accommodative in the early half of the decade and resulted in a massive credit speculation. The imminent impact on a slowing global growth assumption encouraged investors as early as 2006 to begin migrating portfolios towards U.S. domestic companies that depended more heavily on the U.S. consumer and away from traditional cyclical beneficiaries that were poised to benefit from higher global growth outside the U.S. These multinational corporations appeared to be decoupling from the U.S. economic experience as their profits and resulting share prices continued to out strip their domestic counterparts. In retrospect, the Dow Jones Industrials Average plowed ahead of the Standard and Poor's 500 Index for the first time in over three decades.

Although we dropped the sector allocation from the 2006-7 weighting, we continue to validate this international approach despite the possibility of a global recession, because we believe these companies have far better balance sheets and flexible business approaches that create a more diversified and sustainable business model. Since the current economic environment is anything but classical, traditional rotational strategies made by investors may not work in this instance. Without the government assistance allowing markets to clear, housing and retail would have probably done worse than their already abysmal performance. This government aid gives us less confidence that the typical early-cyclical shift will "work" when the turn does come.

In contrast with the early-cyclical argument for 2009, we expect that commodities could still have a very strong if not resurgent bull market, stocks may resume their sideways pattern after moving higher from the November lows, and Treasuries could sell off as market participants finally move from the sidelines.

In Summary …

We stand resolute in our belief that if history remains a proxy for the future, investments made in times of greatest distress offer the most rewarding periods to build wealth for the long term. We believe equity prices will begin anticipating the recovery as early as the first or second quarter of 2009. We remain steadfast in our belief that stepping out of the market at this time 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 more recent periods of financial "setbacks" were followed by significant advances in stock prices in subsequent years, rewarding investors handsomely that stayed the course during the market turmoil.

During these stressful markets, we want to again assure you that we will continue to view your equity holdings as long term conservative investments, and that these companies will be able to navigate through the current adversity and meet these challenges. This is the keystone to our investment philosophy and process. We are encouraged that most of our investors have remained calm and steadfast during this turbulent period, demonstrating the confidence that despite our current setbacks they are fixable and that American enterprise will prevail. We humbly appreciate the confidence and trust that you have demonstrated through these most challenging times and we remain committed to continuing to provide you with our prudent investment discipline that focuses our outlook on the longer term.

ALTMAN INVESTMENT MANAGEMENT, LLC